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

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Using – and not Losing – Tax Losses:

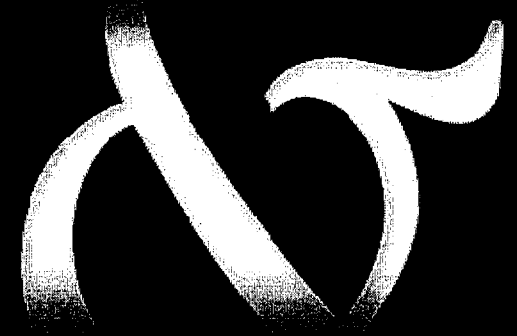
Protecting Tax Losses from a
Section 382 Ownership Change

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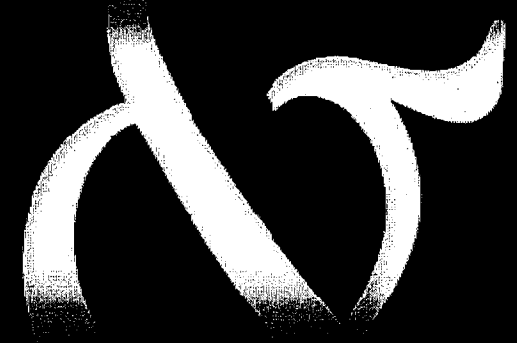
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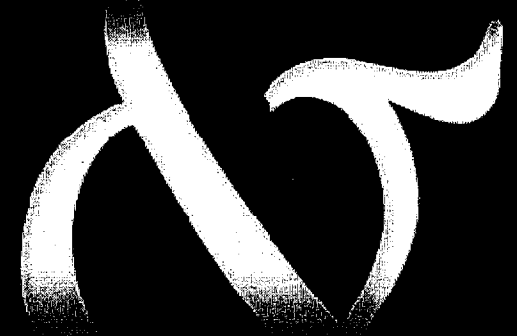
What is at risk?

- Net operating losses (NOLs)
- Net capital losses (NCLs)
- Net unrealized built-in losses
 - *Depreciation deductions attributable to built-in losses*
- Certain tax credits



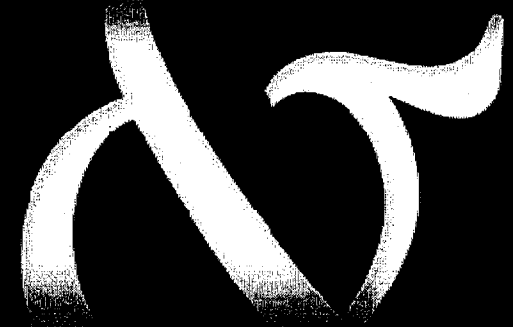
Consequences of an Ownership Change

- Tax benefits subject to the “section 382 limitation”
- Section 382 limitation = market capitalization x “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



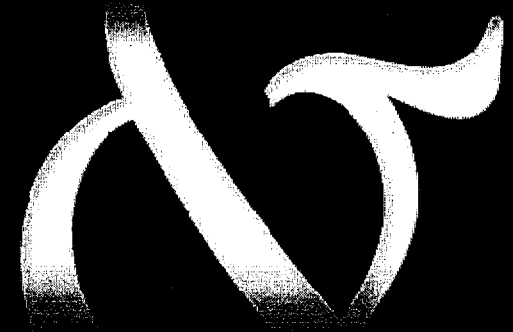
Consequences of an Ownership Change

- 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



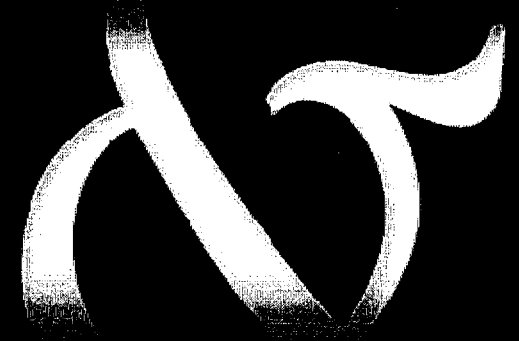
What is an “Ownership Change”?

- “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.”
 - *Selectica, Inc. v. Versata Enters., Inc.*, 2010 Del. Ch. LEXIS 39 (Feb. 26, 2010), *aff’d*, 2010 Del. LEXIS 506 (Oct. 4, 2010).



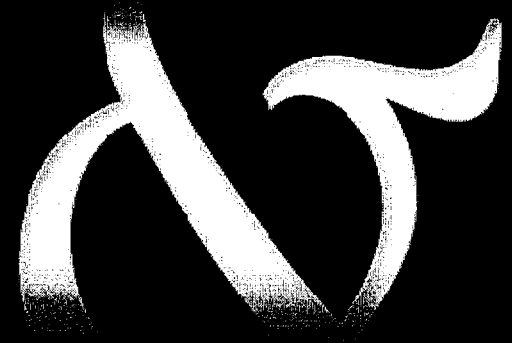
What is an “Ownership Change”? (Cont.)

- 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.”



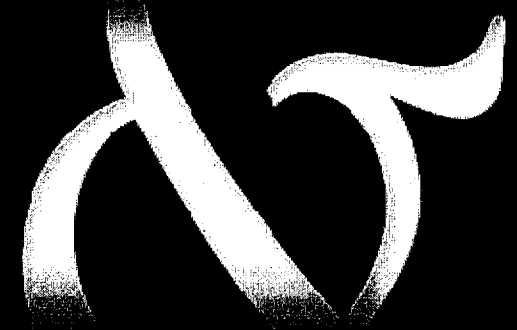
Example

- 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."

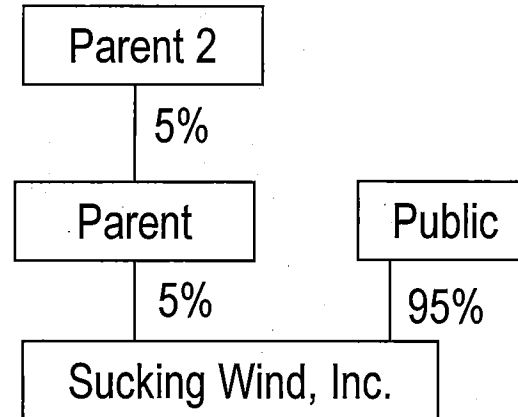


“5-percent shareholders”

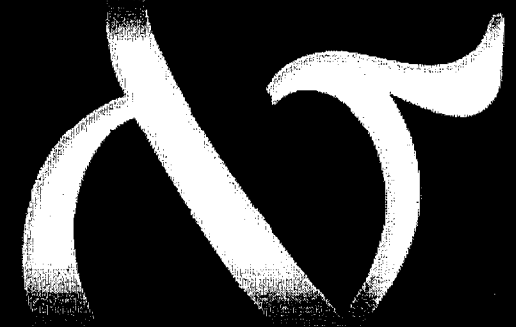
- Individuals that directly own 5% or more of the loss corporation
- Individuals that indirectly own 5% or more of the loss corporation as a result of owning 5% or more of a “first tier” or “higher tier” entity
 - “First tier” entity: any entity owning 5% or more of the loss corporation
 - “Higher tier”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



“5-percent shareholders” (Cont.)

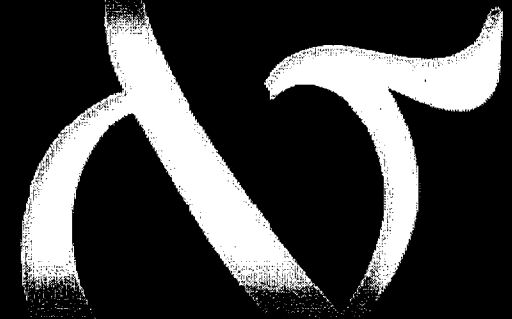


Parent is a “first tier” entity
Parent 2 is a “higher tier” entity

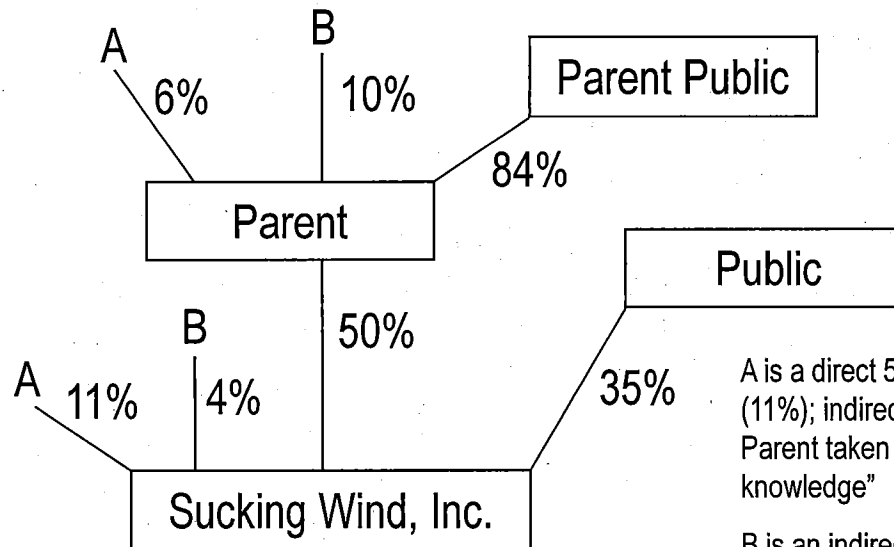


“5-percent shareholders” (Cont.)

- 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

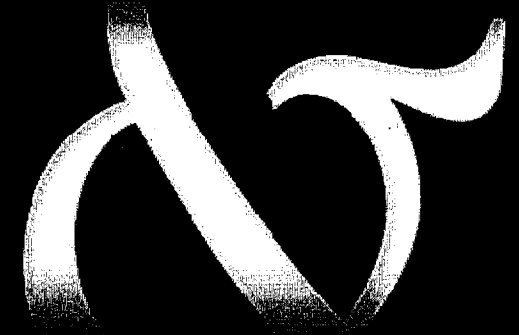


“5-percent shareholders” (Cont.)



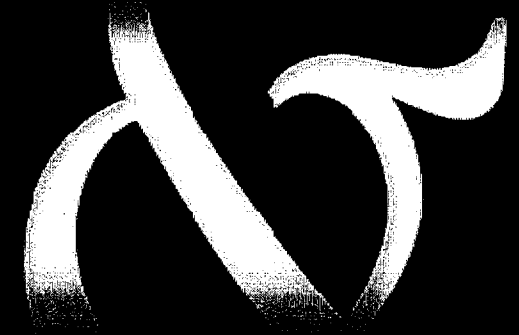
A is a direct 5-percent shareholder (11%); indirect ownership (3%) through Parent taken into account if “actual knowledge”

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



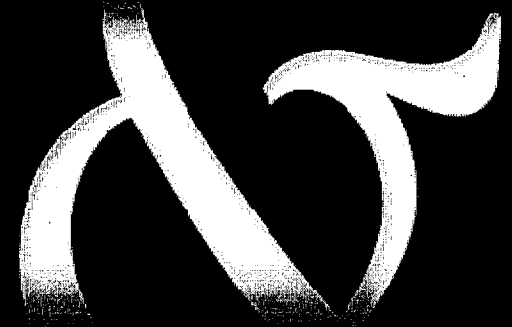
“5-percent shareholders” (Cont.)

- “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)



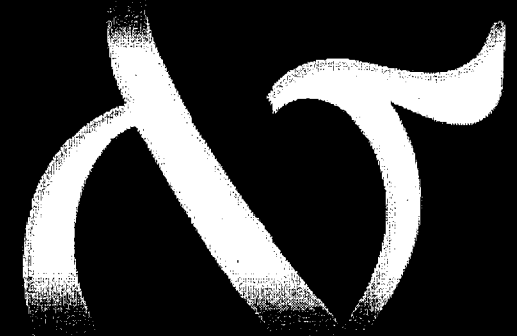
What is “Stock”?

- 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.



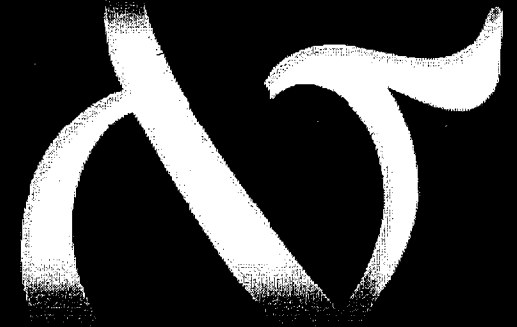
What is “Stock”? (Cont.)

- 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



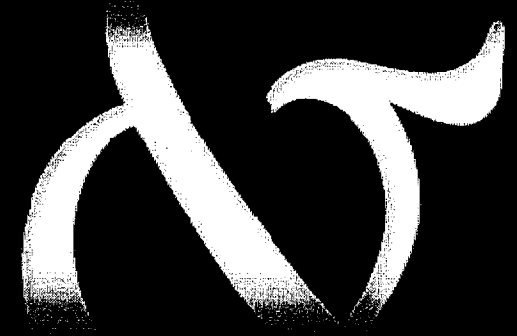
Transactions Causing Percentage Point Increases

- 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



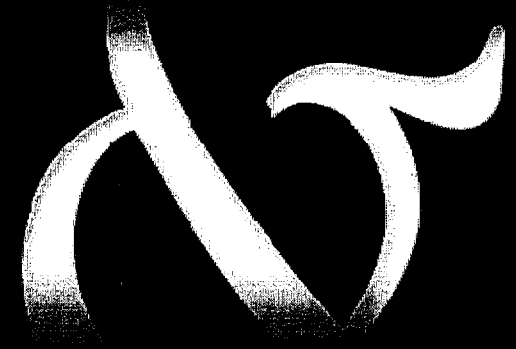
Stock Offerings

- 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)



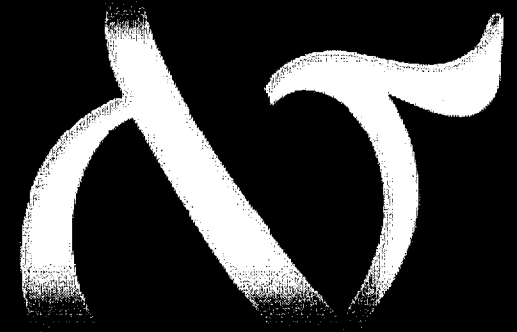
Bankruptcy

- A bankruptcy often causes an ownership change because the former creditors of the loss corporation may become the controlling shareholders of the loss corporation



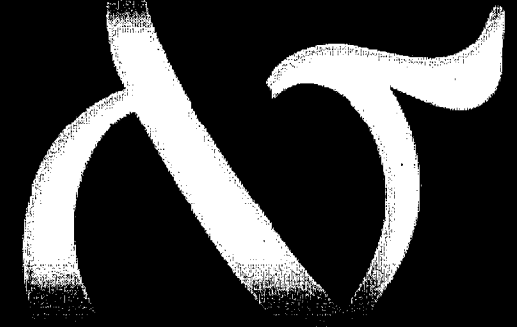
(1)(5) Bankruptcy Election

- 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



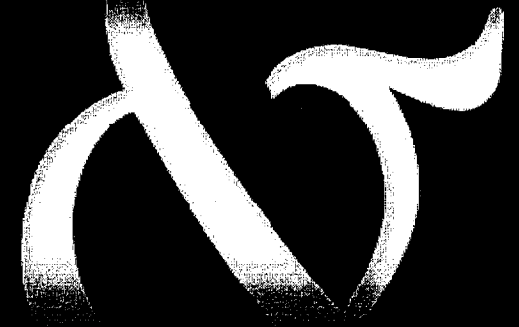
(l)(6) Election

- 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



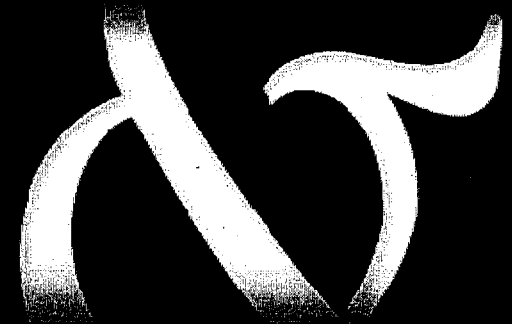
“Testing Period”

- Generally, the 3-year period prior to the testing date
- May be shortened if tax benefits have not existed for entire 3-year period



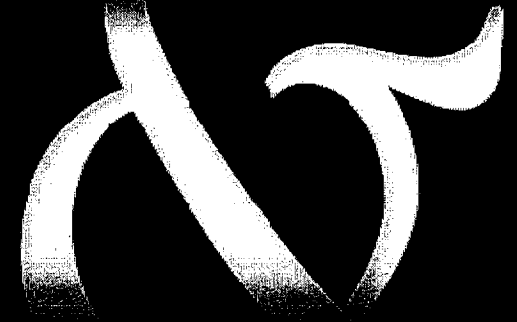
What are the “Testing Dates”?

- “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



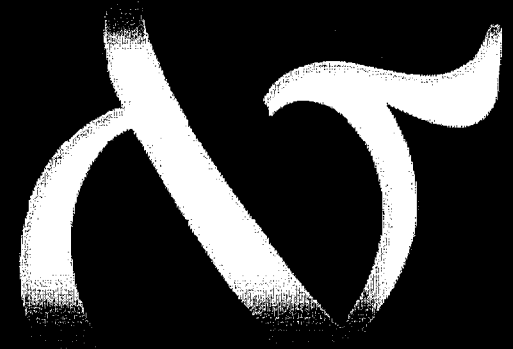
What are the “Testing Dates”? (Cont.)

- “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

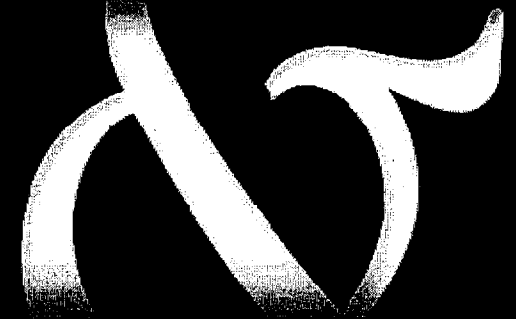


Ownership Change Deterrents

- Adopt a section 382 “poison pill”
- Adopt a 4.9% section 382 ownership limit

Issues with Ownership Change Deterrents

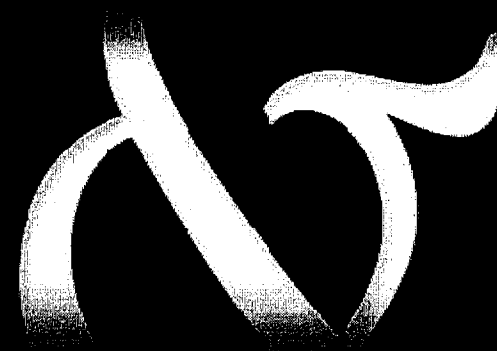
	Adoption	Protection from an Ownership Change	Enforceable	RiskMetrics Proxy Guidelines
Section 382 Poison Pill	Board vote	Lower-level protection <ul style="list-style-type: none"> – tied to section 382 – does not prevent dispositions 	Against all shareholders	–Vote “against/withhold” for election of board if: <ul style="list-style-type: none"> – Term longer than 12-month or – not approved by shareholders –“Case-by-case” review of approval vote
Section 382 Ownership Limit	Shareholder vote	Highest protection <ul style="list-style-type: none"> – tied to section 382 – can prevent dispositions 	VA: Some shareholders may be exempt	“Case-by-case” review of approval vote



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

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Thank you.