IRS Issues Favorable Final Section 382 Regulations on Small Shareholders; Might be Time to Revisit Your 382 Study

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The Treasury and IRS issued Final Treasury Regulations to address the treatment of small shareholders under Section 382 on October 21, 2013.¹ These regulations address a number of concerns expressed over the years about the administrative burden and sometimes inequitable treatment the segregation rules can cause in certain taxpayer situations. Importantly, these regulations can have a positive effect on ownershifts not just for future testing dates, but in the current testing period. This may provide loss companies with significant opportunities, and these companies should review their recent studies to consider the application of the new rules.

BACKGROUND

Section 382 generally requires a corporation to limit the amount of its income in future years that can be offset by historic losses (NOLs) once that corporation has undergone an “ownership change.” An important factor in determining whether or not an ownership change has occurred, and therefore whether or not a limitation is required, is determining the changes in the equity holdings of a corporation’s 5-percent shareholders during the testing period.² A 5-percent shareholder, for purposes of Section 382, includes individuals, entities, and “public groups.” A public group is generally a 5-percent shareholder that is comprised of equity owners of the loss corporation that are not themselves 5-percent shareholders and have not acquired their shares of a loss corporation in a coordinated acquisition.³ Section 382 generally requires that any equity event between the corporation and its...
equity holders, including public groups, is tracked and accounted for in determining whether or not an ownership change occurs.

The segregation rules of Section 382 and the accompanying Treasury regulations generally treat certain transactions as if a new public group, separate from any pre-existing public groups, acquired the stock. In effect, the Section 382 rules presume that persons representing a completely new set of investors purchase such shares.4 Thus, this set of investors will generally constitute a new public group and is treated as a 5-percent shareholder separate from other 5-percent shareholders or previously identified public groups that are treated as 5-percent shareholders.

**Final Regulations**

Because so many of the segregation events constitute transactions that involve less-than-5-percent shareholders, practitioners argued that modifications could be undertaken to ignore certain changes in equity of the loss corporation while preserving the policy goals of tracking ownershifts for purposes of calculating whether or not an ownership change occurred on any given equity event. The IRS acknowledged practitioner concerns and invited public comments on how to further modify the segregation rules in Notice 2010-49 (June 11, 2010) recognizing a few areas of the segregation rules that could be modified. The IRS and Treasury issued proposed regulations November 22, 2011 providing a proposed set of rules and examples in applying the new segregation rules.5

After receiving various comment letters on the proposed regulations, the Treasury and IRS issued the final regulations providing new exemptions to the segregation rules under Treas. Reg. Sections 1.382-3(j)(13)-(17). The final regulations follow the structure of the proposed regulations with a few important changes. Below are some of the highlights of the final regulations that may provide significant opportunities for the loss corporations currently tracking ownershifts for Section 382 purposes.

**Secondary Transfer Exception**

One of the events in which the segregation rules applied under the old rules was a situation where a loss corporation was required to create a new public group upon a transfer or disposition by a 5-percent shareholder of a direct ownership interest in the loss corporation to small shareholders. Taxpayers complained that this rule yielded inequitable results as the loss corporation actually decreased the number of shareholders with significant interests in the loss corporation. This result can also lead to unwanted equity shifts for companies that cannot control the activities of existing shareholders who dispose of their shares to non 5-percent shareholders, regardless of the number of shares that were sold. For example, a 5-percent shareholder who has held all of its shares beyond the inception of the current testing period will likely not contribute to the overall ownershifts. A sale, however, in the open market to public non-5-percent shareholders creates a new public group under the segregation rules. This new public group creates an increase in ownershift and thus may contribute to an ownership change.

For example, assume that all of a loss corporation’s one class of stock is held by small shareholders in two distinct public groups that own 40 percent and 60 percent of the loss corporation, respectively. These groups currently have no ownershift percentages in the current testing period. Buyer A acquires 10 percent from small shareholders in each of the public groups, then later sells all of his shares to small shareholders. Under the old Section 382 segregation rules, A’s shares would have been allocated to him pro rata from the two existing public groups resulting in a 10 percent ownershift at the time of his purchase. A’s subsequent sale would result in the creation of a new public group equal to A’s shares, resulting in a 10-percent ownershift because this new public group would own 10 percent of LossCo.

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**Quotable**

- **Todd B. Reinstein** was quoted in the October 22, 2013 issue of the *BNA Daily Tax Report* on his thoughts regarding the Final Section 382 Small Shareholder Regulations.
- **Todd B. Reinstein** was quoted in *Tax Notes Today* on November 4, 2013 with his thoughts on the Advo decision and 199.
on the sale date and have a low ownership for the testing period of 0 percent. On a subsequent testing date, Buyer B acquires shares in the loss corporation from small shareholders equal to 10 percent. Similar to A’s treatment, B’s shares would be allocated pro rata from each of the existing public groups.

Now, however, there are three public groups (the two original and the new public group formed on A’s sale), which results in a combined 19 percent cumulative shift, with 10 percent representing B’s acquisition and 9 percent from shifts the new public group created from A’s sale. If B later sells all his shares to small shareholders, there will still be a combined 19 percent cumulative ownershift from the public group created when A sold his shares and a new public group created to hold B’s recently sold shares.

New Treas. Reg. Section 1.382-3(j)(13) provides an “Secondary Transfer Exception” in a change to the old rules, whereby the transfer of loss corporation stock by individuals or first-tier entities that directly own 5 percent or more in the loss corporation to the public does not create a new public group if certain requirements are met. Instead, existing public groups are deemed to acquire a proportionate amount of such shares instead of a new segregated public group acquiring the shares.

Assume the same facts as the example above. Under the new rules, A’s subsequent sale will result in an ownershift of 10 percent as it was in example 1. The shares, however, will be deemed to be re-acquired by the other public groups pro rata from A upon A’s sale. Comparing the two public groups’ respective ownershifts on the testing date with the difference in their current ownership and their lowest percentage over the testing period will result in a 10 percent ownershift. Thus, the difference between the current and proposed rules is that B’s acquisition of its shares pro rata from only the two original public groups (and not from a public group created on A’s sale as the example above) will result in a 10 percent ownershift and not the 19 percent ownershift in example 1. When B later sells all his shares, no new public group will be created and the shares will be allocated pro rata back to the existing public groups, also resulting in a 10 percent ownershift. In comparing the old and new rules, the new rules will result in a lower ownershift of 9 percent. This rule should have a favorable impact on Section 382 analysis, as no new public groups will be created upon the disposition of shares by current 5-percent shareholders as longs as the sale is to small shareholders.

Pepper Attorneys Speaking at ABA Section of Taxation 2014 Midyear Meeting

Ellen McElroy, Kevin M. Johnson, Gregory J. Nowak and Timothy J. Leska will be presenting at the American Bar Association (ABA) Section of Taxation’s 2014 Midyear Meeting in Phoenix, AZ on January 23-25.

On January 24, Ms. McElroy will be a panelist for the Capital Recovery and Leasing Committee’s session “Tangible Property Regulations Update - Transition Guidance Discussion, FAQs, and an Update on the Proposed Regulations.”

On January 24, Mr. Johnson will chair the Administrative Practice panels: “Current Developments,” “Appeals: New Initiatives” and “LB&I’s New IDR Enforcement Process.”

On January 24, Mr. Nowak will be a panelist for the Investment Management’s session “The Structure Games (Pooled Investment Entity Edition).”

On January 24, Mr. Leska will be a panelist for the Partnerships & LLCs’s session “Hot Topics in Partnership Taxation.”

For more information, visit http://meetings.abanet.org/meeting/tax/mid14/.
Redemption Exemption

Under Treas. Reg. Section 1.382-2T(j)(2)(iii)(C), a redemption by a loss corporation of its stock from small shareholders results in the segregation of each public group into two groups, one group theoretically participating in the redemption and one that has not. The newly created public group's holdings, which are equal to the shares redeemed, are eliminated in the next testing date that results in a shift in ownership percentages.

Assume a loss corporation with 1,000 shares of a single class of outstanding stock, all of which is held by small shareholders in one public group with no ownershifts for the testing period. The loss corporation redeems 80 shares from the small shareholders. These shares are segregated into a newly formed public group. This split does not cause any ownershifts. On the next testing date, the newly created public group for the redemption shares is eliminated, thus having an accretive owner shift effect on the original public group, resulting in an 8 percent ownershift.

Treas. Reg. Section 1.382-3(j)(14) provides a similar rule to another exception to the segregation rules – the small-issuance exception. The new rule provides that the segregation rules do not apply to “small redemptions.” Under this new rule, a small-redemption limitation is limited to 10 percent of the stock value at the beginning of the year (value measurement), or 10 percent of the number of shares of the class of stock being tested (class-by-class measurement). The limitation method is selected at the taxpayer’s option each year, and there is no consistency requirement with the small-issuance limitation. The small redemption is generally defined as a redemption from public shareholders, to the extent the amount (on an aggregate year-to-date basis) of stock redeemed does not exceed the small-redemption limitation. If a single redemption from public shareholders exceeds the limitation, no part of the redemption qualifies. As is the case with the small-issuance exception in general, a loss corporation must treat as a single redemption those redemptions that are close in time, pursuant to the same plan or arrangement, or in the case of redemptions that are deliberately separated to minimize or avoid an ownershift. If the small-redemption exception applies, the shares subject to the small-redemption limitation are allocated to pre-existing direct public groups proportionately. Actual knowledge, however, may permit greater allocation to existing public groups.

Assuming the same facts as the example above and applying the new proposed rules, the redemption should qualify as a small redemption because the redemption amount is less than 10 percent of the shares held. Thus, no new public group is created and there is no ownershift on the following testing date, as there is no public group created.

Higher Tier Entity Exception

Section 382 generally tracks changes in ownership by individuals, whether they invest directly or through intermediaries. This often requires tracking the ownershifts of indirect shareholders. As noted above, one of the principles behind the segregation rules is that a loss corporation has the ability to track ownership of all of its stock even if the loss corporation cannot identify small shareholders and thus segregation events that apply to indirect public groups must also be tracked under the Section 382 rules. Many financial buyers, such as hedge funds, may be first-tier entities with more than a 5-percent ownership in loss corporations. Hedge funds are reluctant, if not prohibited, from disclosing their ownership to others, including loss corporations in which they own stock. This can make tracking the segregation events difficult. Recognizing this difficulty, the IRS issued Prop. Treas. Reg. Section 1.382-3(j)(15), providing that the segregation rules do not apply to a shift in ownership of a higher-tier entity if: (i) the first-tier entity owns 10 percent or less by value of all outstanding stock of the loss corporation; and (ii) the first-tier entity's direct or indirect investment does not exceed 25 percent of the gross assets (excluding cash and cash items – 382(h)(3))
(B)(ii)) of that entity. Many practitioners commented that this provision was not practicable, as obtaining the information to satisfy the 25-percent-gross-asset test would be difficult. The Treasury and IRS took those comments into account and removed the 25-percent requirement in the final regulations and replaced it with a subjective anti-avoidance rule.

**Effective Date**

The biggest surprise in the new rules is the effective date. The rules have an effective date rule that they apply to testing dates occurring on or after the publication date of October 22, 2013. The final regulations do, however, permit taxpayers to apply the provisions of the final regulations in their entirety to all testing dates that are included in a testing period beginning before and ending on or after October 22, 2013, subject to the limitations that (1) the final regulations may not be applied to any date on or before the date of any ownership change that occurred on a date before October 22, 2013, and (2) they may not be applied if their application would result in an ownership change occurring on a date before October 22, 2013, that did not occur under the regulations in effect before October 22, 2013.

**Pepper Perspective**

The new exception to the segregation rules, in most cases, provide taxpayer-friendly results going forward. Because the rules can be applied retroactively to open testing periods, loss companies should consider applying the rules to see if they can reduce the current ownership shift. In many cases, the reduction in current shift and the knowledge that future equity transactions may not be subject to the segregation rules would allow companies more flexibility in planning corporate transactions, such as stock buy-backs.

**Endnotes**

1. Unless otherwise stated, all references to “Section” are to the Internal Revenue Code of 1986, as amended, and all references to the “Regulations” or to “Treas. Reg.” are to the Treasury Regulations promulgated thereunder.

2. Generally, the “testing period” for any testing date is the three-year period ending on the testing date. Once an ownership change occurs, the three-year testing period is reset and a new testing period begins. See Treas. Reg. Section 1.382-2T(d)(1).

3. See Treas. Reg. Section 1.382-3(a)(1), which provides that an entity is any corporation, estate, trust, association, company, partnership or similar organization. An entity also includes a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock.

4. See Treas. Reg. Section 1.382-2T(j)(2)(iii)(B)-(C). For testing dates occurring during tax years beginning after November 4, 1992, the regulations provide two key exceptions to the full segregation presumption. These special rules significantly modify the segregation rules and provide certain assumptive rules when the equity of the loss corporation was issued in a “small issuance,” or a “cash issuance.” Treas. Reg. Section 1.382-3(j)(2) and (j)(3).


6. Of note, there is one interesting twist in putting all these rules together. If applying these new rules causes a change in ownership change in the current testing period, the rules cannot be applied retroactively. But, they would be applied prospectively. The result would thus be potentially applying two sets of rules in the current testing period.
On August 30, 2013 the Treasury Department released final regulations regarding guidance on Section 362(e)(2), preventing the duplication of loss when property containing a net built-in loss is transferred to a corporation in a transaction covered by Section 351. A simple transaction, such as a taxpayer transferring assets with a basis exceeding value to a newly incorporated entity, may require the application of these rules. While the transaction may well be tax deferred under Section 351, the new regulations impose significant tax basis implications that must be considered. These regulations have the potential to impose compulsory inside basis reductions in situations that may not be otherwise apparent. Fortunately, this provision and the Regulations provide an election to avoid such treatment by shifting the loss reduction to the outside basis.

**BACKGROUND**

Under the general rule, Section 362(a) provides that a transferor takes a basis in the stock received equal to the adjusted basis of the property contributed. Similarly, a transferee takes a basis in the stock received equal to the adjusted basis of the contributed property in the hands of the transferor. Section 362(e) was enacted in two subsections to prevent the importation and duplication of losses in certain corporate nonrecognition transactions. Specifically, Section 362(e)(2) prevents duplication in the context of built-in loss transactions in which Section 351 applies and similar acquisitions of property, such as paid-in surplus or capital contributions. When applicable, Section 362(e)(2) overrides the general basis rules of Section 362(a) and imposes a basis reduction on the acquiring corporation whereby the inside basis of the loss property is reduced by the property’s allocable portion of the transferor’s net built-in loss, essentially marking to market the built-in loss property contributed. Section 362(e)(2)(C) allows the parties to the transaction to make an irrevocable election to apply the basis reduction to the transferor’s stock basis received in the exchange rather than to the transferee’s basis in the assets.

This election is potentially advantageous in that it allows the basis reduction to be transferred away from the assets, preventing the loss of tax depreciation and amortization.

**FINAL REGULATIONS**

Following the guidance issued in Notice 2005-70 and the 2006 proposed Section 362(e)(2) regulations, the final regulations adopt general operative rules to ease the identification of transactions subject to the basis reduction provisions. The operative rule in the regulations provides that whenever a person (Transferor) transfers property to a corporation (Acquiring) in a loss duplication transaction, Acquiring’s basis in each loss duplication property is reduced by the allocable portion of Transferor’s net built-in loss. Loss duplication property is defined as any property that is transferred in a Section 362(a) transfer, in which the transferee’s aggregate basis in the property transferred by the Transferor exceeds the value of the property immediately after the transfer. The Transferor must test each asset independently to determine whether Section 362(e)(2) applies.

As mentioned, to avoid such treatment, parties may elect to apply the basis reduction to the Transferor’s stock basis under Section 362(e)(2)(C) instead. To properly elect Section 362(e)(2)(C), the final regulations require a written, binding agreement to be executed between the Transferor and the acquiring entity agreeing to the irrevocable election, and an election statement must also be filed by the Transferor. Once jointly executed and filed, the election becomes irrevocable. The regulations now require the election statement to be filed in the first taxable year in which the property at issue is acquired by a person required to file a U.S. tax return.

Additionally, significant modifications have also been made in the context of contributions of partnership interests, with particular emphasis on partnership liabilities. To avoid the inconsistency of inside and outside basis resulting from the contribution of such interests, the new regulations specifically modify the definition of value to include liabilities in order to...
obtain equitable results. As a result, the value for determination of built-in loss existence will fluctuate in a manner similar to the partner’s basis, therefore avoiding the false appearance of a built-in loss. Lastly, the definition of “stock” has also been revised. Consequently, the stock received in exchange for contribution of built-in loss property will, in certain circumstances, include both stock and securities.6

While the final regulations provide clarity, there still appears to be some outstanding issues that remain uncertain. In particular, the receipt of nonqualified preferred stock in accordance with Section 351(g) remains unclear. Under this provision, nonqualified preferred stock may be treated as boot, and gain will be recognized to the extent of fair market value of the property received. The Transferor’s basis in the nonqualified preferred stock is treated as “other property” in accordance with Sections 351 and 358, and therefore receives a basis equal to its fair market value. The question that arises when built-in loss property is contributed in exchange for both common and nonqualified preferred stock and a Section 362(e)(2)(C) election is made, is whether the reduction in the contributor’s stock basis is allocated to both the common and nonqualified preferred stock. While it is arguable under the definition of “stock” that both should receive the basis adjustment, the intersection of these provisions is still uncertain. If the basis reduction does apply, the nonqualified preferred stock could create gain with the basis of the common stock increased above the amount of the built-in loss deduction that would have occurred but for nonqualified preferred stock.

ENDNOTES

1. Unless otherwise stated, all references to “Section” are to the Internal Revenue Code of 1986, as amended, and all references to the “Regulations” or “Treas. Reg.” are to the Treasury Regulations promulgated thereunder.

2. Section 358(a)(1).


4. Section 326(a) includes Section 351 transactions and other acquisitions of property as paid-in surplus or capital contributions.

5. Section 362(e)(2)(C).

6. Treas. Reg. Section 1.362-4(g)(11) defines stock as “both Acquiring stock and Acquiring securities received by Transferor in the transaction if gain or loss on the receipt of stock or securities is not recognized in whole or in part.”

PEPPER PERSPECTIVE

As this provision can be easily overlooked, taxpayers may miss making a Section 362(e)(2)(C) election and lose valuable depreciation deductions. Taxpayers failing to make a timely election under these provisions may have relief under Treas. Reg. Section 301.9100. While the new regulations do not explicitly provide for such relief, it appears to still be available for taxpayers, provided the parties have entered into a written binding agreement satisfying the requirements in the Regulations before the relief request is submitted.

While the final regulations provide clarity, there still appears to be some outstanding issues that remain uncertain.
Pepper Hamilton’s Tax Practice Group

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