August 23, 2012

The Honorable Max S. Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Sander Levin
Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Options for Tax Reform under Section 382

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform under section 382. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Rudolph R. Ramelli
Chair, Section of Taxation

Charles H. Egerton
Former Chair, Section of Taxation

Enclosure

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
ABA SECTION OF TAXATION
OPTIONS FOR TAX REFORM
UNDER SECTION 382

These options for tax reform ("Options") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

Principal responsibility for preparing these Options was exercised by Dana L. Trier and Lisa Joire of the Corporate Tax Committee of the Section of Taxation (the "Committee"). Substantive contributions were made by Marc A. Countryman, Jasper L. Cummings, Jr., Julie Divola, Elliot Freier, Jonathan Forrest, Kevin M. Jacobs, Robert Liquerman, Roger M. Ritt, Julie Hogan Rodgers and Eric Solomon. The Options were reviewed by Joseph Pari, Committee Chair, Peter Blessing of the Section's Committee on Government Submissions and Eric Solomon, the Section's Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Options have clients who might be affected by the federal tax principles addressed by these Options, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject of these Options.

Contact:

Julie Divola
(415) 983-7446
julie.divola@pillsburylaw.com

Date: August 23, 2012
Executive Summary

To promote the ability of corporations that are subject to section 382 to raise equity to meet the reasonable needs of their existing active businesses, we offer for your consideration the option that certain issuances that are unlikely to have a loss trafficking motive be treated as not contributing toward the cumulative owner shift under section 382. Specifically, the option that we offer for your consideration is that an issuance of stock solely for cash by a loss corporation to shareholders owning less than five percent of the loss corporation’s stock after the transaction not be taken into account as an owner shift under section 382, provided that the aggregate value of the amount of stock issued in such offering, or series of offerings over a 12-month period, does not constitute more than 30 percent of the total value of the loss corporation's stock outstanding at the beginning of the taxable year in which the issuance occurs.

Present Law

Section 382 was designed to discourage acquisitions of loss corporation stock that would result in the acquirer benefitting from the use of tax attributes of the loss corporation. Absent section 382, acquirers could use the loss corporation’s tax attributes by first acquiring the stock of the loss corporation and then either contributing income-producing assets to the loss corporation or diverting income-producing opportunities to the loss corporation. Section 382 limits the ability of acquirers to utilize tax attributes generated while the loss corporation was owned by other shareholders, making acquisitions of loss corporations less attractive for tax purposes.

Section 382 and its regulations contain complex mechanical rules designed to track the acquisition of loss corporation stock by new shareholders who were not owners of the loss corporation at the time that the tax attributes were generated. Instead of requiring knowledge about each shareholder, section 382 generally limits its shareholder information requirements to those shareholders owning five percent or more of the loss corporation stock. All shareholders not meeting this five-percent threshold are aggregated into a public group under section 382(g)(4)(A). Segregation rules exist to create additional public groups after certain transactions because public shareholders who receive stock in a merger, an issuance, or when a 5-percent shareholder sells its stock are generally presumed to be new shareholders that are unrelated to the existing public shareholders. Reg. § 1.382-2T(j)(1)(iii).

There are currently two exceptions to the segregation rules, related to small issuances and to issuances solely for cash. Under Reg. § 1.382-3(j)(2), small issuances are defined as issuances in a single taxable year of up to ten percent of the total value of the corporation’s stock outstanding at the beginning of the taxable year or up to ten percent of the number of shares of the class outstanding at the beginning of the taxable year. If the issuance qualifies under this exception to the segregation rules, the shares issued are allocated pro rata to existing public groups and not put into a new public group. Reg. § 1.382-3(j)(5).

References to a “section” are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
Under Reg. § 1.382-3(j)(3), cash issuances are defined as issuances of stock solely for cash. If the issuance qualifies under this exception to the segregation rules, the shares issued are allocated in part to a new public group and in part pro rata to existing public groups. Reg. § 1.382-3(j)(5).

**Reasons for Change**

With the recent economic downturn, more and more corporations are subject to section 382 because they have net operating losses or net unrealized built-in loss in their assets. Given the constraints of section 382, corporations are having difficulty raising equity to meet the reasonable needs of their existing active businesses. We believe that certain issuances are unlikely to have a loss trafficking motive, namely issuances to small public shareholders solely for cash of 30 percent or less of the total value of the loss corporation’s stock over a 12-month period.

**Option for Consideration**

The option that we offer for your consideration is that a direct issuance of stock solely for cash by a loss corporation would not be taken into account as an owner shift involving a 5-percent shareholder or an equity structure shift except to the extent that such stock is acquired by an individual shareholder or entity owning five percent or more of the stock of the loss corporation directly or indirectly immediately after the transaction and provided that the aggregate value of the amount of stock issued in such offering (valued on the date of the offering), or series of offerings, over a 12-month period does not constitute more than 30 percent of the total value of the loss corporation's stock outstanding at the beginning of the taxable year in which the issuance occurs (excluding the value of stock described in section 1504(a)(4)).

This option, like the existing small issuance exception, provides an exception to the usual segregation treatment if an issuance is below a certain percentage. Unlike the small issuance exception, this option will apply only to cash issuances, uses a 30% threshold in lieu of a 10% threshold, and uses a 12-month measurement period instead of a taxable year measurement period. Instead of the aggregation rules in the small issuance exception, which require certain issuances to be aggregated if part of a plan or if separated to avoid an ownership change, this option is intended to cover actual issuances (not merely contemplated or planned issuances) over the 12-month period.

Although the small issuance exception allocates shares pro rata among existing public groups, the qualifying issuance generally results in an overall increase in the cumulative shift in situations in which the loss corporation is not completely owned by public groups. Under the option, however, the qualifying issuance would not result in an increase in the cumulative shift regardless of the ownership structure of the loss corporation. It is expected that the option, if adopted, will largely supplant the small issuance exception in transactions in which the issuance is for cash (as opposed to for services or non-cash property).

It is contemplated that the Secretary will prescribe such regulations as may be necessary or appropriate to carry out the purposes of this option, including establishing appropriate anti-abuse rules, amending the segregation rules to put stock meeting the requirements of this section...
into one or more public group(s) (a new public group or one or more existing public groups) whose lowest percentage ownership(s) on the date of the issuance(s) would be increased by an amount equal to the percentage ownership of the shares that it is treated as acquiring in the issuance(s), establishing a rule to coordinate between this rule and other exceptions to the existing segregation rules for small and cash issuances, and determining the effect of related redemptions on the measurement of the value of the loss corporation stock. Under an anti-abuse rule, this rule would not apply in limited cases involving trafficking in net operating loss carryovers. In addition, under this anti-abuse rule, instruments otherwise treated as nonstock could be treated as stock under section 382 in the context of any cash equity offering, irrespective of the 30 percent threshold under this rule. Furthermore, regulations may, as appropriate, characterize redemptions occurring during a reasonable period before or after the relevant issuances as sales to the public group(s) and, thus, not protected by this rule.

Examples

Example 1:

Corporation L incurs substantial net operating loss carryovers during an economic downturn. On Date 1, for section 382 purposes, Corporation L is owned entirely by a single historic public group. On Date 1, as part of an effort to rehabilitate and grow its business, Corporation L issues common stock representing 20 percent of its outstanding equity to public shareholders, each of whom own less than five percent of the overall equity in Corporation L immediately after the issuance. The issuance was solely in exchange for cash. Under current law, the issuance would fall under the cash issuance exception constituting a transaction giving rise to a new deemed “Public” 5-percent shareholder whose current percentage ownership would be ten percent and whose lowest percentage ownership for the testing period would be zero (representing a ten percentage point owner shift). The remaining ten percent of the issuance would be treated as owned by the historic public group. Under the option, the issuance would not be taken into account in determining whether an ownership change occurred because, under the possible mechanics for the option, either (i) the one or more public groups that would be treated as acquiring the stock would have an increase in its lowest percentage ownership equal to the percentage ownership that it is treated as acquiring in the issuance and would, therefore, not contribute to the cumulative owner shift; or (ii) the shares would be allocated to the historic public group whose percentage ownership would remain unchanged at 100% and would, therefore, not contribute to the cumulative owner shift.

Example 2:

The facts are the same as Example 1. On Date 2, which is more than 12 months after Date 1, Corporation L issues additional common stock representing 20 percent of its outstanding equity to public shareholders, each of whom own less than five percent of the overall equity in Corporation L immediately after the issuance. The issuance was solely in exchange for cash. Under current law (as described in Example 1), the second issuance would constitute (in part) a transaction giving rise to a new deemed “Public” 5-percent shareholder. Under the option, because the second issuance was solely for cash and took place more than 12 months after the first, the second issuance would not be taken into account in determining whether an ownership change occurred, even if it was planned as of Date 1. Had the second issuance been within 12
months of the first, the transaction would be bifurcated (similar to the small issuance exception), allocating ten percent under the proposal to one or more public groups whose lowest percentage ownership(s) would be increased by ten percent and the remaining ten percent to public groups based on the cash issuance exception under current law. This is similar to the coordination rule in Reg. § 1.382-3(j)(3)(iii), which allows application of the cash issuance exception when a small issuance partially exceeds the small issuance limitation for the taxable year. A single issuance must be less than 30 percent to qualify for this bifurcated treatment. If any single issuance exceeds 30 percent, then it would be treated as being completely outside of the rule but within the existing cash issuance rule, similar to the operation of the small issuance exception. See Example 4 below.

Example 3:

The facts are the same as Example 1 except that, in the offering, ten percent of the stock was issued to public shareholders, each of whom own less than five percent of the overall equity in Corporation L immediately after the issuance, and ten percent to a new 5-percent shareholder. Under the option, only part of the issuance would not be taken into account in determining whether an ownership change occurred. The percentage ownership acquired by the new 5-percent shareholder would contribute the full ten percentage points to the cumulative owner shift. The ten percent that was issued to the public, however, would be treated as acquired by one or more public groups whose lowest percentage ownership would include the ten percent issued in the offering and would, therefore, not contribute to the cumulative owner shift. In determining the amount of additional shares that could be issued within 12 months to the public under the option without contributing to the cumulative owner shift, the shares issued to the new 5-percent shareholder would be required to be taken into account. In other words, because any issuance solely for cash is taken into account in determining whether the 30 percent threshold is met during the 12-month period, only an additional ten percent of Corporation L’s stock would qualify for the rule within the 12 months following Date 1.

Example 4:

The facts are the same as Example 1 except that stock comprising more than 30 percent of the equity of Corporation L is issued in the initial equity offering. Under the option, the entire offering would be taken into account (current regulations would thus address this transaction). For purposes of this option, acquisitions by all persons, including persons acquiring five percent, would be aggregated.

Example 5:

Corporation L no longer carries on more than an insignificant amount of a trade or business. The common stock of the company continues to be owned largely by historic shareholders who owned the stock during the period that a substantial portion of the net operating loss carryovers were generated. In a direct equity issuance, preferred stock that would be treated as nonstock under sections 382 and 1504 and applicable Regulations is sold to investors. After the transaction, less than 20 percent of the combined value of all stock (including the new preferred) of Corporation L is owned by the historic common stock holders and substantially all of the proceeds of the preferred offering are invested in investment assets.
such as stock, securities and derivatives. It is contemplated that, under the anti-abuse rule, the preferred stockholders would be treated as purchasing “stock” for purposes of section 382. The proportion of the value of the corporation’s outstanding shares represented by the preferred stock, as well as the use of the funds, indicate that the exception for section 1504(a)(4) stock is inappropriate, as this situation is easily distinguished from one in which the corporation is raising fixed income financing for its historical business. See also section 382(c) and section 382(l)(4).