Part III - Administrative, Procedural, and Miscellaneous

REQUEST FOR COMMENTS: MODIFICATION TO THE REGULATIONS UNDER § 382 REGARDING THE TREATMENT OF SHAREHOLDERS WHO ARE NOT 5-PERCENT SHAREHOLDERS

Notice 2010-49

This notice invites public comments relating to possible modifications to the regulations under § 382 of the Internal Revenue Code regarding the treatment of shareholders who are not 5-percent shareholders (Small Shareholders).

I. PURPOSE

The Internal Revenue Service (Service) and Treasury Department (Treasury) are currently considering modifying the regulations under § 382. In particular, the Service and Treasury are studying the operation of the rules relating to Small Shareholders, including the application of the aggregation and segregation rules to public groups. This notice sets forth policy considerations underlying § 382 and requests comments on what modifications would better reflect those policy considerations.

II. BACKGROUND

Section 382 provides special rules for Small Shareholders. Under § 382(g)(4)(A), Small Shareholders are aggregated and treated as one 5-percent shareholder. Section 382(g)(4)(B), however, requires that this aggregation rule must be applied separately to Small Shareholders of parties to certain § 368 reorganizations. Section 382(g)(4)(C) broadens the scope of the segregation rule of § 382(g)(4)(B) and provides that, except as provided in the regulations, similar segregation rules shall apply in determining whether there has been an owner shift involving a 5-percent shareholder and whether such shift (or a subsequent transaction) results in an ownership change.

III. POLICY CONSIDERATIONS UNDERLYING § 382

The proper treatment of Small Shareholders under § 382(g)(4)(C) depends upon a determination concerning the policy considerations underlying § 382. This request for comments describes two general approaches, the Ownership Tracking Approach and the Purposive Approach, and sets forth some of the policy considerations underlying each. Both approaches recognize that one of the primary abuses § 382 seeks to prevent involves an acquisition of loss corporation stock followed by the contribution of income-producing assets or the diversion of income-producing opportunities to the corporation. The two approaches differ, however, in the extent they seek to identify and limit their effect to circumstances in which that abuse is most likely to occur.

A. OWNERSHIP TRACKING APPROACH

Under the Ownership Tracking Approach, it generally is of no significance whether the shareholders who increase their ownership are Small Shareholders or 5-percent shareholders. This approach ensures that abusive transactions are addressed by tracking all changes in ownership without regard to their particular circumstances. Thus, any transaction that allows the corporation to track the increase in ownership interests held by Small Shareholders results in the segregation of Small Shareholders into a new public group, which is treated as a 5-percent shareholder. See § 1.382-

2T(j)(3)(i) of the Income Tax Regulations. The creation of the new, segregated public group results in an increase in ownership for that public group. For example, if a 5-percent shareholder sells stock to Small Shareholders, these Small Shareholders are segregated into a separate public group because it is not unduly burdensome for the corporation to know that a 5-percent shareholder has reduced its ownership and that ownership interest has been acquired by Small Shareholders. However, the Ownership Tracking Approach makes a concession to administrative convenience and acknowledges that "public trading," which is the purchase by one Small Shareholder of stock from another Small Shareholder, should not be taken into account because it is unduly burdensome for a corporation to take into account all such transactions. See § 1.382-2T(e)(1)(ii).

B. PURPOSIVE APPROACH

Consistent with the purpose of § 382, the Purposive Approach seeks to identify more specifically the circumstances in which abuses are likely to arise. This approach reflects the view that it is unnecessary to take into account all readily-identifiable acquisitions of stock by Small Shareholders, because Small Shareholders are generally not in a position to acquire loss corporation stock in order to contribute income-producing assets or divert income-producing opportunities. Instead, if the Purposive Approach is adopted, special rules generally could provide for a lesser percentage change in ownership for acquisitions of stock by Small Shareholders.

C. CURRENT REGULATIONS UNDER § 382

The current regulations primarily reflect the Ownership Tracking Approach. Although certain provisions may seem to follow the Purposive Approach, their justification is nevertheless based upon the Ownership Tracking Approach. For example, the cash issuance exception of § 1.382-3(j)(3) reduces the segregation effect of an issuance of stock to Small Shareholders by treating existing direct public groups as buying some of the stock sold in the issuance. However, this rule is justified on the grounds that there is likely to be substantial overlap between Small Shareholders who acquire stock in such an issuance and the existing Small Shareholder ownership base.

D. OWNERSHIP TRACKING APPROACH VERSUS PURPOSIVE APPROACH

The different consequences of the two approaches may be illustrated by the treatment of 5-percent shareholders that acquire stock from Small Shareholders, and then sell the acquired stock back to Small Shareholders.

Example (1).

Facts. All the stock of loss corporation is owned by a single public group, Original Public Group. The following acquisitions and dispositions each occur during the testing period. First, Investor A acquires 10 percent of the corporation's stock from Small Shareholders, and sells it to Small Shareholders a few months later. Second, Investor B acquires 10 percent of the stock from Small Shareholders, and sells it a few months later to Small Shareholders. Third, Investor C does the same.

Analysis. (i) Ownership Tracking Approach. The regulations reflect the Ownership Tracking Approach, and require the creation of a new, segregated public group when each of Investors A, B and C sells its stock back to Small Shareholders. As a result, the loss corporation has four 5-percent shareholders, Original Public Group and three new, segregated public groups (New Public Group 1, New Public Group 2, and New Public Group 3). Each investor is treated as acquiring the loss corporation stock proportionately from the direct public groups that exist immediately before the acquisition. See § 1.382-2T(j)(2)(vi). Accordingly, New Public Group 1, New Public Group 2, and New Public Group 3, the only 5-percent shareholders whose interests in loss corporation have increased during the testing period, have increased their respective ownership interest by 27.1 percent, in the aggregate – from zero to 8.1 percent for New Public Group 1, from zero to 9 percent for New Public Group 2, and from zero to 10 percent for New Public Group 3. This is so even though the stock is now, and at the beginning of the testing period was, held 100 percent by Small Shareholders, and even though no actual 5-percent shareholder ever held more than 10 percent of the corporation's stock. This treatment is justified on the grounds that the corporation is able to track each time a 5-percent shareholder sells stock to new shareholders, including Small Shareholders.

(ii) Purposive Approach. Under the Purposive Approach, the amount of change in ownership is different from the amount under the Ownership Tracking Approach. When each investor sells its shares to Small Shareholders, the shares could be treated as being re-acquired by Original Public Group rather than the new, segregated public groups. As a result, the aggregate effect on the change in ownership is significantly reduced. Accordingly, Original Public Group is treated as increasing its ownership interest from 90 percent to 100 percent during the testing period.

A full embrace of the Purposive Approach could go further. For example, when Original Public Group acquires shares from each investor, Original Public Group could be treated, for testing dates on or after such an acquisition, as having owned them during the period they were owned by the seller. Under such a rule, there would have been no increase in ownership of any 5-percent shareholder during the testing period. Instead, Original Public Group would be treated, for testing dates on or after its reacquisition of the shares from the investors, as owning 100 percent of the corporation during the entire period. Such a result would be justified on the grounds that where Small Shareholders owned the shares at the beginning of the testing period and on the last testing date, no shareholder has increased its ownership interest in such a way that would allow it to engage in any abuse that § 382 was enacted to prevent.

<u>Example (2)</u>.

<u>Facts</u>. The facts are the same as <u>Example (1)</u>, except each acquisition by Investors A, B, and C precedes all dispositions by the investors to Small Shareholders.

<u>Analysis</u>. (i) <u>Ownership Tracking Approach</u>. The results are the same as in <u>Example (1)</u>.

(ii) <u>Purposive Approach</u>. Under a limited application of the Purposive Approach, Original Public Group would be treated as increasing its ownership interest from 70 percent to 100 percent for an increase of 30 percentage points. However, under an expanded application of this principle, Original Public Group could be treated as always having owned the stock owned by Investors A, B, and C for testing dates on or after the sales to Small Shareholders. Under this rule, for testing dates on or after the reacquisition of the shares by Original Public Group from the investors, there would have been no increase in the ownership interest of any 5-percent shareholder during the testing period.

Other transactions would also receive different treatment under the Purposive Approach. For example, when stock is issued by a loss corporation, the stock could be treated as being acquired by the existing public group or groups, instead of by a new, segregated public group. Some type of look-back rule could also be employed in this context to mitigate the change in ownership that results from an issuance to Small Shareholders. The effect of redemptions of stock held by Small Shareholders under a Purposive Approach would also be different from the treatment of such transactions under the existing regulations.

The complete adoption of a Purposive Approach to public groups would require significant changes to the existing regulations. Alternatively, it may be appropriate to adopt new rules reflecting the Purposive Approach only for certain transactions. For example, stock issuances, which allow the loss corporation to receive additional income-producing capital, present concerns that shareholder-to-shareholder sales do not.

The Service and Treasury are also studying more modest changes. For example, the cash issuance exception is currently limited, as the name implies, to issuances of stock for cash. Under consideration is the possible expansion of this rule to issuances for other property, including the debt of the loss corporation. The Service and Treasury also are considering whether it would be appropriate to expand the small issuance exception to exempt larger share issuances from the application of the segregation rules.

IV. REQUEST FOR COMMENTS

The Service and Treasury request comments concerning what modifications, if any, to the existing rules for public groups are appropriate, and an analysis of whether authority exists for any recommended changes. Comments are requested concerning whether the regulations under § 382 should follow the Ownership Tracking Approach, Purposive Approach, or another approach. Additionally, consistent with an application of a Purposive Approach, comments are requested regarding whether the look-through treatment of first-tier and higher-tier entities should be limited in cases where these entities have a relatively small direct or indirect investment in the loss corporation. Due to the complexity of the existing regulations under § 382, modifications to the treatment of public groups would likely raise questions regarding how such modifications should be harmonized with other rules. The Service and Treasury also request comments on the consequences of any recommended modifications on these questions.

Comments should be submitted by September 9, 2010, and include a reference to Notice 2010-49. Send submissions to Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2010-49), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044 or hand-deliver Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to Courier's Desk, Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2010-49), 1111 Constitution Avenue, N.W., Washington, D.C. 20044. Alternatively, comments may be submitted electronically via the following e-mail address: Notice.Comments@irscounsel.treas.gov. Please include "Notice 2010-49" in the subject line. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Rubin B. Ranat of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice contact Rubin B. Ranat on (202) 622-7530 (not a toll-free call).