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SECTION 382
FLUCTUATION IN VALUE

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Mark J. Silverman
Steptoe & Johnson LLP
Washington, D.C.

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Section 382(l)(3)(C) provides that, in the absence of regulations stating otherwise, changes in the ownership of a corporation attributable solely to fluctuations in the relative value of the different classes of stock shall not be taken into account in the ownership change calculation. To date, the regulations promulgated under section 382 have reserved this issue.

I. Notice 2010-50

Recently, in Notice 2010-50, the IRS and Treasury addressed different methodologies used by taxpayers to address the application of section 382(l)(3)(C). The notice stated that the IRS and Treasury are aware that taxpayers employ a number of different methodologies in interpreting and applying section 382(l)(3)(C) and stated that until further guidance is issued, the IRS will accept either of two methodologies as reasonable approaches to the application of the statute.

The two methodologies addressed in the notice are (i) the "Full Value Methodology" and the "Hold Constant Principle." Under the Full Value Methodology, the effect of section 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. Other taxpayers, however, have interpreted section 382(l)(3)(C) more broadly and apply a methodology that factors 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. The essential principle of

this methodology is that, as to a particular share, the value ratios between and among various classes of stock are fixed, or "held constant" on the date a particular share is acquired. For this reason, this approach is referred to as the "Hold Constant Principle." Notice 2010-50 provides that the IRS will accept either of these two approaches as a reasonable application of section 382(l)(3)(C), provided that a single methodology is applied consistently.

A. Full Value Methodology

Under the Full Value Methodology, once there is a testing date, then the changes in percentage ownership as a result of fluctuations in value are taken into account, regardless of whether a particular shareholder actively participates in or is otherwise party to the transaction that causes the testing date to occur.

> 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 year 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 ($20/$100) 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.

In Example 1 above, using the Full Value Methodology, an ownership change occurs, even though B's ownership of the preferred stock remains the same. B's ownership originally represented 20% of the value of X, but has fluctuated upward to 80% on the testing date. Therefore it has increased 60 percentage points and an ownership change has occurred.

B. The Hold Constant Principle

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. Accordingly, the Hold Constant Principle is individualized for each acquisition of stock by each shareholder. In addition, the ownership interest represented by a tested share is adjusted for subsequent issuances and 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 section 382(g), under the Hold Constant Principle.

In Example 2, A is still treated as owning 20 percent of X on the testing date under the Hold Constant Principle because under that approach the common stock and the preferred stock maintain the relative values that existed on the acquisition date of the tested share. The only share that is "marked to market" at fair market value on the testing date is the one share acquired by C, which represents only 10% of the corporation's equity value on the testing date. Thus, under the Hold Constant Principle, no ownership change would occur as a result of the acquisition by C.

Notice 2010-50 described two alternative methodologies for implementing the Hold Constant Principle.

1. <u>Alternative Hold Constant Methodology 1: Look Back from Testing Date</u>

The first alternative methodology to implement the Hold Constant Principle described in the notice 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.[1] The 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 Hold Constant Methodology 2: Ongoing Adjustments from Acquisition Date

The second alternative methodology to implement the Hold Constant Principle described in the notice is to track the percentage interest represented by a tested share from the date of acquisition forward, making adjustments for subsequent dispositions and for the subsequent issuance or redemption of other stock. Under this method, 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. The increase is then reduced for subsequent dispositions of shares by the owner. If the shareholder does not engage in any acquisitions or dispositions, the percentage ownership calculation "rolls over" from one testing date to another.

3. Common Elements of Both Alternative Methodologies

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 testing date. In other words, neither Alternative 1 nor Alternative 2 factors out fluctuations in value as a result of actual acquisitions. In addition, under both alternative methodologies, a shareholder's increase in proportion interest during a testing period is reduced by share dispositions. The method for

[1] The notice references Mark R. Hoffenberg, Owners Shifts and Fluctuations in Value: A Theory of Relativity, 106 Tax Notes 1446 (March 21, 2005).

accounting for dispositions may vary. One method accounts for the effect of a share disposition based upon the percentage ownership that the disposed share represents on the date of its disposition (as opposed to the percentage represented by that share on its acquisition date). The notice describes this method as a "fair market value approach." Another method accounts for the effect of a disposition based upon the percentage ownership that the disposed share represents on another testing date during the testing period upon which the shareholder acquired shares. The notice describes this method as a "share equivalent approach." This approach determines the results that would be obtained as if the disposed 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 the share equivalent approach, A would 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 there have been multiple acquisitions and dispositions, then the taxpayer must also determine the source of shares in order to apply this method because tested shares of a single class likely will represent different percentages of a loss corporation depending upon when the tested shares were acquired. The notice states that 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, or as being soured first from the first acquisition.

The notice also addresses redemptions and issuances. In a redemption, the remaining shareholders are viewed as having acquired a greater interest in the corporation with respect to their shares. The notice states that to apply the Hold Constant Principle, the size of this resulting acquisition could be determined by reference to current values at the time of the redemption or

relative values in effect when the non-redeemed shareholders established their positions. Conversely, an issuance is viewed as reducing the interests in the corporation held by preexisting shareholders with respect to their preexisting shares. The notice states that the effect of the issuance on preexisting shares could also be determined by reference to current or relative historical values. The notice acknowledges that 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 and that even if historical values are used, the use of one methodology of implementing the Hold Constant Principle compared to another can produce different results.

The notice also addresses the application of the Hold Constant Principle to nondisposition transactions. The notice states that for purposes of applying a method based on the Hold Constant Principle, an owner of loss corporation stock is not treated as disposing or acquiring loss corporation stock to the extent the owner remains treated as an owner of the loss corporation, or its successor. In such case, under the Hold Constant Principle the original acquisition date and other hold constant characteristics are preserved. 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. The notice states that this principle also applies to reorganizations described in Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(1)(i) (reorganizations to which section 381(a)(2) applies) and holding company formations.

C. Consistent Application of Single Methodology

The notice states that until additional guidance is issued under Section 382(l)(3)(C), the IRS will not challenge any reasonable application of either a Full Value Methodology or the Hold Constant Principle in determining whether an ownership change has occurred, provided

that a single methodology is applied consistently. The notice requires a taxpayer to generally employ a single methodology consistently to all testing dates in a "consistency period." Under the notice, with respect to a particular testing date (the "current testing date"), the "consistency period" includes all prior testing dates beginning with the latest of: (i) 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. The notice defines a "single methodology" as a methodology that applies a consistent treatment to a given situation, even on different testing dates. As an example, the notice states that a single Hold Constant Principle methodology might treat the accretive effect of redemptions differently from acquisitions (because they are different situations), but a single methodology should not treat the dilutive effect of issuances differently from other dispositions. If relative historical values are used to evaluate one issuance, then relative historical values, not current values, should be used to evaluate other issuances in the consistency period.

The notice provides that a taxpayer may change its methodology by amending returns, but subject to certain limitations with respect to the effect on closed years. Under the notice, a taxpayer may not employ a methodology in an open year if using that methodology would have changed the taxpayer's Federal income tax liability for a closed year in the consistency period, unless the position taken in the closed year is not consistent with any reasonable methodology. In the later circumstance, the notice allows a taxpayer to adopt any single methodology that is a reasonable application of either the Full Value Methodology or the Hold Constant Principle, 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. As a result of these rules, a taxpayer generally is free to adopt any

reasonable methodology as long as any inconsistent returns in the consistency period can be and are amended.

D. Difficulty of Selecting One Methodology

On April 29, 2011, Bill Alexander, IRS Associate Chief Counsel (Corporate), indicated that the IRS has not yet determined which of the methodologies detailed in Notice 2010-50 may be the best. Moreover, he questioned whether, given the difficult logistics of now implementing a single methodology for all taxpayers, it would ever be a possibility, let alone a worthwhile possibility, for the IRS to select a single methodology applicable to all taxpayers. See Amy Elliott, No Easy Way to Pick a Right Value Fluctuation Calculation Method, IRS Official Says, 2011 TNT 84-6 (May 2, 2011).

II. Application of Fluctuation in Value Rule by IRS in Private Letter Rulings

Recently, the IRS has issued several private letter rulings permitting taxpayers to employ the Hold Constant Principle. See PLR 200901001, PLR 20100009, PLR 201001017, PLR 201015023, PLR 201017002, PLR 201017003, PLR 201017004, PLR 201027030, PLR 201032032, 201043019, 201039013. The IRS has previously addressed the application of section 382(l)(3)(C) in several other private letter rulings. See PLR 200411012, PLR 200511008, PLR 200520011, PLR200622011. In each of these PLRs, with respect to fluctuations in the value of a class of stock, the IRS stated that the value of shares within a class of stock relative to all other stock outstanding would be considered to remain constant for purposes of the ownership change calculation. In addition, the PLRs stated the value of such shareholder's stock relative to the value of all other stock of the corporation issued subsequent to such acquisition date shall also be considered to remain constant since that subsequent date.

III. Examples

The examples set forth below focus only on the impact of stock value fluctuations on the ownership change calculation. Each class of stock in the examples is presumed to count for section 382 purposes. The problem becomes quite complex if the possibility of disregarding stock as "stock" is factored into the analysis.

1. On 1/1/88, individual A and individual B form loss corporation L. A contributes $80 to L in exchange for all of the L common stock. B contributes $20 to L in exchange for all of the voting preferred stock of L. There are no other classes of stock outstanding. L obtains a loan from a third party lender to complete its initial capitalization. Assume that initially A's common stock and B's preferred stock represent 80% and 20%, respectively, of the voting power and value of L.

    a. Subsequent to the formation of L, significant losses are incurred, and the value of L drops to $25. Assume that, because the continued viability of L is in considerable doubt, the valuation of the common and preferred stock is based on liquidation values. Thus, the preferred stock represents 80% of the value of L (20/25) and the Common stock represents 20% of the value of L (5/25).

    b. Suppose A transfers all of his common stock to individual C for $5. Does an ownership change occur?

        (1) Technically, it appears so. B alone has increased his interest in L by 60 points. C has increased his interest 20 points. This result obtains even

though B did not transfer any stock and, presumably, could not prevent A from transferring his common stock.

(2) As a policy matter, triggering an ownership change in these circumstances seems unduly harsh. Even though B's percentage interest has increased, his interest economically remains the same. B's percentage interest increased strictly because of the loss in value of A's common stock.

(3) Moreover, the threat of an ownership change would chill any attempt by the loss corporation to restructure its capital. Any transfer of stock -- to creditors or otherwise -- would trigger section 382. To avoid section 382, stock ownership would have to be frozen until the value of the corporation improved to the point where an ownership change would not result. Efforts to rehabilitate the loss corporation should not be paralyzed in this manner.

c. On these facts, a better approach may be to report the transfer by A as only a 20% shift in ownership.

(1) In other words, B's percentage increase attributable to fluctuations in value would be ignored.

(2) Only the changes in percentage interest that are attributable to actual transfers or owner shifts would be counted. This would comport with the policy of section 382 to prevent trafficking in loss carryovers.

(3) Under Notice 2010-50, either approach is permissible if applied consistently. Under the Full Value Methodology, there will be an ownership change in this example. Under the Hold Constant Principle, there will not be an ownership change. The IRS position in the PLRs further supports the Hold Constant Principle approach

2. Same as example 1, except that A waits until the value of L drops to $10 before he transfers his interest to C. (C pays only nominal consideration for the shares.) Thus, if L were liquidated on the date of A's transfer, B would not recover the full amount of his original investment ($20).

a. A, in effect, has transferred a worthless interest. Arguably, the transfer does not constitute an owner shift since it does not affect the percentage interest of either A, B or C. A and C each own 0% before and after the transfer.

b. However, assuming that there must be some value in the common stock for C to acquire the interest (even if only to speculate in the possible future profitability of L), the transfer would constitute an owner shift. Given this, would an ownership change then result?

(1) B's preferred stock interest now represents close to 100% of the value of L. Consequently, B's percentage interest increased by almost 80 points during the testing period.

(2) If an ownership change results, it will occur even though, economically, B has lost value in his investment. In other words, B's percentage interest is not indicative of his actual economic position.

c. Thus, as in example 1, it seems inappropriate to impose section 382 on L and its shareholders in these circumstances.

d. Under the Full Value Methodology in Notice 2010-50, there would be an ownership change in this example. Under the Hold Constant Principle, there would not be an ownership change. As explained above, Notice 2010-50 indicates that the IRS will accept either approach as reasonable, as long as the approach is applied consistently.

3. Same as example 2, except that following the acquisition of A's common stock, C either contributes business assets or diverts income-producing opportunities to L. As a result, L's income stream and value both increase.

a. If C immediately contributes assets to L, L's value would increase, the increase in value could be reflected as a change in percentage interests of the C shareholder (<u>i.e.</u>, an owner shift). Section 382 could be applied at this point.

b. If no ownership change occurs either as a result of A's transfer of stock to C or C's transfer of assets to L, C arguably would be free to make such contributions to L and have L's losses offset any income generated by the contributed assets.

(1) Would it matter if C contributed assets or income opportunities to L which were germane to L's business? For example, what if L were in the steel business and C contributed steel manufacturing contracts to L?

(2) This case seems less like trafficking in losses than if C contributed totally unrelated business assets to L. Cf. Old section 382(a)(1)(C).

(3) C may be attempting to rehabilitate L, a cause which would be hampered if section 382 were imposed.

c. As a practical matter though, C may not be willing to contribute assets or income opportunities (e.g., supply contracts) to L, inasmuch as such assets will redound to the benefit of B to the extent of the liquidation preference inherent in B's preferred stock.

d. Even though the transfer by A to C has potential for abuse, section 269 would appear to be the more appropriate weapon to combat an actual abuse. (Here, C would own 80% of the voting power of L and would thus control L within the meaning of section 269.)

(1) The "principal purpose" standard of section 269 seems more suited to dealing with cases where C has no intent to rehabilitate the loss corporation but is interested instead in the loss corporation's tax attributes.

(2) Note also that section 269 would disallow L's losses completely, a result more strict than section 382.

4. Same facts as example 1, except that as of the time when L is valued at $25, L grants options and stock appreciation rights (to any extent) to management. As a result of management's efforts, L's financial condition improves.

   a. If the options were treated as exercised, an ownership change apparently would occur. B and management here increased their collective interest by over 50 points.

   b. This is true even though there has been no semblance of loss trafficking. The only actual owner shift was the transfer of an option, which could not have triggered an ownership change but for the presence of severe value fluctuation.

5. L is formed and capitalized in the same manner as set forth in example 1. At the time when L is valued at $25 (so that the preferred stock represents 80% of the value of L), B transfers all of his preferred stock to individual C in exchange for $20.

   a. In this example, an actual transfer of more than 50 percentage points occurred.

   b. Thus, an ownership change should clearly result here under either the Full Value Methodology or the Hold Constant Approach since: (1) the transfer was an affirmative act by a shareholder, and (2) the change in interest was not due to mere fluctuation in value.

   c. Note that this result obtains even though A has retained his common stock interest in full. Thus, even though 80% of the voting power remained with A, an ownership change results because more than 50% of the value of L stock changed hands.

6. Same as example 5, except that B only transfers 10% of his preferred stock interest to C.

    a. In this case, only an 8% owner shift occurred because of affirmative shareholder action (10% of 80%).

    b. B's remaining stock interest has increased on a percentage basis but has not economically increased in value.

    c. Under the Hold Constant Principle approach, the transfer by B should not cause B's remaining percentage interest to be re-valued and re-measured since any resulting percentage increase would be attributable strictly to fluctuation in value. Therefore under the Hold Constant Principle approach there is no ownership change. However, under the Full Value Methodology approach, the transfer by B results in B's interest being determined at "full value," thereby resulting in an ownership increase by B from 20% to 72%. This results in an ownership change.

7. L is formed and capitalized as follows: A puts in $60 for all of the L common stock, and B puts in $40 for all of the L voting preferred stock. B's voting preferred stock bears a fixed dividend rate of 10%. There are no other classes outstanding. A and B's interest represents 60% and 40%, respectively, of the initial value of L.

    a. During the testing period, assume that interest rates rise to 12%. Further assume that the value of B's preferred stock consequently depreciates in value to 35%. Due to the decline in value of B's preferred stock, A's interest increases in value to 65%.

(1) These shifts in percentage interest clearly should be ignored under section 382(1)(3)(C).

(2) No transfer of stock has occurred, thus no owner shift should be deemed to occur.

b. Assume that within the testing period, interest rates subsequently fall to 6%. B's preferred stock appreciates in value, so that it represents 55% of the relative fair market value of all the L stock. Due to the increase in the value of B's interest, A's interest consequently depreciates in value to 45%. As in paragraph a, above, such shifts in percentage interest should be ignored under section 382(1)(3)(C) under either the Full Value Methodology or the Hold Constant Principle approach because there has not been any acquisition.

c. However, suppose that at the time when interest rates are at 6%, A transfers to individual C a block of common stock representing 31% of the value of L.

(1) The owner shift should be limited to 31%, the percentage change due to an actual transfer.

(2) The owner shift should not be regarded as 46% (31% for C plus 15% (55%-40%) for B) nor as 51% (31% for C plus 20% (55%-35%) for B) under the Hold Constant Principle approach since both these amounts include percentage interest changes attributable solely to the fluctuation in value of B's preferred stock.

(3) However, under the Full Value Methodology approach, the owner shift would result in an ownership change.

8. The facts are the same as example 7, except that the preferred stock also fluctuated in value as a result of changes in the ratings of the stock by various rating services (e.g., Moody's). The results should be the same.

9. L has a value of $100. L's only class of stock outstanding is held by individual A. A would like to turn the operation of L over to an employee, B. Accordingly, L is recapitalized, and A exchanges all of his common stock for new common and new voting preferred stock. The new common stock, representing 45% of the value of L, is transferred to B. It is fully expected that B's common stock will subsequently appreciate in value, while A's preferred stock will remain frozen at its current value.

    a. Since the recapitalization is an equity structure shift but not an owner shift, it is ignored. However, the transfer of A's common stock to B results in a 45% owner shift.

    b. Assume that B's common stock subsequently increases in value to 55% of the total value of L stock. (This change could be due to the improved performance or growth of L, or due to an increase in the interest rates above the dividend rate specified in A's preferred stock.) Further assume that B transfers one share of common stock to C, another employee of L. C's interest represents l% of the value of L.

        (1) B's transfer should result in an owner shift of l%, and combined with the earlier transfer of 45%, is not sufficient to trigger an ownership change.

(2) Under the Hold Constant Principle approach, B's interest should not be viewed as increasing from 0 percent to 54% during the testing period, inasmuch as 9% of this increase (54% - 45%) is due to a fluctuation in value.

(3) However, under the Full Value Methodology approach, B’s interest increases by 54% during the testing period and therefore there is an ownership change.

10. L was formed several years ago. Its founding members, individuals A and B, each own 50 shares of the 100 shares of L common stock outstanding. No other stock is outstanding. On June 30, 1989, L issues 50 shares of common stock to the public (Public L) in an initial public offering (IPO). On December 31, 1989, L issues 15 shares of common stock to individual C. On June 30, 1990, L issues an additional 35 shares of common to new public investors (Public L-1). The value of L has continuously fallen throughout the period from July 1, 1987 through June 30, 1990.

a. As a result of the IPO, Public L has increased its interest by 33 points. Following the December 31, 1989 issuance, C holds 9% of the common stock, and Public L owns 30%; thus, the total increase is 39%.

b. Following the June 30, 1990 issuance, Public L owns 25% of L, C owns 8% of L and Public L-1 owns 17% of L, for a total percentage change of 50 points.

c. Because only one class of stock is outstanding, the fluctuation in value issue is not present.

11. All of the L common stock is owned by individual A (80 shares) and all of the L voting preferred stock is owned by individual B (20 shares). There are no other classes of stock outstanding. At the beginning of the testing period, A's common stock represents 80% of the value of all of the L stock, and B's preferred stock represents 20% of the value of all of the L stock. Assume that at that time, L is valued at $100.

   a. Subsequently during the testing period, the value of L drops to $25. Thus, the preferred stock represents 80% of the value of the L stock, and the common stock represents 20% of the value of the L stock. Assume that B transfers 2 shares of his preferred stock to individual C. This should count as an 8% owner shift (10% of 80%).

   b. L issues common stock to the public (Public L), representing 43% of the total value of L. The infusion of capital increases the value of L and the value of common stock. The increase in value of the common stock results in a decline in the percentage interest of the preferred stock (even though the preferred stock has improved in value economically). As a result, assume that C's interest is diluted to 5% of L.

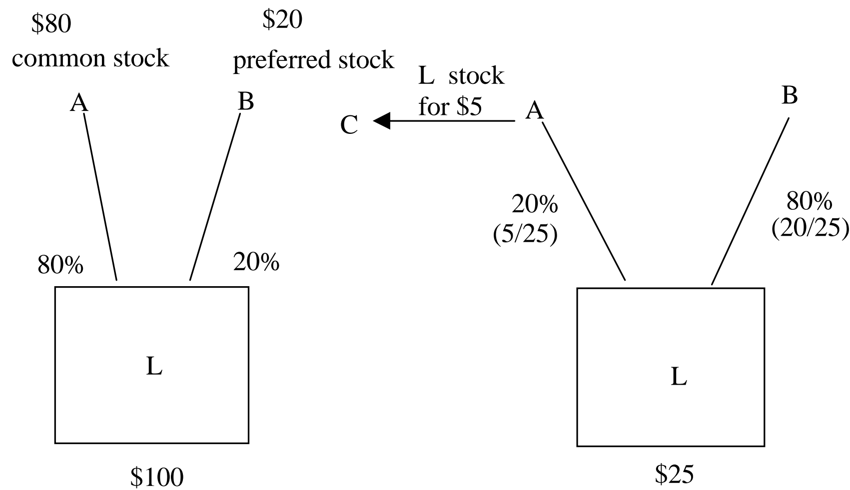
      (1) If the transfer by B to C is to count as an 8% owner shift (i.e., only the percentage interest relating to actual transfers is counted), how should C's interest be valued at the close of the testing date on which the public offering occurred?

      (2) Under the Hold Constant Principle approach, the value would remain at 8% (i.e., no downward fluctuation in value is counted) and the public

offering will trigger an ownership change (43% and 8%). This method overstates the actual percentage change.

(3) However, under the Full Value Methodology approach, C's interest would be measured at its current 5% and no ownership change would result (43% and 5%). Under this approach, the fluctuation in value would have been taken into account even though C did not transfer any stock at the time of the additional capital contribution.

Section 382 -- Example 1 (p. 10)



1. On 1/1/88, individual A and individual B form loss corporation L.

2. A contributes $80 to L in exchange for all of the L Common stock; B contributes $20 to L in exchange for all of the voting preferred stock of L.

3. Initially, A's common stock and B's preferred stock represent 80% and 20%, respectively, of the voting power and value of L.

4. Subsequent to the formation of L, significant losses are incurred, and the value of L drops to $25.

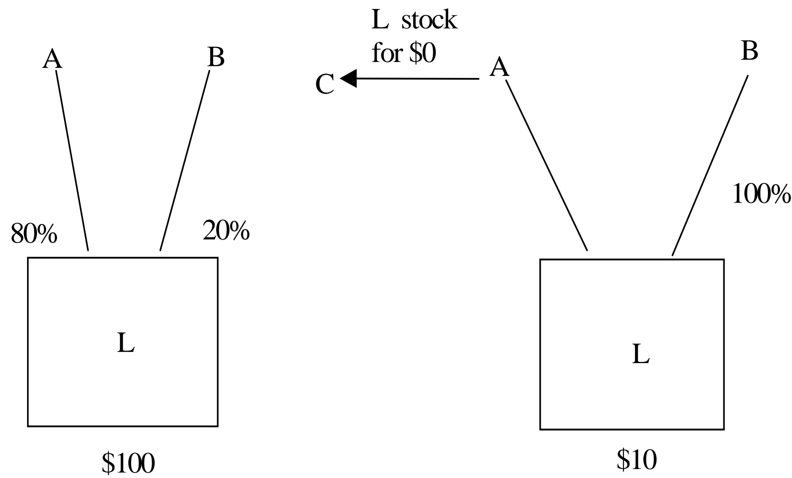
5. Based on liquidation values, the preferred stock represents 80% (20/25) of the value of L and the common stock represents 20% (5/25) of the value of L.

6. Suppose A transfers all of his common stock to Individual C for $5.

7. Technically, an ownership change may have occurred. As a policy matter, section 382 should not apply.

8. A more reasonable approach would be to focus only on interests that have changed hands during the testing period.

<u>Section 382 -- Example 2 (p. 12)</u>



1. Same facts as the previous diagram, except that A waits until the value of L drops to $10 before he transfers his interest to C.

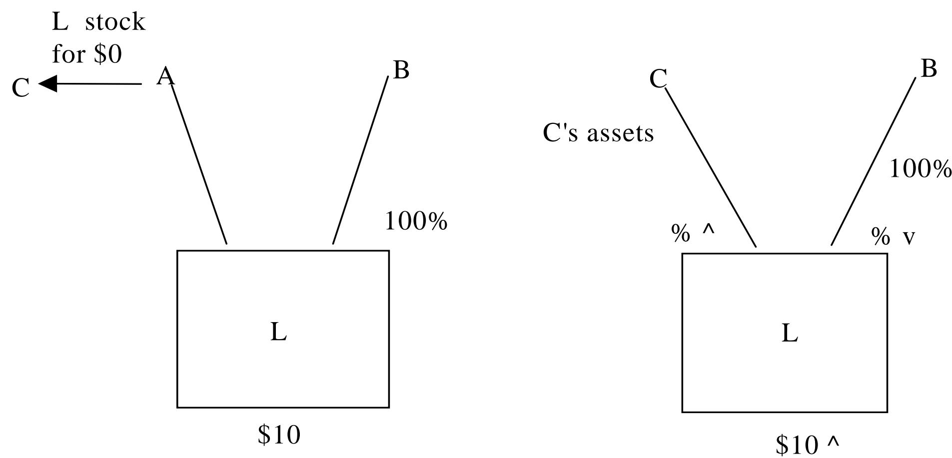
2. If L were liquidated on the date of A's transfer, B would not recover the full amount of his original investment ($20). A's interest is worthless.

3. Arguably, the transfer does not constitute an owner shift since it does not affect the percentage interest of either A, B or C. A and C each own 0% before and after the transfer.

4. However, on the theory that A's Common stock has some value -- even if only to speculate in L's future profitability -- the transfer would constitute an owner shift.

5. Given this, an ownership change could result. The imposition of section 382 on L and its shareholders in this circumstance seems inappropriate.

Section 382 -- Example 3 (p. 13)



1. Same facts as in the previous diagram, except that following the acquisition of A's common stock. C either contributes business assets or diverts income-producing opportunities to L.

2. L's income stream and value both increase.

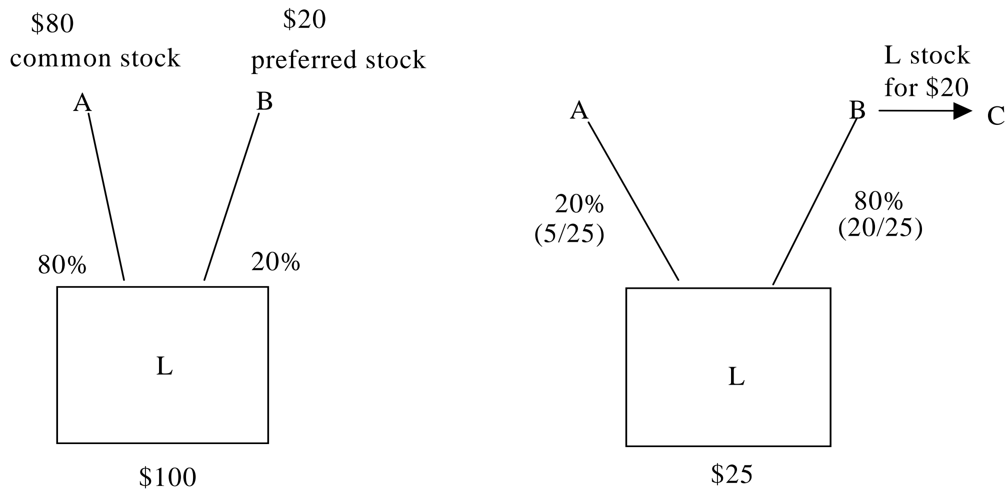
3. If C contributes assets to L, the increase in L's value would be reflected as a change in percentage interests of the C shareholder, i.e., an owner shift. Section 382 could be applied at this point.

4. If no ownership change occurs (either because of the stock transfer or the asset stuffing), C would be free to make such contributions to L and have L's losses offset any income generated by the contributed assets.

5. C may not be willing to contribute assets or income opportunities to L, inasmuch as such assets will redound to the benefit of B to the extent of the liquidation preference inherent in B's preferred stock.

6. Section 269 would be more appropriate in this scenario to combat an actual abuse.

Section 382 -- Example 5 (p. 15)



1. L is formed and capitalized in the same manner as set forth in example 1.

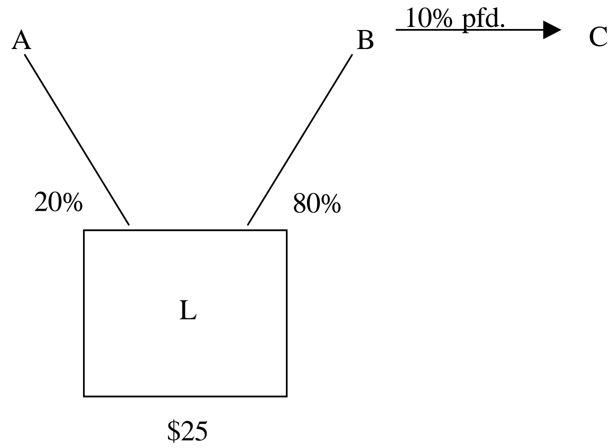
2. At the time when L is valued at $25, B transfers all of his preferred stock to individual C In exchange for $20.

3. An actual transfer of more than 50 percentage points has occurred.

4. An ownership change should clearly result here since: (1) the transfer was an affirmative act by a shareholder, and (2) the change in interest was not due to mere fluctuation in value.

5. This result is obtained even though A has retained his common stock interest in full.

Section 382 -- Example 6 (p. 16)



1. Same facts as in the previous diagram. B transfers 10% of his preferred stock interest to C.

2. Only an 8% owner shift occurred because of affirmative shareholder action (10% of 80%).

3. B's remaining stock interest has increased on a percentage basis but has not economically increased in value.

4. The transfer by B should not cause B's remaining percentage interest to be re-valued and re-measured since any resulting percentage increase would be attributable strictly to fluctuation in value.

Section 382 -- Example 7 (p. 16)

1) $80 common stock A — $40 preferred stock B
60% 40%
L

2) A B
^ 65% value v 35%
L

3) A B
45% ^ 55%
L

4) C ◄ 31% of L stock A B
40%
L

1. L is formed and capitalized as follows: A puts in $60 for all of the L common stock, and B puts in $40 for all of the L voting preferred stock. B's voting preferred stock bears a fixed dividend rate of 10%.

2. A and B's interest represents 60% and 40%, respectively, of the initial value of L.

3. As interest rates rise to 12%, the value of B's preferred stock depreciates in value to 35%, while A's interest increases in value to 65%.

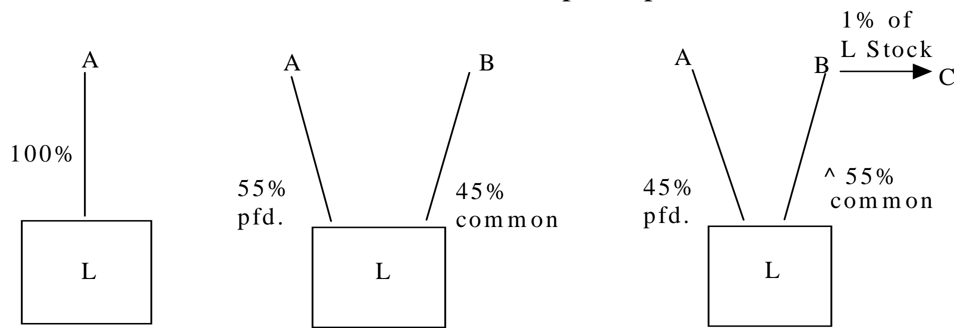
4. No transfer of stock has occurred, and thus no owner shift has occurred; therefore, these shifts in percentage interest should be ignored under section 382(l)(3)(C).

5. As interest rates subsequently fall to 6%, B's preferred stock appreciates in value, so that it now represents 55% of the relative fair market value of all of the L stock.

6. A's interest depreciates in value to 45%, and, again, no shift in ownership occurs.

7. While interest rates are at 6%, A transfers to individual C a block of common stock representing 31% of L's value. The percentage change should be limited to 31%, not 46% or 51%.

Section 382 -- Example 9 (p. 18)



1. L has a value of $100.

2. L's only class of stock outstanding is held by individual A.

3. A would like to turn the operation of L over to an employee, B.

4. L is recapitalized, and A exchanges all of his common stock for new common and now voting preferred stock. The new common stock, representing 45% of the value of L, is transferred to B.

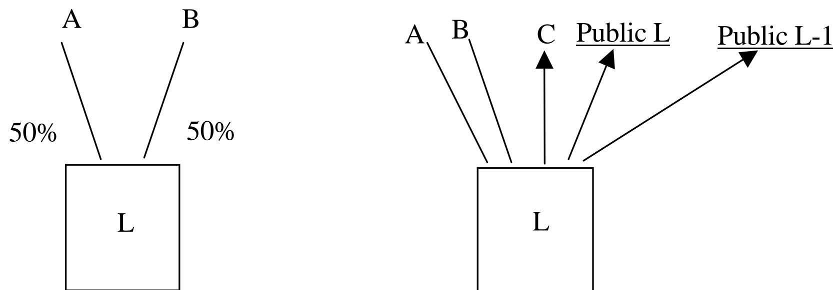
5. The transfer of A's common stock to B results in 45% owner shift.

6. B's common stock subsequently increases in value to 55% of the total value of L stock.

7. B transfers one share of common stock to C, another employee of L. C's interest represents 1% of the value of L.

8. B's transfer should result in an owner shift of 1%, and combined with the earlier shift of 45%, is not sufficient to trigger an ownership change.

Section 382 -- Example 10 (p. 19)



1. L was formed several years ago. Its founding members, individuals A and B, each own 50 shares of the 100 shares of L common stock outstanding.

2. On June 30, 1989, L issues 50 shares of common stock to the public (Public L) in an initial public offering (IPO).

3. On December 31, 1989, L issues 15 shares of common stock to individual C.

4. On June 30, 1990, L issues an additional 35 shares of common stock to new public investors (Public L-1).

5. The value of L has continuously fallen throughout the period from July 1, 1987 through June 30, 1990.

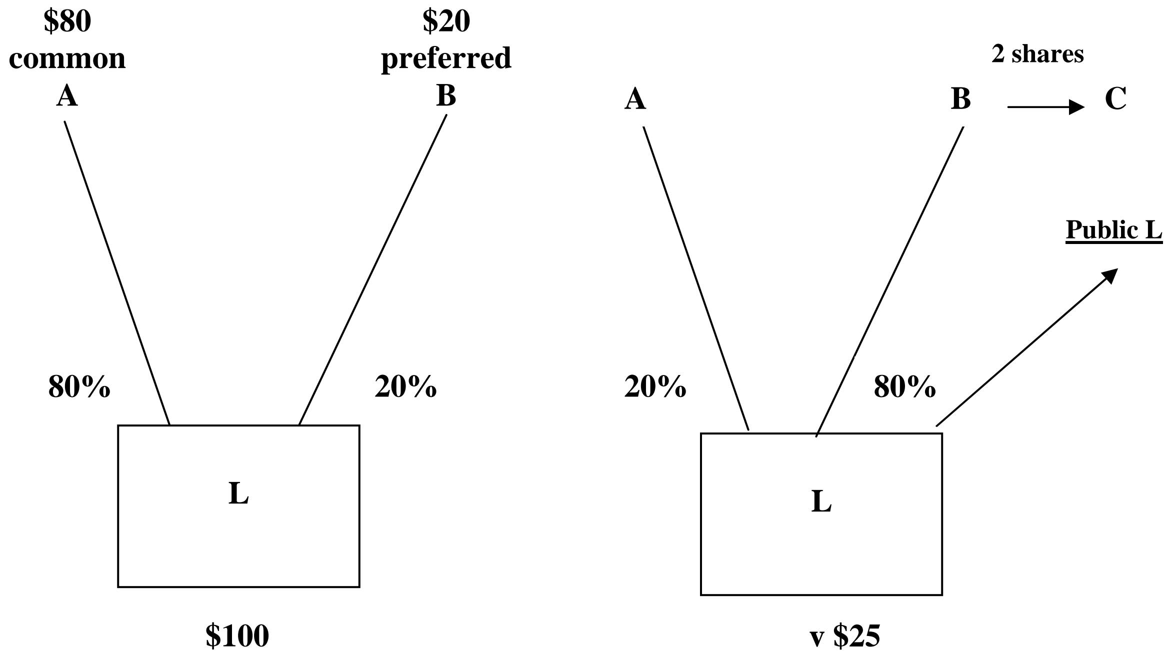
6. As a result of the IPO, Public L has increased its interest by 33 points.

7. Following the December 31, 1989 issuance, C holds 9% of the common stock, and Public L owns 30%.

8. Following the June 30, 1990 issuance, Public L owns 25% of L. C owns 8% of L and Public L-1 owns 17% of L, for a total percentage of 50 points.

9. Because only one class of stock is outstanding, the fluctuation in value issue is not present.

Section 382 -- Example 11 (p. 20)



1. All of the L common stock is owned by individual A and all of the L voting preferred stock is owned by individual B.

2. A's common stock represents 80% of the value of all of the L stock, and B's preferred stock represents 20% of the value of all of the L stock.

3. L is valued at $100.

4. The value of L drops to $25. The preferred stock now represents 80% of the value of the L stock, and the common stock represents 20% of the value of the L stock.

5. B transfers 2 shares of his preferred stock to Individual C. This should count as only an 8% owner shift.

6. L issues common stock to the public (Public L), representing 43% of the total value of L.

7. The infusion of capital increases the value of L and the value of common stock.

8. The increase in value of the common stock results in a decline in the percentage interest of the preferred stock.

9. C's interest is diluted to 5% of L. How should C's interest be measured for section 382 purposes -- at 5% or 8%?