Section 382 Guidance Issues

Below is a list of suggested guidance issues under section 382 of the Internal Revenue Code. The issues are listed generally in order of priority, with the issues under categories 1-5 having the most immediate need for guidance.

1. Guidance under section 382(h)
2. Capital Contributions:
   a. Regulations narrowing section 382(l)(1) and providing exceptions to the section 382(l)(1) rule re: capital contributions to avoid or increase the section 382 limitation. Consider whether the following exceptions are appropriate:
      (1) Exception for capital contributions received on formation of the loss corporation.
      (2) Exception for capital contributions received before the first year from which there is an NOL carryover.
      (3) Exception for capital contributions made to fund continuing operations of the business.
      (4) Exception for conversion of “old and cold” debt into equity.
   b. Guidance regarding what “shall not be taken into account” means in section 382(l)(1)(A). Section 382(1)(1)(A) provides that if a capital contribution is treated as part of a prohibited plan, such contribution "shall not be taken into account" for purposes of section 382.
      (1) Does this mean that the value of the loss corporation stock is reduced by the value of the contributed property either at the time of contribution or at the change date?
      (2) How is a contribution of cash to be taken into account if the loss corporation uses the cash to purchase assets that subsequently appreciate in value?
(3) If the contributed property is income-producing property, is the earnings generated from the property (and retained in the business) taken into account?

c. Guidance re: the interrelationship of the capital contribution, built-in gains and losses, and nonbusiness assets provisions.

d. Clarification regarding the circumstances under which a transferee in a section 351 transaction can be considered a "successor," and how section 382(l)(1) would apply to such a situation.

3. Fluctuations in value:


b. Multiple classes of stock: Fluctuations between classes of stock during different testing dates.

4. Stock vs. Not Stock Issues:


(1) Under the regulations, an ownership interest that would otherwise constitute "stock" will not be treated as stock if:

(a) As of the time of its issuance or transfer to (or by) a 5-percent shareholder, the "likely participation" of such interest in future corporate growth is "disproportionately small" when compared to the value of such stock as a proportion of total value of the outstanding stock of the corporation (the "growth participation" test);

(b) Treating the interest as not constituting "stock" would result in an ownership change (the "ownership change" test); and,

(c) The amount of pre-change loss (determined as if the testing date were the change date and treating any net unrealized built-in loss as a pre-change loss) exceeds a certain threshold amount -- twice the product of the value of the loss corporation on the testing date and the long term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs (i.e., essentially...
double the section 382 amount for a single 365-day post-change year) (the "de minimis" test).

(2) All three elements of the test in the regulations must be met in order for stock to be disregarded. However, the timing of the testing of the three elements is unclear. The growth participation test is clearly applied only when the ownership interest in question is issued or transferred (to or by a 5-percent shareholder); however, it is not clear whether the ownership change test and the de minimis test are applied only when the interest in question is issued or transferred, or whether such tests are to be applied anew as of any testing date (including testing dates where the interest in question was not issued or transferred).

(3) With respect to the ownership change test, one cannot determine whether treating a stock interest as not stock will result in an ownership change unless one knows whether the reclassification of stock as not stock will be given retroactive effect throughout the testing period.

(4) It is not clear whether the three-part test applies only to the ownership interest that was actually issued or transferred, or whether it applies to the entire class of the ownership interest (only part of which may have been transferred or issued).

(5) Guidance is needed re: the definitions of "likely participation" and "disproportionately small" under the growth participation test. Safe Harbors would be helpful.

(6) Under present regulations, straight voting preferred stock could be treated as not stock.


(1) The Preamble to the regulations states that this provision could apply to an instrument that is otherwise treated as debt under the income tax laws, but nevertheless offers a potential significant participation in the growth of the loss corporation. This statement appears to be in conflict with the rule itself which provides only that "ownership interests" may be treated as stock.
(2) The regulations fail to provide guidance as to when a non-stock ownership interest will be considered to offer "potential significant participation" in the growth of the corporation.

(a) The extent to which “underwater debt” will be treated as stock, if at all.

(3) As with the “stock treated as not stock” test, an apparent timing difference exists as to when each element of the test is applied, and it is unclear whether the test applies only to the portion of the stock issued or transferred or the entire class of stock.

(4) It is unclear whether reclassification of an ownership interest as stock will be given retroactive effect throughout the testing period or whether the interest will be treated as not stock up until the immediate testing date (in which case a deemed recapitalization -- stock for not stock -- in effect occurs on the testing date).

(5) This rule may lead to unintended results where preferred stock is in dividend arrearages. Treas. Reg. § 1.382-2(a)(3)(i) states that stock described in section 1504(a)(4) does not become "stock" solely because the stock became voting stock as a result of dividend arrearages. However, dividend arrearages also signal the deteriorating financial condition of the loss corporation. Where the loss corporation is experiencing such difficulties, the value of its assets may be well below the liquidation preference of the preferred stock.

(a) In such a case, the preferred stock may be viewed as offering potential significant participation in the growth of the corporation. Moreover, if such an interest is not retroactively treated as stock throughout the testing period, the reclassification from not stock to stock could trigger an ownership change.

(b) Thus, even though such preferred stock remains as not stock under Treas. Reg. § 1.382-2(a)(3)(i), it may nevertheless be treated as stock under Treas. Reg. § 1.382-2T(f)(18)(iii) and trigger an ownership change.
(6) Redeemable, Nonvoting Preferred Stock: The terms of redeemable, nonvoting preferred stock may provide that the stock will become voting if a prescribed redemption schedule is not maintained. If such stock does become voting stock because of the corporation's financial inability to meet the redemption schedule, should such stock still be treated as not stock? (Treas. Reg. § 1.382-2T(f)(18)(iii) could apply to offer a contrary result.)

c. Clarify Treas. Reg. § 1.382-2T(f)(18)(iv), which states that "stock" of the loss corporation includes stock as that term is defined by Treas. Reg. § 1.382-2T(f)(18) and, as the context may require, includes any indirect ownership interest in the loss corporation.

(1) It is unclear what is intended by the inclusion of indirect ownership interests in the definition of the term "stock" or when "the context may require" such treatment. The regulations offer no insight into the extent of this provision.

(2) Applied literally, this provision treats a purely constructive ownership interest in the loss corporation as stock.

d. Guidance under section 382(k)(6) treating rights to acquire stock as stock in determining the section 382 limitation.

5. Ownership Change Calculation:

a. How to treat employee groups: Employee plans typically involve separate trusts. Should employee trusts be combined for purposes of the section 382 calculation?

b. How to treat mutual funds (RICs) and investment advisors: Issues related to how commonly managed funds should be combined for purposes of the section 382 calculation.

(1) Family vs. Individual Funds

(2) Managers of Multiple Funds

6. Elective Ownership Change: Consider whether a section 382 elective ownership change would facilitate the administration of section 382.

7. Regulations re: valuing the old loss corporation: Section 382(e) and (k)(5) - value of publicly traded companies. Whether the listed per share market listing should be used - which reflects a minority discount vs. a higher value by valuing company as a whole.
8. Clarify Actual Knowledge rules:
   a. What is meant by a 5 percent shareholder “who would be taken into account” but for the limitation on additions to percentage ownership? See Treas. Reg. § 1.382-2T (g)(3).
   b. Define “actual knowledge” and provide guidance as to when the loss corporation will be deemed to possess “actual knowledge.”
   c. Corporations are “required to determine the stock ownership” on various testing dates of 5% shareholder’s, first-tier entities, etc. Treas. Reg. § 1.382-2T(k)(3). What is the required standard of care for determining this stock ownership (i.e., good faith effort, reasonableness, etc.)?
   d. If a 13G is filed, but it does not state that there are any beneficial owners that own 5% of the loss corporation (which is required in the filing), can a loss corporation rely on the lack of such statement in a filed 13G to the effect that there are no 5-percent shareholders?

9. Clarify Constructive Ownership Rules:
   a. Brothers and sisters are treated as one individual if one of their parents are living, but not if both are dead. Should the rules work the same whether their parents are living or dead?
   b. Should stock owned by 501(c)(3) organizations be attributed to its members?
   c. Option Attribution: If an option is deemed exercised on a change date, the option is not treated as exercised on any subsequent testing date and prior to a transfer that would itself cause the option to satisfy the ownership, control or income tests. Treas. Reg. § 1.382-4(d)(10)(i)(A). Exercise of the option by the person who owned the option immediately after the ownership change does not cause another ownership change on the date of exercise. Treas. Reg. § 1.382-4(d)(10)(i). It is unclear how the final regulations apply if less than all the options outstanding before an ownership change are exercised or deemed exercised. It is ambiguous whether options that are not deemed exercised will benefit from the relief afforded by this rule.

10. Issues re: 5-percent shareholder rules:
    a. Clarify “next lower tier entity” rules of Treas. Reg. § 1.382-2T(j)(1)(iv)(A). It is unclear how the rules work where several “next lower tier entities” are present.
b. Stock ownership presumptions: Treas. Reg. § 1.382-2T(g)(5) provides for certain stock ownership presumptions that may be applied to determine the percentage interest of a shareholder following certain acquisitions and dispositions of loss corporation stock. The regulations do not state whether these presumptions, once applied, are irrevocable during the remainder of the testing period.

c. Treas. Reg. § 1.382-2T(g)(5)(i)(A) refers to a shareholder that "acquires" a five percent interest. It is unclear what results if a shareholder's interest increases to more than five percent as a result of the redemption of another shareholder's stock.

11. Issues re: Segregation Rules:

a. Acquisitions following segregation: Guidance re: Application of pro-rata acquisition rule if the loss corporation redeems its stock when it has multiple groups of shareholders.

(1) Once a group of shareholders is segregated as a result of the segregation rules, the group generally remains segregated until a new testing period begins.

(2) Treas. Reg. § 1.382-2T(j)(2)(vi) provides that, in testing subsequent transactions for ownership changes, unless a different proportion is established by either the loss corporation or the Service, an acquisition of loss corporation stock by either a 5-percent shareholder or the loss corporation itself, on any date in which more than one public group of the loss corporation exists by virtue of the segregation rules, will be treated as being made proportionately from each public group existing immediately before the acquisition.

(3) Treas. Reg. § 1.382-2T(j)(2)(vi) indicates that this pro rata acquisition rule also applies if the loss corporation redeems its own stock at a time when multiple groups of shareholders are present at the loss corporation level. In such a case, the result is unclear.

(a) For example, assume that loss corporation (L) is owned 40 percent and 60 percent by two public groups -- Public L and Public L-1, respectively. Assume that L redeems 10 percent of its stock pro rata. If 4 percent of the stock is simply deemed to be acquired from Public L and 6 percent from Public L-1, an owner shift would not result.
(b) However, if the transaction is also treated as a segregation transaction under Treas. Reg. § 1.382-2T(j)(2)(iii)(C), a third public group would be created ("Public L-2"). Public L-2 would be deemed to own the 10 percent that was redeemed. Of the 10 percent attributed to Public L-2, 6 percent would be treated as coming from Public L-1 and 4 percent from Public L. A 10 percent owner shift would thus occur because the continuing groups ("Public CL" and "Public CL-1") would have increased their collective interest from 90 percent before the redemption to 100 percent of L afterwards.


(1) Under Treas. Reg. § 1.382-2T(j)(3)(i), if a loss corporation is owned, in whole or in part, by a public group(s), the segregation rules applicable to section 381(a)(2) equity structure shifts and section 1032 transactions (Treas. Reg. § 1.382-2T (j)(2)(iii)(B)) will apply to any transaction in which a first tier entity or an individual that owns 5 percent or more of the loss corporation stock transfers a direct ownership interest in the loss corporation to public shareholders.

(2) It is unclear why this provision applies only to individual(s) or first tier entities that own five percent or more of the loss corporation stock at the time of the transfer. This class of shareholders is more narrow than 5-percent shareholders who own a direct interest in the loss corporation.

c. Public Groups

(1) There are mechanical issues as to how and when a segregated group folds back into the residual public group. Technically, it happens 3 years after the segregated group is formed. But the regulations do not provide for the fact that when that happens, the ownership by the residual public is increased. Should the regulations provide that the residual public will be deemed to have the ownership of the shares in the segregated group for the past 3 years?

(2) In addition, under the de minimis and Cash Issuance exceptions, segregated groups can increase their ownership
over time. How and when does the segregated group fold back into the residual public?

d. Treas. Reg. § 1.382-2T(j)(3)(iii) states that the principles set forth in Treas. Reg. § 1.382-2T(j)(2)(iii)(C) (redemption-type transactions involving the loss corporation) are to apply to any transaction that has the "effect" of a redemption-type transaction. Examples of when this regulation would apply would be helpful.

e. Should the Cash Issuance Exception be extended to include cash-type items, such as negotiable instruments? Treas. Reg. § 1.382-3(j)(3)(i).

12. **Section 382(k)(1) - Definition of a "loss corporation"**: In certain situations, the term "loss corporation" should not include a corporation that has a net unrealized built-in loss, but does not have an NOL.

13. **Simplify section 382 / SRLY overlap subgroup rules**

14. **Section 382(l)(4)**: Guidance regarding the treatment of working capital reserves as investment assets under section 382(l)(4).

15. **Section 381 Transactions**: It is unclear whether the special rules where the loss corporation, as a distributor or transferor corporation in a section 381(a) transaction, ceases to exist under state law, apply only where the transferor ceases to exist but does not undergo an ownership change, or whether they apply regardless of whether an ownership change occurs with respect to the transferor. Treas. Reg. § 1.382-2(a)(1)(ii).