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Using - And Not Losing - Tax Losses, Part 1: Protecting Tax Losses from a Section 382 Ownership Change (Slides)

Mark C. Van Deusen

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Using – and not Losing – Tax Losses:

Protecting Tax Losses from a Section 382 Ownership Change

Mark C. Van Deusen
Hunton & Williams LLP

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What is at risk?

- Net operating losses (NOLs)
- Net capital losses (NCLs)
- Net unrealized built-in losses
  - Depreciation deductions attributable to built-in losses
- Certain tax credits
Consequences of an Ownership Change

- Tax benefits subject to the “section 382 limitation”
- Section 382 limitation = market capitalization \times “long-term tax-exempt rate”
  - Long-term tax-exempt rate for Oct. 2010: 3.98%
- Section 382 limitation is zero if “continuity of business enterprise” requirement is not satisfied for 2 years following the ownership change
Consequences of an Ownership Change

- No extension of carryover period for tax benefits exceeding section 382 limitation
  - NCLs, and even NOLs, may expire before utilized
- Recognized built-in losses and related depreciation deductions subject to the section 382 limitation for only 5 years
What is an “Ownership Change”?

- “The precise definition of an ‘ownership change’ under Section 382 is rather complex....Calculating the likelihood of a Section 382 ownership change at a given company at a particular time is extraordinarily difficult and requires making a number of factual assumptions, subject to varied interpretations of the correct application of Section 382, upon which reasonable experts may disagree.”

What is an “Ownership Change”? (Cont.)

- The percentage of stock owned by one or more “5-percent shareholders” has increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders at any time during the relevant “testing period.”
Example

- 10 individuals each acquire 6% of Sucking Wind, Inc.'s outstanding stock. Each individual is a “5-percent shareholder” and each caused a 6 percentage point increase. In the aggregate, Sucking Wind, Inc. has experienced a 60 percentage point increase and, thus, has experienced an “ownership change.”
“5-percent shareholders”

- Individuals that directly own 5% or more of the loss corporation
- Individuals that indirectly own 5% or more of the loss corporation as a result of owning 5% or more of a “first tier” or “higher tier” entity
  - “First tier” entity: any entity owning 5% or more of the loss corporation
  - “Higher tier” entity: any entity that owns 5% or more of any first tier entity or higher tier entity
“5-percent shareholders” (Cont.)

Parent 2

5%

Parent

5%

Public

95%

Sucking Wind, Inc.

Parent is a “first tier” entity
Parent 2 is a “higher tier” entity
“5-percent shareholders” (Cont.)

- Individuals owning 5% or more of “first tier” or “higher tier” entities are treated as 5-percent shareholders only if such indirect ownership causes the individual to own 5% or more of the loss corporation.

- Ownership of “first tier” and “higher tier” entities by a person that is a direct 5-percent shareholder of a loss corporation is not taken into account unless (1) the individual’s indirect ownership interest constitutes 5% or more of the loss corporation or (2) the loss corporation has actual knowledge of the less than 5% indirect ownership.
"5-percent shareholders" (Cont.)

A is a direct 5-percent shareholder (11%); indirect ownership (3%) through Parent taken into account if "actual knowledge"

B is an indirect 5-percent shareholder through Parent (5%); direct ownership (4%) taken into account only if "actual knowledge"
“5-percent shareholders” (Cont.)

- “Public groups” can also be 5-percent shareholders
  - Section 382 aggregates unrelated shareholders that do not individually own 5% or more of the loss corporation’s stock into a “public group”
  - A “public group” may be treated as a 5-percent shareholder (in some cases even if it does not own 5% of the loss corporation)
What is "Stock"?

- Does not include "plain vanilla" preferred stock:
  - not entitled to vote (other than following a dividend arrearage),
  - limited and preferred as to dividends and does not participate in corporate growth to any significant extent,
  - redemption and liquidation rights do not exceed the issue price of the stock (except for a "reasonable" redemption or liquidation preference), and
  - not convertible into another class of stock.
What is “Stock”? (Cont.)

- Options are treated as exercised if issued or transferred for “a principal purpose” of avoiding or ameliorating the consequences of an “ownership change” and other tests are satisfied
  - Compensatory options are excluded if they are nontransferrable and do not have a readily ascertainable fair market value
Transactions Causing Percentage Point Increases

- Direct and indirect acquisitions of stock
- Aggregation and segregation rules for "public groups"
  - Disposition of stock by individuals and entities owning 5% or more of loss corporation's stock
  - Redemptions
  - Mergers
Stock Offerings

- A stock offering can create a new public group under the segregation rules
- Segregation rules relaxed for
  - Stock offerings “solely for cash”
    - Amount of benefit depends on percentage of stock owned by direct “public groups”
  - “Small issuances” of stock
    - Limited to 10% of stock (measured on an aggregate or class-by-class basis)
Bankruptcy

- A bankruptcy often causes an ownership change because the former creditors of the loss corporation may become the controlling shareholders of the loss corporation.
(1)(5) Bankruptcy Election

- Bankruptcy ownership change is ignored
- Available only if historic shareholders and “qualified creditors” own 50% of the voting power and value of the loss corporation after the ownership change
  - “Qualified Creditor”: (1) held debt for at least 18 months before bankruptcy filing or (2) debt arose in the ordinary course of loss corporation’s business and creditor held debt at all times
- If the loss corporation has a second ownership change within 2-years of bankruptcy, the section 382 limitation for the second ownership change will be ZERO
(1)(6) Election

- Higher section 382 limitation for a bankruptcy ownership change
- Value of the loss corporation for calculating the section 382 limitation will include any increase in value attributable to any surrender or cancellation of creditors’ claims in bankruptcy
“Testing Period”

- Generally, the 3-year period prior to the testing date
- May be shortened if tax benefits have not existed for entire 3-year period
What are the “Testing Dates”? 

- “Owner shift”: Any change in the ownership of stock of a loss corporation that affects the percentage of stock owned by any 5-percent shareholder, including:
  - Purchase or disposition of stock by a 5-percent shareholder
  - Section 351 exchange that affects the percentage ownership of a 5-percent shareholder
  - Redemption, recapitalization, or stock issuance that affects the percentage ownership of 5-percent shareholder
What are the “Testing Dates”? (Cont.)

- “Equity structure shift”:
  - Any reorganization that affects a 5-percent shareholder (other than “F” reorgs and certain “D” or “G” reorgs)
  - Taxable reorganization-type transactions, public offerings and similar transaction

- Certain issuances or transfers of options
Determining Whether an Ownership Change has occurred

- Generally, public companies can rely on securities filings (e.g., Schedules 13D and 13G) to determine the existence of 5-percent shareholders and the amount of shares owned.

- No reliance on securities filings and certain presumptions if “actual knowledge” to the contrary.
Ownership Change Deterrents

- Adopt a section 382 "poison pill"
- Adopt a 4.9% section 382 ownership limit
## Issues with Ownership Change Deterrents

<table>
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<tr>
<th>Section 382 Poison Pill</th>
<th>Adoption</th>
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<td>Board vote</td>
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<td>– Vote “against/withhold” for election of board if:</td>
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<td>Section 382 Ownership Limit</td>
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<td>VA: Some shareholders may be exempt</td>
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Reporting Requirements

- Loss corporation must include a statement in its return for each year in which there is a testing date
- Loss corporation must retain records necessary to identify 5-percent shareholders and their ownership
Thank you.