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Part III - Administrative, Procedural, and Miscellaneous

SECTION 382(l)(3)(C)

Notice 2010-50

This notice provides guidance under § 382 of the Internal Revenue Code for measuring owner shifts of loss corporations that have more than one class of stock outstanding, and, in particular, regarding the effect of fluctuations in the value of one class of stock relative to another class of stock (fluctuations in value). It provides interim guidance to the effect that the Internal Revenue Service (IRS) will accept certain methodologies for taking into account or not taking into account fluctuations in value, and identifies one methodology that the IRS views as inconsistent with § 382(l)(3)(C). It also requests comments to assist in the development of future guidance. Any terms and definitions used in this notice have the same meaning as they do in § 382 and the § 382 regulations unless otherwise provided in this notice.

I. Background

A. Overview of § 382(l)(3)(C)

Many of the critical determinations under § 382 depend upon the value of the stock owned by a particular shareholder. For example, whether an ownership change under § 382(g) occurs depends upon whether one or more 5-percent shareholders have increased their ownership in the loss corporation by more than 50 percentage points. Such ownership determinations are by reference to value; i.e., the relative fair market value of the stock owned to the total fair market value of the corporation's outstanding stock. See § 1.382-2(a)(3)(i) of the Income Tax Regulations.

Section 382(l)(3)(C) provides that, except as provided in regulations, any change in proportionate ownership of the stock of a loss corporation attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account. The regulations under § 382 do not provide any specific guidance on § 382(l)(3)(C). Instead, § 1.382-2T(l) sets forth a heading and a reservation: "*Changes in Percentage Ownership which are attributable to fluctuations in value.*— [Reserved.]"

The Treasury Department (Treasury) and the IRS are aware that taxpayers employ a number of different methodologies in interpreting and applying § 382(l)(3)(C).

For example, some taxpayers have interpreted more general provisions of the regulations to require the valuation of all outstanding shares of stock of a corporation on every testing date. See §§ 1.382-2(a)(3)(i) and 1.382-2T(c)(1). Under this interpretation, the effect of § 382(l)(3)(C) is limited to ensuring that a testing date does not occur solely by virtue of a fluctuation in the relative values of different share classes. For purposes of this notice, such a valuation of all shares on every testing date is referred to as a "Full Value Methodology." Other taxpayers have interpreted § 382(l)(3)(C) more broadly, factoring out fluctuations in value on a testing date based upon relative value ratios among different classes of stock established at the time a particular share of stock was acquired. There are variations in the methods that apply this view, described in more detail below, but the essential principle upon which the broader interpretation is based is that, as to a particular share, value ratios between and among various classes of stock are fixed, or "held constant," on the date a particular share is acquired (hereafter, the "Hold Constant Principle," or "HCP"). The remainder of this section describes the government's understanding of the Full Value Methodology, the Hold Constant Principle, and two methodologies that implement the HCP.

B. Full Value Methodology

Under a Full Value Methodology, the determination of the percentage of stock owned by any person is made on the basis of the relative fair market value of the stock owned by such person to the total fair market value of the outstanding stock of the corporation. Thus, changes in percentage ownership as a result of fluctuations in value are taken into account if a testing date occurs, regardless of whether a particular shareholder actively participates or is otherwise party to the transaction that causes the testing date to occur; essentially, all shares are "marked to market" on each testing date.

> Example 1. Upon formation, corporation X issues $20 of convertible preferred stock to A and issues two shares of common stock to B for $80, such that A and B own 20 percent and 80 percent, respectively, of X. The fortunes of X deteriorate, and, two years later, when the common stock has a value of $2.50 per share and the preferred stock has a value of $20, B sells one share of common stock to C. At the time of B's sale to C, X is a loss corporation. On that testing date, A will be treated as increasing its proportionate interest from 20 percent to 80 percent ($20/$25) under the Full Value Methodology as a result of the upward fluctuation in value of the preferred stock relative to the common stock.

As Example 1 illustrates, an ownership change under § 382 would occur as a consequence of the sale of stock worth 10% of the loss corporation's value because a stake originally representing 20% of the corporation's value has fluctuated upward to 80% on the testing date, for a cumulative shift of 70 percentage points. The Full Value Methodology is a narrow interpretation of § 382(l)(3)(C), but it may be viewed as giving effect to the statutory language by not requiring value marks more frequently than each

testing date (e.g., daily fluctuations in value between various classes are ignored, where such fluctuations occur between testing dates).

C. Hold Constant Principle

Broadly stated, under the Hold Constant Principle, the value of a share, relative to the value of all other stock of the corporation, is established on the date that share is acquired by a particular shareholder. On subsequent testing dates, the percentage interest represented by that share (the "tested share") is then determined by factoring out fluctuations in the relative values of the loss corporation's share classes that have occurred since the acquisition date of the tested share. Thus, as applied, the HCP is individualized for each acquisition of stock by each shareholder. Moreover, the ownership interest represented by a tested share is adjusted for the dilutive effects of subsequent issuances and the accretive effects of subsequent redemptions following the tested share's acquisition date.

> Example 2. Upon formation, corporation X issues $20 of convertible preferred stock to A and issues two shares of common stock to B for $80, such that A and B own 20 percent and 80 percent, respectively, of X. The fortunes of X deteriorate, and, two years later, when the common stock has a value of $2.50 per share and the preferred stock has a value of $20, B sells one share of common stock to C. At the time of B's sale to C, X is a loss corporation. On that testing date, although A actually owns 80% of the value of X, A will be treated as owning 20% of the value of X for purposes of § 382(g), under the Hold Constant Principle.

As Example 2 illustrates, A would still be treated as owning 20 percent of X on the testing date because the HCP hypothesizes that (for purposes of determining A's percentage ownership) the common stock and the preferred stock maintain the relative values that existed on the acquisition date of the tested share (here, each share held by A). The only share that is "marked" to value is the one share acquired by C, representing only 10% of the corporation's equity value on the date of acquisition. Thus, no ownership change under § 382 would occur as a consequence of the acquisition of that share by C. The Hold Constant Principle may thus be viewed as giving effect to the statutory language of § 382(l)(3)(C) by factoring out fluctuations in the value of stock held by passive shareholders across multiple testing dates. The "factoring out" process generally continues for a particular share until the holder is no longer treated as owning the tested share for § 382 purposes (e.g., the holder engages in affirmative activity such as a taxable sale). What follows is a description of two methodologies that implement the HCP.

1. Alternative Methodology 1: Look Back from Testing Date

One methodology for implementing the Hold Constant Principle is to recalculate the hold constant percentage represented by a tested share to factor out changes in its relative value since the share's acquisition date (hereafter, "Alternative 1"). This

methodology was described by a commentator in 2005. *See generally* Mark R. Hoffenberg, Owner Shifts and Fluctuations in Value: A Theory of Relativity, 106 Tax Notes 1446 (March 21, 2005). Generally, this methodology calculates the percentage interest represented by a tested share on a testing date, beginning with the value of the tested share on the testing date, and then making adjustments based on the changes in relative value of the tested share to the value of all the stock of the loss corporation that have occurred since the tested share's acquisition date.

2. Alternative Methodology 2: Ongoing Adjustments from Acquisition Date

The second methodology for implementing the HCP tracks the percentage interest represented by a tested share from the date of acquisition forward, adjusting for subsequent dispositions and for the subsequent issuance or redemption of other stock (hereafter, "Alternative 2"). Generally, the increase in percentage ownership represented by the acquisition of a tested share during the testing period is established on the date the tested share is acquired. This increase is reduced (but not below zero) for subsequent dispositions of shares by the owner. To the extent the particular shareholder is not engaging in acquisitions or dispositions, the percentage ownership calculation "rolls over" from one testing date to another. Whereas under Alternative 1, the loss corporation generally determines the relative value of shares of its stock at the beginning of the testing period, or an earlier date, this may not be necessary under Alternative 2. Thus, Alternative 2 may involve fewer calculations on a particular testing date than Alternative 1.

3. Common Elements of Both HCP Methodologies

a. Acquisitions

Under either Alternative 1 or Alternative 2, the loss corporation determines, on each testing date during a testing period, the value of a tested share acquired on that testing date as compared to the value of all the stock of the loss corporation on that date (i.e., neither alternative factors out value fluctuations for actual acquisitions).

b. Dispositions and sourcing

Under either of the HCP alternative methodologies, a shareholder's increase in proportionate interest during a testing period will be reduced by share dispositions. The government is aware of at least two methods to account for dispositions in such cases. One method may account for the effect of a share disposition based upon the percentage ownership that the sold share represents on the date of its disposition (as opposed to the percentage represented by that share on its acquisition date) (a "fair market value approach"). Another method may account for the effect of a share disposition based upon the percentage ownership that the sold share represented on another testing date during the testing period upon which the selling shareholder acquired shares. As one example, if the shares disposed of are being offset against shares of another class acquired during the testing period, the percentage offset could

be determined as of the date the other class was acquired (a "share equivalent approach"). The results obtained would be as if sold shares were converted into a share-equivalent number of shares of the acquired class.

> Example 3. A purchases 10 shares of X's common stock for $10 on testing date 1, when each share of common stock represents one percent of X. X is a loss corporation. On testing date 1, A also holds 2 shares of participating preferred stock, with each share valued at $2 and each preferred share representing 2 percent of X. On testing date 2, A disposes of one share of the preferred stock. Under a share-equivalent approach, A may be considered to have disposed of two shares of common stock, which is the common share equivalent of one share of preferred stock as determined on the acquisition date of the common stock.

If a taxpayer determines the effect of a share disposition based upon the percentage represented by the sold share on the share's acquisition date, under either of the two methodologies, the taxpayer must also determine the source of shares disposed of where a 5-percent shareholder has had multiple acquisitions and dispositions of loss corporation stock. For example, tested shares of a single class likely will represent different percentages of a loss corporation depending upon when the tested shares were acquired. In these cases, taxpayers may treat sold shares as being sourced pro rata from all acquisitions, as being sourced first from the most recent acquisition ("LIFO"), or as being sourced first from the first acquisition ("FIFO").

c. Redemptions and issuances

Section 382 takes into account not only trading in loss corporation shares, but also the redemptions and issuances of shares, for purposes of tracking changes in percentage ownership by 5-percent shareholders. For this purpose, a redemption may be analogized to a pro-rata acquisition by non-redeeming shareholders of the redeemed shares, while an issuance may be analogized to a pro-rata sale of shares by shareholders holding stock immediately before the issuance to those shareholders acquiring shares in the issuance. There are a variety of possible approaches in applying the HCP to stock redemptions and issuances.

In a redemption, § 382 views the remaining shareholders as having acquired a greater interest in the corporation with respect to their shares held immediately after the redemption. Applying the HCP, the size of this acquisition for each shareholder could be determined either by reference to current values at the time of the redemption or relative values in effect when the non-redeemed shareholders established their positions.

In an issuance, § 382 views the interest in the corporation held by pre-existing shareholders with respect to their preexisting shares as being reduced. In applying the HCP, the effect of the issuance on preexisting shares, could also be determined by reference to current or relative historical values.

Whether current or historical values are used in determining the effect of subsequent redemptions or issuances can make a substantial difference in the amount of the owner shifts determined for 5-percent shareholders. Moreover, even if historical values are used, the use of one HCP alternative versus another can produce differing results. *See generally* NYSBA Tax Section, Report on the Treatment of Fluctuations in Value under Section 382(l)(3)(C), Dec. 22, 2009, reprinted in 2009 TNT 245-16 (Example 5 in the report).

Finally, §§ 1.382-3(j)(3) and (5) contain a special rule for determining the effects of certain cash issuances. Sections 1.382-3(j)(2) and (5) contain a special rule for determining the effect of certain small issuances. The issues discussed in this notice are relevant in determining the amount of exempted stock under the cash issuance rule, and the allocation of exempted stock among direct public groups under both rules.

d. Non-disposition transactions

For purposes of applying a method based on the HCP, an owner of loss corporation stock is not treated as disposing of or acquiring loss corporation stock to the extent the owner remains treated as an owner of the loss corporation, or its successor, under § 382 and the regulations thereunder. See generally § 1.382-2T(h)(2) (relating to constructive stock ownership); § 1.382-2T(f)(18)(iv) (stock of the loss corporation, as the context may require, includes any indirect interest in the loss corporation); § 1.382-2T(j)(2)(iii)(B)(*1*)(*i*) (relating to equity structure shifts). In these cases, the original acquisition date and other hold constant characteristics are preserved. Thus, for example, if a shareholder exchanges loss corporation stock for other loss corporation stock in a value-for-value recapitalization, the stock received in the exchange would retain the same hold-constant characteristics as the surrendered shares. This principle also applies to reorganizations described in § 1.382-2T(j)(2)(iii)(B)(*1*)(*i*) and holding company formations.

II. Guidance

Because of the complexity of the issues involved in measuring owner shifts of loss corporation stock where fluctuations in value are present, the IRS and Treasury have determined that it is appropriate to accept taxpayers' reasonable attempts to measure increases in ownership where fluctuations in value are present. Accordingly, the IRS will not challenge any reasonable application of either a Full Value Methodology or the HCP, provided that a single methodology (as described below) is applied consistently to the extent required in this Notice. The IRS and Treasury believe that each of the HCP alternative methodologies discussed in section I above—including the common elements of both for dealing with various transactions such as issuances and redemptions—are reasonable applications of the HCP.

Taxpayers may rely on the guidance provided in this notice until such time as the IRS and Treasury issue additional guidance under § 382(l)(3)(C).

A. **Acquisitions**

All reasonable applications of either the Full Value Methodology or the HCP must determine the increase in ownership represented by the acquisition of a share of stock by dividing the fair market value of that share on the acquisition date by the fair market value of all of the outstanding stock of the loss corporation on that date. For this purpose, an acquisition does not include a deemed acquisition of stock by non-redeeming shareholders resulting from a redemption. In addition, under a HCP methodology, an acquisition is not an event upon which the acquiring shareholder marks to fair market value other shares that it holds.

However, the IRS and Treasury view any alternative treatment of an acquisition as inconsistent with § 382(l)(3)(C). For example, the IRS intends to challenge a methodology that fixes the relative fair market value of a class of preferred stock to common stock on the issue date of the preferred stock, regardless of the actual value of either class on the subsequent date that a shareholder whose percentage ownership is being computed acquires a share of either such class of stock.

B. **Consistency**

In general, a taxpayer may employ any methodology that is a reasonable application of either a Full Value Methodology or the HCP in determining when an ownership change has occurred. For prior years, a taxpayer may change its methodology by amending returns. However, a taxpayer must generally employ a single methodology consistently to all testing dates in a "consistency period." With respect to a particular testing date (the "current testing date"), the consistency period includes all prior testing dates, beginning with the latest of--

(1) the first date on which the taxpayer had more than one class of stock;
(2) the first day following an ownership change; or
(3) the date six years before the current testing date.

In some cases, a methodology implementing the HCP may treat as the acquisition date for a tested share a date that is later than the date the share was actually acquired. The issuance of a second class of stock generally establishes the acquisition date for the preexisting class as well as the second class. Moreover, taxpayers may substitute certain other dates, if later, for the date shares were acquired, such as, if used consistently: May 6, 1986; January 1, 1987; or the beginning of the testing period.

C. **Closed Years**

Notwithstanding the foregoing, a taxpayer may not employ a methodology in a year not barred by the statute of limitations (an "open year") if using that methodology would have changed the taxpayer's Federal income tax liability for a year barred by the

statute of limitations (a "closed year") in the consistency period, unless the position taken in the closed year is not consistent with any reasonable methodology. A taxpayer taking a position in a closed year that is not consistent with any reasonable methodology may adopt any single methodology that is a reasonable application of either the Full Value Methodology or the HCP, regardless of whether use of that methodology would have changed its liability in a closed year, provided that the adopted methodology is applied consistently to the greatest extent permitted by the statute of limitations.

The effect of the consistency period rule is that a taxpayer generally is free to adopt any reasonable methodology as long any inconsistent returns in the consistency period can be and are amended. In addition, there is no necessary correlation between the start of a consistency period, which governs the taxpayer's choice of methodology, and the acquisition date for shares of stock, which is an element of HCP methodologies.

D. Single Methodology

For purposes of this Notice, a "single methodology" means a methodology that applies a consistent treatment to a given situation, even on different testing dates (e.g., applying a LIFO convention for all share disposition sourcing determinations if using an HCP alternative). A single HCP methodology might treat the accretive effect of redemptions differently from other acquisitions but should not treat the dilutive effect of issuances differently from other dispositions. To determine the amount of exempted stock pursuant to the cash issuance exception of § 1.382-3(j)(3), a taxpayer using an HCP methodology may either use the hold constant percentages determined for its direct public groups under its methodology or the percentages determined based upon current values. Allocations of exempted stock under § 1.382-3(j)(5) (relating to the small issuance and cash issuance exceptions) should be determined under that same methodology.

III. Request for Comments

The IRS and Treasury plan to issue proposed or temporary regulations on the application of § 382(l)(3)(C) in fluctuation in value situations, and request comments on that subject, including the issues addressed in this notice.

A. Threshold Question

The threshold question is whether interpreting § 382(l)(3)(C) broadly to require rules for factoring out fluctuations in value, such as may be done through methodologies employing the HCP, is appropriate in light of the purposes of § 382 and administratively viable.

The primary purpose of § 382's loss limitation rules is to preserve the integrity of the carryover provisions. The carryover provisions perform a needed averaging function by reducing distortions caused by the annual accounting system. If carryovers

can be transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. The loss limitation rules of § 382 generally apply when shareholders who bore the economic burden of a corporation's pre-change loss no longer hold a controlling interest in the corporation. In such a case, the possibility arises that new shareholders will contribute income producing assets (or divert income producing opportunities) to the loss corporation, resulting in a greater utilization of the loss corporation's pre-change losses than would have been the case had there been no ownership change. *See* Staff of the Joint Comm. on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 288 (Comm. Print 1987).

The application of the HCP could result in the avoidance of an ownership change, even though the shareholders who did not bear the economic burden of the loss corporation's pre-change loss have assumed a controlling interest in the loss corporation. Consider, for example, a case in which the value of a loss corporation's common stock declines steeply in relation to the relative value of its voting preferred stock, permitting preferred shareholders who bought in with a 10 percent interest (by value) to obtain a 90 percent interest (by value), while being "held constant" at 10 percent. In such a case, arguably, there is the heightened possibility that a pre-change loss could be offset against unrelated income. For example, the preferred shareholders could enhance their controlling position by causing a recapitalization in which they obtain the majority of the common stock and, thereby, a significantly greater potential to participate in the growth of the company. Thereafter, they could contribute income producing assets (or built-in gain assets) to the loss corporation in order to offset resulting income (or gain recognized) against the corporation's loss attributes (provided the value of the stock issued in exchange for the contributed assets was insufficient to cause an ownership change). A similar opportunity to avoid the application of § 382 could present itself to shareholders who bought the common stock when it represented 10 percent of the value of the loss corporation, followed by a large upward fluctuation in its relative value.

On the other hand, arguably Congress enacted § 382(l)(3)(C) because it did not view owner shifts and possibly ownership changes attributable to valuation changes with as much policy concern as it viewed acquisitions. By limiting the operation of the statute to testing dates, Congress may have expressed a greater tolerance for shifts in corporate ownership that would have occurred even in the absence of events giving rise to a testing date. In a period of broad-based economic growth, where all other factors are equal, it can be expected that common stock will increase in value relative to preferred stock, which effect alone could result in owner shifts and possibly ownership changes. The converse result can be expected in a period of broad-based economic contraction. Arguably, in most of such cases, the shareholders considered to have acquired a greater percentage of the loss corporation's stock do not thereby have a greater incentive to contribute income producing assets to the loss corporation. The IRS and Treasury appreciate any comments on this threshold question.

B. **Possible Application of the HCP**

Part II of this notice permits broad application of the HCP until such time as future guidance is provided. If application of the HCP is to be required or permitted in future guidance, comments are requested as to whether to continue to permit the use of a range of methodologies to implement the HCP (and, if so, how broad a range) or to require that a particular HCP methodology (or methodologies) be used. The IRS and Treasury would appreciate any comments regarding which methodology or methodologies best implement the HCP from the standpoint of theory, practicality, and administrability.

Under an alternative approach, the HCP could be applied only in limited circumstances, such as to protect a loss corporation's ability, in the event of bankruptcy, to make use of the special provisions of §§ 382(l)(5) and (6). The IRS and Treasury request comments on whether it would be appropriate to limit the HCP to special circumstances and how the HCP might be applied in those situations.

Comments are also requested as to the appropriate methodologies for dealing with—(i) the deemed acquisition by non-redeeming shareholders occurring as a result of a redemption, (ii) the deemed disposition by preexisting shareholders occurring as a result of the issuance of other shares, (iii) the amount of stock exempt under the cash issuance exception of § 1.382-3(j)(3), and (iv) the allocation of exempt stock to direct public groups under the cash and small issuance exceptions of § 1.382-3(j)(5). Comments are requested as to the extent to which appropriate methodologies applied to the above enumerated items ought to be applied consistently to said items.

C. **<u>Instructions</u>**

Comments should include a reference to Notice 2010-50 Send submissions to Internal Revenue Service, Attn: CC:PA:LPD:PR Room 5203 (Notice 2010-50), P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044 or hand-deliver comments Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to Courier's Desk, Attn: CC:PA:LPD:PR Room 5203 (Notice 2010-50), Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, comments may be sent electronically via the following email address: Notice.Comments@irscounsel.treas.gov. Please include the notice number 2010-50 in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

The principal author of this notice is Keith E. Stanley of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Mr. Stanley at 202-622-7700 (not a toll-free number).