



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-149625-10]

RIN 1545-BK03

Application of the Segregation Rules to Small Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 382 of the Internal Revenue Code (Code). These proposed regulations provide guidance regarding the application of the segregation rules to public groups under section 382 of the Code. These regulations affect corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-149625-10), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-149625-10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS REG-149625-10).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Stephen R. Cleary, (202) 622-7750; concerning submission of comments or to request a public hearing, Oluwafunmilayo (Funmi) P. Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

1. Segregation and Aggregation – Statute, Legislative History, and Current Regulations

Section 382 imposes a limitation on a corporation's use of net operating loss carryovers following a change in ownership. The legislative history explains that a limitation is necessary following a change in ownership because new shareholders otherwise would have an opportunity to contribute income-producing assets (or divert income opportunities) to the corporation, thus inappropriately accelerating the use of net operating loss carryovers. The section 382 limitation is intended to prevent a corporation from obtaining greater loss utilization than it could have achieved absent a change in ownership. S. Rep. No. 99-313 at 232 (1986).

A loss corporation has an ownership change if the percentage of stock of a loss corporation that is owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by such shareholders at any time during the testing period (generally, a three-year period). For purposes of section 382, the attribution rules of section 318(a)(2) apply, without limitation, to treat individuals as the owners of loss corporation stock. Pursuant to section 382(g)(4)(A), individual shareholders who own

less than five percent of a loss corporation are aggregated and treated as a single 5-percent shareholder (a public group).

The regulations extend the public group concept to situations in which a loss corporation is owned by one or more entities, as defined in §1.382-3(a) (generally, partnerships, corporations, estates, and trusts). If an entity directly or indirectly owns five percent or more of the loss corporation, that entity has its own public group if its owners who are not 5-percent shareholders own, in the aggregate, five percent or more of the loss corporation. (Such an entity is referred to as a 5-Percent Entity in this preamble.)

The segregation rules, which are generally contained in §1.382-2T(j), and the exceptions thereto, which are generally contained in §1.382-3(j), apply to certain transactions affecting ownership by the loss corporation's direct public group and by the public groups of a 5-Percent Entity. The application of the segregation rules results in the creation of a new public group in addition to the one (or more) that existed previously. That new group is treated as a new 5-percent shareholder that increases its ownership interest in the loss corporation.

Section 382(g)(4)(B) mandates application of the segregation rules to transactions constituting equity structure shifts of the loss corporation. Generally, equity structure shifts are acquisitive asset reorganizations and recapitalizations under section 368. Section 382(g)(3)(B) provides regulatory authority to treat public offerings and similar transactions as equity structure shifts. Pursuant to that authority, the current segregation rules, subject to the cash issuance and small issuance exceptions (described in this preamble), treat issuances of stock under section 1032, redemptions,

and redemption-like transactions as segregation events. The segregation rules also apply to transfers of loss corporation stock by an individual 5-percent shareholder to public shareholders and a 5-Percent Entity's transfer of loss corporation stock to public shareholders.

The small issuance and cash issuance exceptions exempt certain amounts of stock issuances from the segregation rules. Generally, the small issuance exception exempts the total amount of stock issued during a taxable year to the extent it does not exceed 10 percent of the total value of the corporation's outstanding stock at the beginning of the taxable year or 10 percent of the class of stock issued and outstanding at the beginning of the taxable year (the small issuance limitation). However, the small issuance exception does not apply to any issuance of stock that, by itself, exceeds the small issuance limitation. If stock is issued solely for cash, the cash issuance exception exempts a percentage of the total stock issued equal to 50 percent of the aggregate percentage ownership interest of the public groups of the corporation immediately before the issuance. In determining the size of the issuance for this purpose, stock issued to 5-percent shareholders is taken into account. If the small issuance exception excludes only a portion of a stock issuance, the cash issuance exception may apply to the portion not excluded under the small issuance exception. Pursuant to a grant of regulatory authority in section 382(m)(4), the small issuance exception can apply to recapitalizations, but otherwise, neither exception applies to equity structure shifts.

2. Notice 2010-49

Notice 2010-49, 2010-27 I.R.B. 10, invited public comment relating to possible modifications to the regulations under section 382 regarding the treatment of

shareholders who are not 5-percent shareholders (Small Shareholders). See §601.601(d)(2)(ii)(b).

Notice 2010-49 describes two general approaches – the Ownership Tracking Approach and the Purposive Approach – and sets forth some of the policy considerations underlying each approach. Both approaches recognize that a primary abuse section 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.

Under the Ownership Tracking Approach, generally it 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. 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).

Consistent with the purpose of section 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 generally are not in a position to acquire loss corporation stock in order to contribute income-producing assets or divert income-producing opportunities.

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 but 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 Small Shareholders who already own stock.

Explanation of Provisions

1. Overview

The IRS and the Treasury Department received a range of comments in response to Notice 2010-49. Some comments endorsed substantial changes to the existing regulations, while others supported changes within the existing regulatory framework. One commenter supporting more modest changes to the existing regulations suggested that an overhaul of the current regulations likely would produce new uncertainties and complexities. Additionally, the comment observed that revisions allowing substantial infusions of capital into a loss corporation without section 382 implications would be counter to section 382 policies.

After consideration of the comments received, these regulations propose revisions following the Purposive Approach within the existing regulatory framework. Consistent with the Purposive Approach, these proposed regulations are intended to lessen the administrative burden and section 382 implications associated with transactions that are unlikely to implicate section 382 policy concerns. In general, these proposed regulations employ objective criteria to implement the Purposive Approach. The IRS and the Treasury Department believe that, where practicable, objective rules best serve the interests of loss corporations that desire certainty with respect to their section 382 positions, and best serve the interests of the government in fairly and consistently administering a complex statutory scheme.

Comments that embraced a more fundamental reform of the existing regulations were not incorporated into this proposal primarily because the approaches introduced significant subjectivity. For example, one commenter suggested that, subject to an anti-abuse rule, the segregation rules should not apply to redemption transactions. Another commenter suggested that if certain stock issuances and redemptions of Small Shareholders are sufficiently related, those transactions should be treated as public trading. These suggestions were not incorporated in favor of proposals that will provide greater certainty of result to the government and to loss corporations.

2. Proposed Revisions

A. Inapplicability of the Segregation Rules to Certain Secondary Transfers

Several of the comments supported rendering the segregation rules inoperative to transfers of loss corporation stock to Small Shareholders by 5-Percent Entities or individuals who are 5-percent shareholders. These comments also supported relief

from the segregation rules for transactions in which an ownership interest in a 5-Percent Entity is transferred to a public owner or a 5-percent owner who is not a 5-percent shareholder.

The IRS and the Treasury Department agree that adoption of these exceptions is appropriate because these transactions do not introduce new capital into the loss corporation and because direct or indirect ownership of the loss corporation becomes less concentrated, thus diminishing the opportunity for loss trafficking. Furthermore, limiting the creation of additional public groups where loss trafficking is not implicated simplifies tax compliance and administration. Accordingly, these proposed regulations generally render the segregation rules inoperative to transfers of loss corporation stock to Small Shareholders by 5-Percent Entities or individuals who are 5-percent shareholders. In these cases, the stock transferred will be treated as being acquired proportionately by the public groups existing at the time of the transfer. This rule also applies to transfers of ownership interests in 5-Percent Entities to public owners and to 5-percent owners who are not 5-percent shareholders.

B. Inapplicability of the Segregation Rules to Certain Redemptions

Two of the comments supported limiting application of the segregation rules in the case of redemptions. These commenters observed that, generally, a loss corporation's redemption of its stock from Small Shareholders does not raise loss trafficking concerns because (i) the capital of the loss corporation is contracting, and (ii) Small Shareholders generally cannot traffic in losses. One comment supported a rule that would, subject to an anti-abuse rule, render the segregation rules inapplicable to all redemptions. In addition to supporting the inapplicability of the segregation rules to all

redemptions, the comment supported an objective rule for exempting redemptions based upon the mechanics of the small issuance exception.

In general, these proposed regulations adopt a rule based upon the mechanics of the small issuance exception to obviate the need for a subjective anti-abuse rule. Like the small issuance exception, this exception for redemptions exempts 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 taxable year, or 10 percent of the number of shares of the redeemed class outstanding at the beginning of the taxable year. Where this exception applies, each public group existing immediately before the redemption will be treated as redeeming its proportionate share of exempted stock.

Like the small issuance exception, the small redemption exception will allow a loss corporation to plan its affairs as of the beginning of each taxable year. Furthermore, consistent with the Purposive Approach, the exception reduces administrative burden and the section 382 impact of transactions in which the abuses that section 382 is intended to prevent are unlikely to arise.

C. Inapplicability of the Segregation Rules to 5-Percent Entities in Certain Circumstances

One commenter expressed the need for relief from tracking shifts of ownership by Small Shareholders of 5-Percent Entities. The comment expressed that, in many cases, a loss corporation cannot obtain information relating to this ownership – either because the entity chooses not to respond or because the entity is prohibited from sharing information regarding its owners with the loss corporation. The inability to obtain this information may restrict capital-raising activities beyond what section 382

requires, because the loss corporation may choose to make worst-case assumptions about shifts in ownership when the relevant information cannot be obtained. The IRS and the Treasury Department agree that it is appropriate to provide relief in situations in which tracking shifts in ownership by Small Shareholders does not further the policy objectives of section 382. Furthermore, the IRS and the Treasury Department recognize that application of the segregation rules and the exceptions thereto present compliance issues for taxpayers and issues of tax administration for the government. Accordingly, these proposed regulations limit the situations in which the segregation rules apply to situations that potentially implicate the policies underlying section 382.

Under these proposed regulations, the segregation rules will not apply to a transaction if, on a testing date on which the rules would otherwise apply (i) the 5-Percent Entity owns ten percent or less (by value) of all the outstanding stock of the loss corporation (the ownership limitation), and (ii) the 5-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). For purposes of the asset threshold, the entity's cash and cash items within the meaning of section 382(h)(3)(B)(ii) are not taken into account. Generally, the loss corporation may establish the ownership limitation through either actual knowledge or, absent actual knowledge to the contrary, the presumptions regarding stock ownership in §1.382-2T(k)(1).

The IRS and the Treasury Department believe that the proposal strikes an appropriate balance between reducing complexity and safeguarding section 382 policies. The proposal will enable loss corporations to disregard indirect changes in its ownership that may, under the current regulations, require burdensome information

gathering and may unnecessarily impede the loss corporation's ability to reorganize its affairs. At the same time, however, the proposal imposes criteria that protect the government's interests. The asset threshold makes it unlikely that the loss corporation's attributes motivate transactions in the equity of 5-Percent Entities. Additionally, like the small issuance exception and the relief for redemptions that appears elsewhere in this proposal, the ownership limitation makes it unlikely that transactions among Small Shareholders one or more tiers removed from the loss corporation implicate loss trafficking concerns. (Note that the asset threshold and the ownership limitation do not apply to the exception for secondary transfers described elsewhere in this preamble because secondary transfers do not implicate the same policy concerns as transactions in which loss corporations can obtain additional capital.)

D. Clarification of §1.382-2T(j)(3)

Section 1.382-2T(j)(3) provides that, in general, the segregation rules apply to sales of loss corporation stock by individual 5-percent shareholders and by first tier entities. This section further provides that the "principles" of the foregoing apply to "transactions in which an ownership interest in a higher tier entity that owns five percent or more of the loss corporation (without regard to §1.382-2T(h)(i)(A)) or a first tier entity is transferred to a public owner or a 5-percent owner who is not a 5-percent shareholder." This proposed regulation clarifies that the segregation rules apply to such a transfer only if the seller indirectly owns five percent or more of the loss corporation. In the case of a sale by an entity, ownership is determined without regard to §1.382-2T(h)(i)(A).

E. Small Issuance and Cash Issuance Exceptions

Several of the comments requested expansion of the small issuance and cash issuance exceptions as a percentage of stock that is exempted from the segregation rules. Some of these comments also suggested that the cash issuance exception should apply to issuances of stock for non-cash property, including debt.

As previously discussed, transactions that infuse new capital into a loss corporation are of particular concern to section 382 policies because the capital infusion can accelerate the use of tax attributes. This is the case even if the new investors are Small Shareholders. Moreover, in its current form, the cash issuance exception dilutes the owner shifts that are attributable to capital-raising transactions.

The IRS and the Treasury Department request comments as to whether further refinement of either or both of these exceptions might be warranted in the context of any potential expansion of the exceptions proposed in this document.

F. Coordinated Acquisitions

Questions have arisen concerning the application of §1.382-3(a), which provides, in part, that a group of persons making a coordinated acquisition of stock can constitute an entity for purposes of section 382. Adding additional distinctions between larger and smaller shareholders, as proposed here, will increase the significance of this provision. The IRS and the Treasury Department are interested in 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.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. The certification is based on the fact that this rule would not impose new burdens on small entities and in fact, may reduce the recordkeeping burden on small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. In addition to the specific requests for comments made elsewhere in this preamble, the IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection at www.regulations.gov or upon request. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Stephen R. Cleary of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.382-3 also issued under 26 U.S.C. 382(g)(4)(C) and 26 U.S.C. 382(m). * * *

Par. 2. Section 1.382-3 is amended as follows:

1. Adding paragraph (i).
2. Revising the heading of paragraph (j) and the introductory text of paragraph (j)(1).
3. Redesignating paragraphs (j)(13) and (j)(14) as (j)(16) and (j)(17).
4. Adding new paragraphs (j)(13) through (j)(14).
5. Adding new Examples 5, 6, 7, 8, 9, 10, 11, and 12 to newly redesignated paragraph (j)(16).
6. Revising newly redesignated paragraph (j)(17).

The revisions and additions read as follows:

§1.382-3 Definitions and rules relating to a 5-percent shareholder.

* * * * *

(i) Segregation rules applicable to transactions involving first tier or higher tier entities--(1) In general. The last sentence of §1.382-2T(j)(3)(i) applies only if the transferor of the ownership interest indirectly owns five percent or more of the loss corporation. If the transferor is an entity, ownership is determined without regard to the application of §1.382-2T(h)(2)(i)(A).

(2) Effective/Applicability date. This paragraph (i) applies to testing dates occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

(j) Modification of the segregation rules of §1.382-2T(j)(2)(iii) and (3)--(1) Introduction. This paragraph (j) exempts, in whole or in part, certain transfers of stock from the segregation rules of §1.382-2T(j)(2)(iii) and (3). Terms and nomenclature used in this paragraph (j), and not otherwise defined herein, have the same meanings as in section 382 and the regulations issued under section 382.

* * * * *

(13) Secondary transfer exception. The segregation rules of §1.382-2T(j)(3)(i) will not apply to the transfer of a direct ownership interest in the loss corporation by a first tier entity or an individual that owns five percent or more of the loss corporation to public shareholders. Instead, each public group existing at the time of the transfer will be treated under §1.382-2T(j)(3)(i) as acquiring its proportionate share of the stock exempted from the application of §1.382-2T(j)(3)(i). The segregation rules also will not apply if an ownership interest in an entity that owns five percent or more of the loss corporation (determined without regard to the application of §1.382-2T(h)(2)(i)(A)) is transferred by either a 5-percent owner that is a 5-percent shareholder or a higher tier

entity owning five percent or more of the loss corporation (determined without regard to the application of §1.382-2T(h)(2)(i)(A)), provided that the transferee is either a public owner or a 5-percent owner who is not a 5-percent shareholder. Instead, each public group of the entity existing at the time of the transfer is treated under §1.382-2T(j)(3)(i) as acquiring its proportionate share of the transferred ownership interest.

(14) Small redemption exception--(i) In general. Section 1.382-2T(j)(2)(iii)(C) does not apply to a small redemption (as defined in paragraph (j)(14)(ii) of this section), except to the extent that the total amount of stock redeemed in that redemption and all other small redemptions previously made in the same taxable year (determined in each case on redemption) exceeds the small redemption limitation. This paragraph (j)(14) does not apply to a redemption of stock that, by itself, exceeds the small redemption limitation.

(ii) Small redemption defined. Small redemption means a redemption of public shareholders by the loss corporation of an amount of stock not exceeding the small redemption limitation.

(iii) Small redemption limitation--(A) In general. For each taxable year, the loss corporation may, at its option, apply this paragraph (j)(14)--

(1) On a corporation-wide basis, in which case the small redemption limitation is 10 percent of the total value of the loss corporation's stock outstanding at the beginning of the taxable year (excluding the value of stock described in section 1504(a)(4)); or

(2) On a class-by-class basis, in which case the small redemption limitation is 10 percent of the number of shares of the class redeemed that are outstanding at the beginning of the taxable year.

(B) Class of stock defined. For purposes of this paragraph (j)(14)(iii), a class of stock includes all stock with the same material terms.

(C) Adjustments for stock splits and similar transactions. Appropriate adjustments to the number of shares of a class outstanding at the beginning of a taxable year must be made to take into account any stock split, reverse stock split, stock dividend to which section 305(a) applies, recapitalization, or similar transaction occurring during the taxable year.

(D) Exception. The loss corporation may not apply this paragraph (j)(14)(iii) on a class-by-class basis if, during the taxable year, more than one class of stock is redeemed in a single redemption (or in two or more redemptions that are treated as a single redemption under paragraph (j)(14)(v) of this section).

(E) Short taxable years. In the case of a taxable year that is less than 365 days, the small redemption limitation is reduced by multiplying it by a fraction, the numerator of which is the number of days in the taxable year, and the denominator of which is 365.

(iv) Proportionate redemption of exempted stock--(A) In general. Each direct public group that exists immediately before a redemption to which this paragraph (j)(14) applies is treated as having been redeemed of its proportionate share of the amount of stock exempted from the application of §1.382-2T(j)(2)(iii)(C) under this paragraph (j)(14).

(B) Actual knowledge of greater redemption. Under the last sentence of §1.382-2T(k)(2), the loss corporation may treat direct public groups existing immediately before a redemption to which this paragraph (j)(14) applies as having been redeemed of more stock than the amount determined under paragraph (j)(14)(iv)(A) of this section, but only

if the loss corporation actually knows that the amount redeemed from those groups in the redemption exceeds the amount so determined.

(v) Certain related redemptions. For purposes of this paragraph (j)(14), two or more redemptions (including redemptions of stock by first tier or higher tier entities) are treated as a single redemption if--

(A) The redemptions occur at approximately the same time pursuant to the same plan or arrangement; or

(B) A principal purpose of redeeming the stock in separate redemptions rather than in a single redemption is to minimize or avoid an owner shift under the rules of this paragraph (j)(14).

(vi) Certain non-stock ownership interests. As the context may require, a non-stock ownership interest in an entity other than a corporation is treated as stock for purposes of this paragraph (j)(14).

(15) Exception for first tier and higher tier entities--(i) In general. The segregation rules of §1.382-2T(j)(3)(iii) will not apply if, after taking into account the results of such transaction and all other transactions occurring on that date--

(A) The first tier or higher tier entity owns 10 percent or less (by value) of all the outstanding stock (without regard to §1.382-2(a)(3)) of the loss corporation; and

(B) The entity's direct or indirect investment in the loss corporation does not exceed 25 percent of the entity's gross assets. For this purpose, the entity's cash and cash items within the meaning of section 382(h)(3)(B)(ii) are not taken into account.

(ii) Special Rules. If paragraph (j)(15)(i) applies to combine one or more public groups, then--

(A) the amount of increase in the percentage of stock ownership of the continuing public group will be the sum of its increase and a proportionate amount of any increase by any public group that is combined with the continuing public group (the former public group); and

(B) the continuing public group's lowest percentage ownership will be the sum of its lowest percentage ownership and a proportionate amount of the former public group's lowest percentage ownership.

(iii) Ownership of the loss corporation. In making the determination under paragraph (j)(15)(i)(A) of this section--

(A) The rules of §1.382-2T(h)(2) will not apply;

(B) The entity will be treated as owning the loss corporation stock that it actually owns, and any loss corporation stock if that stock would be attributed to the entity under section 318(a) (without regard to paragraph (4) thereof unless an option is treated as exercised under §1.382-4(d)); and

(C) The operating rules of paragraph (j)(15)(iv) of this section will apply.

(iv) Operating Rules. Subject to the principles of §1.382-2T(k)(4), a loss corporation may establish the ownership limitation of paragraph (j)(15)(i)(A) of this section through either--

(A) Actual knowledge; or

(B) Absent actual knowledge to the contrary, the presumptions regarding stock ownership in §1.382-2T(k)(1).

(16) Examples. * * *

* * * * *

Example 5. Secondary transfer exception to segregation rules – no new public group. (i) Facts. L is owned 60 percent by one public group (Public L₁) and 40 percent by another public group (Public L₂). On July 1, 2010, A acquires 10 percent of L's stock over a public stock exchange. On December 31, 2010, A sells all of his L stock over a public stock exchange. No individual or entity acquires as much as five percent of L's stock as a result of A's disposition of his L stock. On January 3, 2011, B acquires 10 percent of L's stock over a public stock exchange. On June 30, 2011, B sells all of her L stock over a public stock exchange. No individual or entity acquires as much as five percent of L's stock as a result of B's disposition of her L stock.

(ii) Analysis. The dispositions of the L stock by A and B are not transactions that cause the segregation of L's direct public groups that exist immediately before the transaction (Public L₁ and Public L₂). When A and B sell their shares to public shareholders over the public stock exchange, the shares are treated as being reacquired by Public L₁ and Public L₂. As a result, Public L₁'s ownership interest is treated as increasing from 54 percent to 60 percent during the testing period, and Public L₂'s ownership interest is treated as increasing from 36 percent to 40 percent during the testing period.

Example 6. Secondary transfer exception – first tier entity. (i) Facts. L has a single class of common stock outstanding that is owned 60 percent by a direct public group (Public L) and 40 percent by P. P is owned 20 percent by Individual A and 80 percent by a direct public group (Public P). On October 6, 2013, A sells 50 percent of his interest in P to B, an individual who is a member of Public P.

(ii) Analysis. P is an entity that owns five percent or more of L. A is a 5-percent owner of P that is a 5-percent shareholder of L. Because A's sale of the P stock is to a member of Public P, the disposition of the P stock by A is not a transaction that causes the segregation of P's direct public group that exists immediately before the transaction (Public P). See paragraph (j)(13) of this section. When A sells his shares to B, the shares are treated as being acquired by Public P. As a result, Public P's ownership interest in L is treated as increasing from 32 percent to 36 percent during the testing period.

Example 7. Small redemption exception. (i) Facts. L is a calendar year taxpayer. On January 1, 2010, L has 1,060 shares of a single class of common stock outstanding, all of which are owned by a single direct public group (Public L). On July 1, 2010, L acquires 60 shares of its stock for cash. On December 31, 2010, in an unrelated redemption, L acquires 90 more shares of its stock for cash. Following each redemption, L's stock is owned entirely by public shareholders. No other changes in the ownership of L's stock occur prior to December 31, 2010.

(ii) Analysis. The July redemption is a small redemption because the number of shares redeemed (60) does not exceed 106, the small redemption limitation (10 percent of the number of common shares outstanding on January 1, 2010). Under paragraph (j)(14) of this section, the segregation rules of §1.382-2T(j)(2)(iii)(C) do not apply to the

July redemption. Under paragraph (j)(14)(iv) of this section, Public L is treated as having all 60 shares redeemed.

(iii) The December redemption is a small redemption because the number of shares redeemed (90) does not exceed 106, the small redemption limitation (10 percent of the number of common shares outstanding on January 1, 2010). However, under paragraph (j)(14)(i) of this section, only 46 of the 90 shares redeemed are exempted from the segregation rules of §1.382-2T(j)(2)(iii)(C) because the total number of shares of common stock redeemed in the July and December redemptions exceeds 106, the small redemption limitation, by 44. Accordingly, under paragraph (j)(14)(iv) of this section, Public L is treated as having 46 shares redeemed in the December redemption. Section 1.382-2T(j)(2)(iii)(C) applies to the remaining 44 shares redeemed. Accordingly, Public L is segregated into two different public groups immediately before the transaction (and thereafter) so that the redeemed interests (Public RL) are treated as part of a public group that is separate from the ownership interests that are not redeemed (Public CL). Therefore, as a result of the December redemption, Public CL's interest in L increases by 4.4 percentage points (from 95.6 percent (956/1,000) to 100 percent (910/910)) on the December 31, 2010 testing date. For purposes of determining whether an ownership change occurs on any subsequent testing date having a testing period that includes such redemption, Public CL is treated as a 5-percent shareholder whose percentage ownership interests in L increased by 4.4 percentage points as a result of the redemption.

Example 8. Segregation rules inapplicable – proportionate amount. (i) Facts. P₁ is a corporation that owns 8 percent of the stock of L. The remaining L stock (92 percent) is owned by Public L. P₁ is entirely owned by Public P₁. Excluding cash and cash items within the meaning of section 382(h)(3)(B)(ii), P₁'s investment in L represents 11 percent of P₁'s gross assets. P₂ is a corporation owned 90 percent by individual A and 10 percent by a public group (Public P₂). On May 22, 2013, P₁ merges into P₂ with the shareholders of P₁ receiving an amount of P₂ stock equal to 25 percent of the value of P₂ immediately after the reorganization. Following the merger, P₂'s investment in L represents 6 percent of the combined gross assets of P₁ and P₂ (excluding cash and cash items). L was owned 92 percent by Public L and 8 percent by P₁ throughout the testing period ending on the date of the merger.

(ii) Analysis. Assuming L can establish that P₂ owns 10 percent or less (by value) of L on May 22, 2013 pursuant to the operating rules of paragraph (j)(15)(iv) of this section, the segregation rules of §1.382-2T(j)(3)(iii) will not apply to segregate P₁'s direct public group (Public P₁) immediately before the merger from P₂'s direct public group (Public P₂). Thus, following the merger, P₂ is owned 67.5 percent (90% x 75%) by A and 32.5 percent (25% + (10% x 75%)) by Public P₂. Pursuant to paragraph (j)(15)(ii)(B) of this section, Public P₂'s lowest percentage of ownership is the sum of its lowest percentage of ownership (zero) and a proportionate amount of former Public P₁'s lowest ownership percentage of L of 2.6 percent (32.5% x 8%). P₂ will be treated as having one public group whose ownership interest in L was 2.6 percent before the merger and remains 2.6 percent after the merger. Because Public P₂ owns less than 5

percent of L, Public P₂ is treated as part of Public L. See §1.382-2T(j)(1)(iv). Thus, pursuant to paragraph (j)(15)(ii)(B) of this section, Public L's lowest ownership percentage of L during the testing period is 94.6 percent.

Example 9. Segregation rules inapplicable – prior increase in ownership by former public group during testing period. (i) Facts. The facts are the same as Example 8, except that P₁ acquired its 8 percent interest in L during the testing period that includes the merger.

(ii) Analysis. Pursuant to the rules of paragraph (j)(15)(ii)(A) of this section, the amount of increase in the percentage of stock ownership by Public P₂ is the sum of its increase and any increase by a former public group (Public P₁). Accordingly, Public P₂, the continuing public group, is treated as having increased its ownership interest by 2.6 percent, and Public L is treated as increasing its ownership interest by 2.6 percent.

Example 10. Ownership limitation based upon fair market value. (i) Facts. L has two classes of stock outstanding, common stock and preferred stock. The preferred stock is stock within the meaning of §1.382-2(a)(3). A direct public group (Public L) owns all of the common stock of L. P purchased 100 percent of the preferred stock of L at a time when the preferred stock represented 9 percent of the value of all the outstanding stock of L. The common stock owned by Public L represents the remaining 91 percent of the value of the stock of L. P has one class of common stock outstanding, all of which is owned by a direct public group (Public P). On October 7, 2013, P redeems 30 percent of its single outstanding class of common stock. Due to a decline in the relative value of the common stock of L, the preferred stock of L represents 40 percent of the value of all the outstanding stock of L on the date of the redemption.

(ii) Analysis. The rules of paragraph (j)(15) of this section do not apply to the redemption because P owns more than 10 percent of L (by value) on that date.

Example 11. Ownership limitation – fair market value includes preferred stock. The facts are the same as in Example 10, except that the preferred stock is not stock within the meaning of §1.382-2(a)(3). The results are the same as in Example 10.

Example 12. Ownership limitation – application of attribution rules. (i) Facts. Individual A owns all the outstanding stock of X. A also owns preferred stock in Y that is not stock within the meaning §1.382-2(a)(3), which represents 50 percent of the value of Y. All the Y common stock is owned by public owners. Each of X and Y own 6 percent of the single class of L stock outstanding. On October 6, 2013, Y redeems 15 percent of its common stock.

(ii) Analysis. In determining the ownership limitation of this paragraph, the attribution rules of section 318(a) apply. Pursuant to section 318(a)(2), A is treated as owning the L stock owned by X. Pursuant to section 318(a)(3), Y is treated as owning the L stock that A indirectly owns. Because Y's ownership of L exceeds the ownership

limitation, the rules of paragraph (j)(15) of this section do not apply.

(17) Effective/applicability date. This paragraph (j) generally applies to issuances or deemed issuances of stock in taxable years beginning on or after November 4, 1992. However, paragraphs (j)(13) through (j)(15) and Examples 5 through 12 of paragraph (j)(16) apply to testing dates occurring on or after the date these regulations are published as final regulations in the **Federal Register**. See §1.382-3(j)(14)(ii) and (iii), as contained in 26 CFR part 1 revised as of April 1, 1994, for the application of paragraph (j)(10) to stock issued on the exercise of certain options exercised on or after November 4, 1992 and for an election to apply paragraphs (j)(1) through (12) retroactively to certain issuances and deemed issuances of stock occurring in taxable years prior to November 4, 1992.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2011-30290 Filed 11/22/2011 at 8:45 am; Publication Date: 11/23/2011]