

PRACTISING LAW INSTITUTE  
TAX STRATEGIES FOR CORPORATE ACQUISITIONS,  
DISPOSITIONS, SPIN-OFFS, JOINT VENTURES,  
FINANCINGS, REORGANIZATIONS AND  
RESTRUCTURINGS 2007

SECTION 382  
FLUCTUATION IN VALUE

June 2007

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

Copyright, 2007, by Mark J. Silverman, All rights reserved.

Internal Revenue Service Circular 230 Disclosure: As provided for in IRS regulations, advice (if any) relating to federal taxes that is contained in this document (including attachments) is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code or (2) promoting, marketing or recommending to another party any plan or arrangement addressed herein.

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. The IRS has recently articulated the manner in which section 382(l)(3)(C) should apply, as evidenced by four private letter rulings (the "PLRs"): PLR 200411012, PLR 200511008, PLR 200520011, and 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.

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) The IRS position in the PLRs appears to support this 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.
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 contributes assets to L, L's value would increase, the increase in 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.
  - 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 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. 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.
  - d. The approach advocated in the PLRs seems to indicate that the IRS would not re-value or re-measure B's stock upon a sale or disposition.
  
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).
- 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) since both these amounts include percentage interest changes attributable solely to the fluctuation in value of B's preferred stock.
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 1% of the value of L.

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

(2) 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.

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

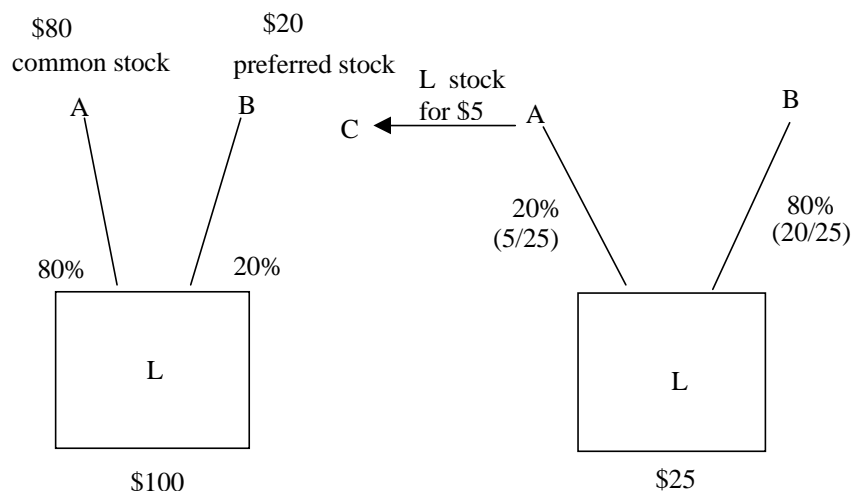
common to new public investors (Public L-1). The value of L has continuously fallen throughout the period from July 1, 1987 through June 30, 1990.

- 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.

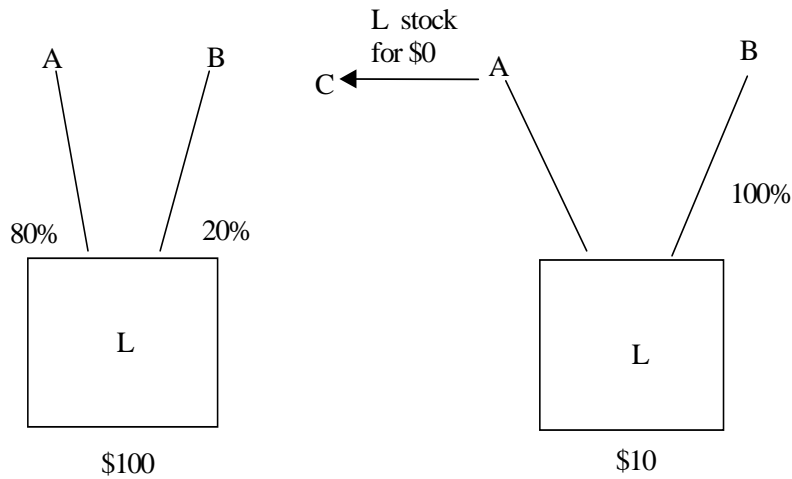
- (1) If the transfer by B to C is to count as an 8% owner shift (i.e., only the percentage interest relating to actual transfers is counted), how should C's interest be valued at the close of the testing date on which the public offering occurred?
- (2) If the value remains at 8% (i.e., no downward fluctuation in value is counted) then the public offering will trigger an ownership change (43% and 8%). This method overstates the actual percentage change.
- (3) However, if C's interest is measured at its current 5%, no ownership change would result, but the fluctuation in value would have been taken into account even though C did not transfer any stock.
- (4) The IRS position in the PLRs seems to suggest that fluctuation in value should not be taken into account, and therefore C's interest is treated as 8%. However, in this example, not taking fluctuation in value into account causes an ownership change to have occurred. It is not clear that this is the result intended by either the statute or the PLRs.

Section 382 -- Example 1 (p. 1)



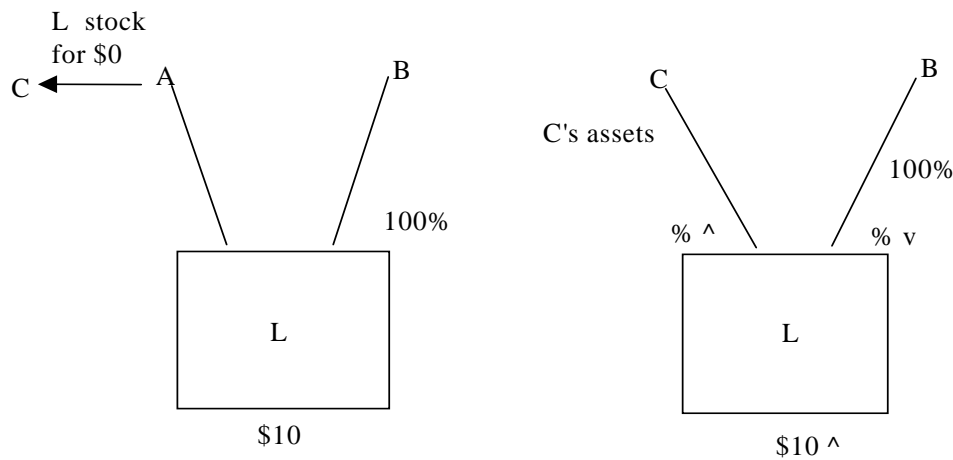
1. On 1/1/88, individual A and individual B form loss corporation L.
2. A contributes \$80 to L in exchange for all of the L Common stock; B contributes \$20 to L in exchange for all of the voting preferred stock of L.
3. Initially, A's common stock and B's preferred stock represent 80% and 20%, respectively, 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.

Section 382 -- Example 2 (p. 3)



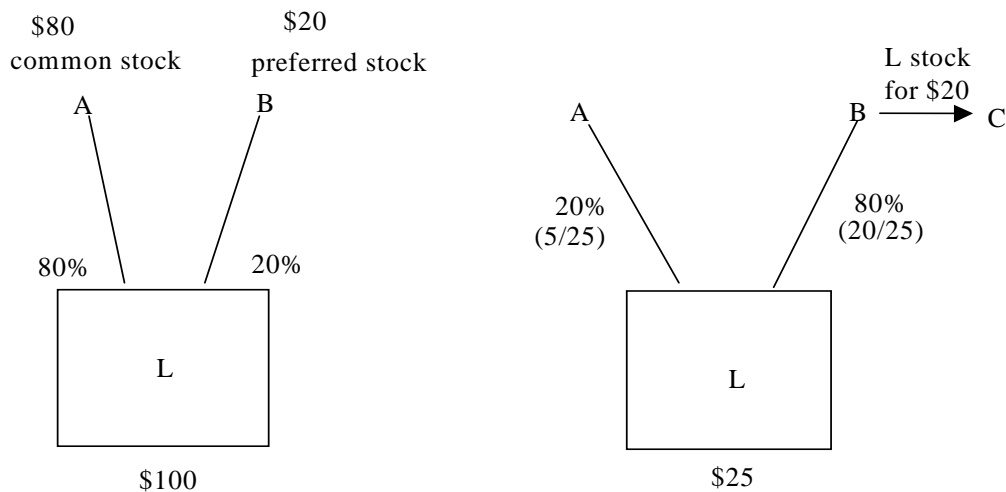
1. Same facts as the previous diagram, except that A waits until the value of L drops to \$10 before he transfers his interest to C.
2. If L were liquidated on the date of A's transfer, B would not recover the full amount of his original investment (\$20). A's interest is worthless.
3. Arguably, the 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. 4)



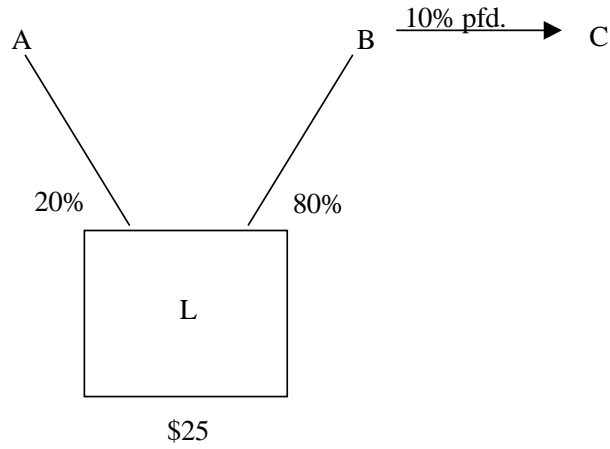
1. Same facts as in the previous diagram, except that following the acquisition of A's common stock. C either contributes business assets or diverts income-producing opportunities to L.
2. L's income stream and value both increase.
3. If C contributes assets to L, the increase in L's value would be reflected 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. 6)



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. 6)

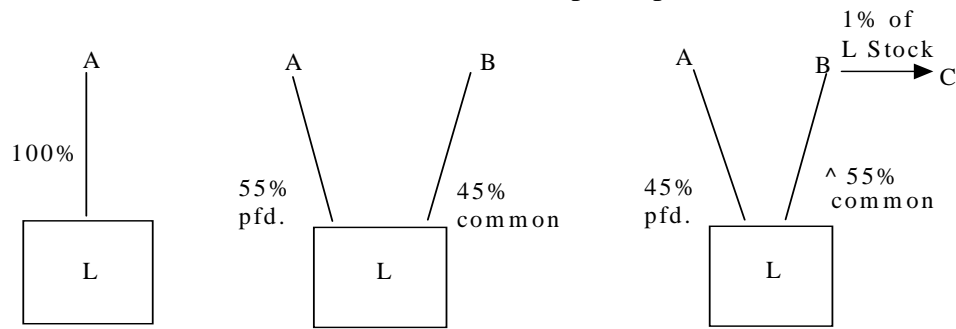


1. Same facts as in the previous diagram. B transfers 10% of his preferred stock interest to C.
2. Only an 8% owner shift occurred because of affirmative shareholder action (10% of 80%).
3. B's remaining stock interest has increased on a percentage basis but has not economically increased in value.
4. 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.



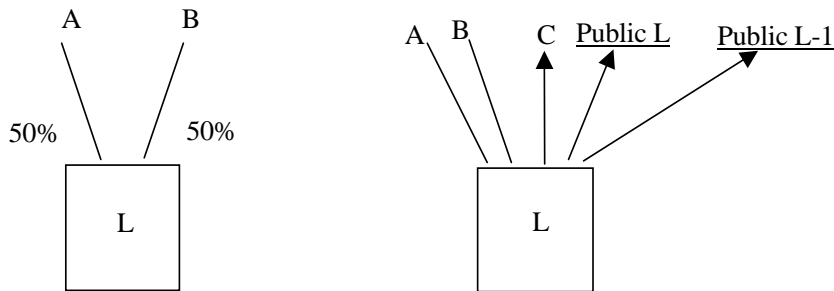
6. A's interest depreciates in value to 45%, and, again, no shift in ownership occurs.
7. While interest rates are at 6%, A transfers to individual C a block of common stock representing 31% of L's value. The percentage change should be limited to 31%, not 46% or 51%.

Section 382 -- Example 9 (p. 8)



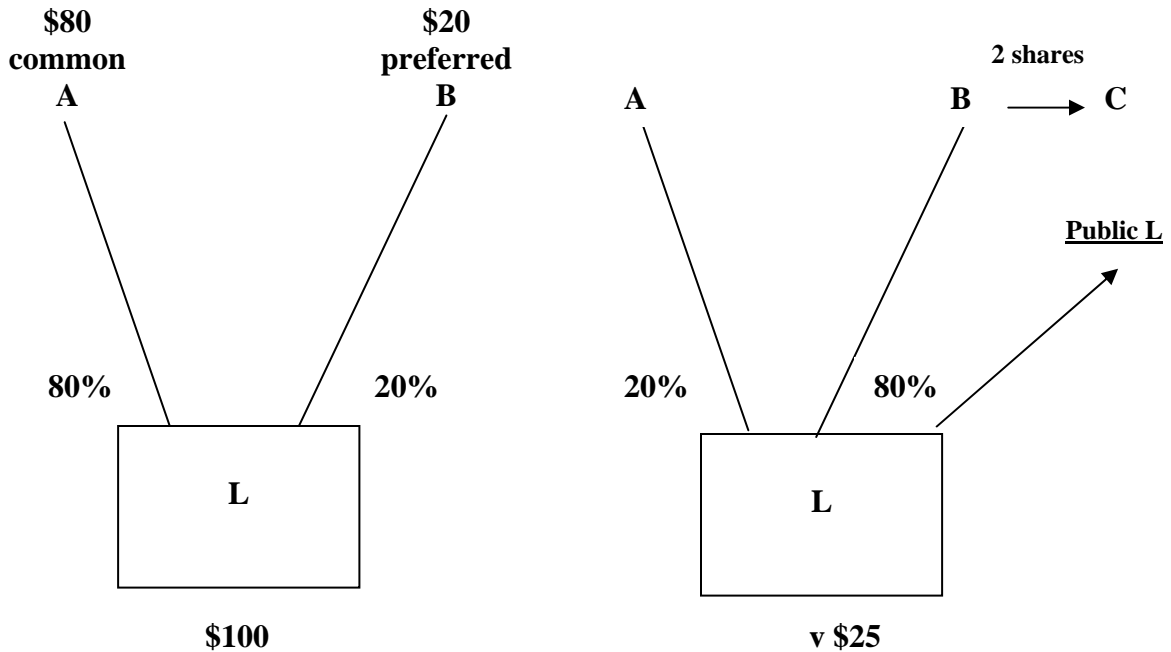
1. L has a value of \$100.
2. L's only class of stock outstanding is held by individual A.
3. A would like to turn the operation of L over to an employee, B.
4. L is recapitalized, and A exchanges all of his common stock for new common and now voting preferred stock. The new common stock, representing 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. 9)



1. L was formed several years ago. It's 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. 9)



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%?