1987

1986 Tax Reform Act (TRA) Limitations on Net Operating Loss Carryforwards (Sections 382 and 383, IRC and Section 621, ACT)

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LIMITATIONS ON NET OPERATING LOSS CARRYFORWARDS
(SECTIONS 382 and 383, IRC AND SECTION 621, ACT)

SUMMARY ANALYSIS: Under current law there are liberal restrictions on the use of net operating loss (NOLs) carryforwards after the purchase of the stock of a loss corporation or a reorganization involving a loss corporation. The new law severely restricts the use of the loss corporation's NOL carryforwards. Furthermore, the distinctions between stock purchases and reorganizations are eliminated. As a result of the new law, most of the abuses realized in trafficking of NOLs have been curbed.

PRIOR LAW: STOCK PURCHASES -- If there was a 50 percent change in stock ownership by purchase during a two-year period and the loss corporation's business was not continued, the loss corporation's net operating loss carryforwards were entirely eliminated. If the loss corporation continued its business, the NOLs were allowed in full.

REORGANIZATIONS -- If there was a reorganization involving the loss corporation and the shareholders of the loss corporation owned less than 20 percent of the stock of the surviving corporation, the loss corporation's NOLs were reduced or possibly eliminated.

The Tax Reform Act of 1976 attempted to curb abuses in this area. However, there were several technical problems with the 1976 amendments to Section 382 and the effective date of the amendment was continuously postponed. Although the 1976 amendment was effective as of January 1, 1986, it was retroactively repealed by the TRA.

EFFECTIVE DATE: The new law will generally be effective for an owner shift involving a 5 percent shareholder occurring after December 31, 1986 and an equity structure shift occurring pursuant to a plan of reorganization adopted after December 31, 1986.

1. OVERVIEW:

    a. Generally, NOLs are not reduced under the new law. Instead, an annual limitation is placed on earnings which can be offset by NOLs.

b. The limitation is based upon the equity value of the loss corporation. The limitation represents an estimation of the potential future annual earnings of the loss corporation.

c. The limitation is caused only by a change in stock ownership by value.

2. REQUIREMENTS:

a. OWNERSHIP CHANGE - GENERAL:

(i) The limitation on the use of a loss corporation's NOLs is caused by a more than 50 percentage point change in stock ownership of 5 percent shareholders.

(ii) If the ownership change is caused by a transaction which is not a reorganization, the change in stock ownership is measured with respect to the loss corporation.

(iii) If the ownership change is caused by a reorganization, the change in stock ownership is measured with respect to the corporation which inherits or retains the NOLs.

b. OWNERSHIP CHANGE NOT INVOLVING A REORGANIZATION:

(i) An ownership change occurs if immediately after an owner shift involving a 5 percent shareholder the percentage of the stock of the loss corporation owned by 1 or more 5 percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by those 5 percent shareholders at any time during the testing period. The testing period is the 3 year period ending on the day of any owner shift involving a 5 percent shareholder.

(ii) An owner shift involves a 5 percent shareholder if there is any change in the ownership of stock and that change affects the percentage of stock of the loss corporation owned by any person who was a 5 percent shareholder before or after the change.

(iii) In determining whether an owner shift has occurred, stock includes all stock except for stock defined in Section 1504(a) (4) (non-voting, non-convertible, non-participating preferred stock).

(iv) A five percent shareholder is any person who holds 5 percent or more in value of the stock of the loss corporation at any time during the testing period. All stock owned by shareholders of the loss corporation who are not 5 percent shareholders are treated as stock owned by one 5 percent shareholder.

(v) Attribution under Section 318 (with modifications) applies in determining stock ownership.

(vi) Examples of an owner shift involving a 5 percent shareholder:

(1) A taxable purchase of stock of the loss corporation by a person who becomes a 5 percent shareholder as a result of the purchase.

L is a loss corporation whose stock is publicly traded. No shareholder holds 5 percent or more of L stock. On September 1, 1990, A, B, and C each purchase one-third of L stock. Prior to the purchase, A, B, and C did not own any L stock. A, B, and C are not related to each other or to any L shareholder. A, B, and C each have become 5 percent shareholders. An ownership change has occurred because the percentage of stock owned by A, B, and C has increased after the owner shift (100 percent) by more than 50 percentage points over the lowest percentage of L stock owned by A, B, and C at any time during the 3-year period prior to September 1, 1990 (0 percent).

(2) A disposition of stock by a person who holds at least 5 percent of the stock of the loss corporation either before or after the disposition.

(3) A taxable purchase of the stock of the loss corporation by a person who becomes a 5 percent shareholder as a result of the purchase.

(4) A Section 351 exchange that affects the percentage of stock ownership of the loss corporation by one or more 5 percent shareholders.

c. OWNERSHIP CHANGE INVOLVING REORGANIZATIONS:

(i) An ownership change occurs if, immediately after an equity structure shift, the percentage of the stock of the corporation inheriting or retaining the NOLs owned by one or more 5 percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by those 5 percent shareholders at any time during the testing period. Stock includes all stock except stock defined in Section 1504(a)(4). The testing period is the 3-year period ending on the date of any equity structure shift.

(ii) An equity structure change is any reorganization other than a reorganization described in Section 368(a)(1)(F) or one to which Section 355 applies.

(iii) A 5 percent shareholder is any person holding 5 percent or more of the stock of the corporation inheriting or retaining the NOLs at any time during the testing period. All stock owned by shareholders of each corporation, which is a party to the reorganization, who are not 5 percent shareholders is treated as stock owned by one 5 percent shareholder of that corporation.

(iv) Attribution under Section 318 (with modifications) applies in determining stock ownership.

Example of an equity structure shift:

L is a loss corporation. All of the L stock is owned by A. P is a profitable corporation. All of the P stock is owned by B. On September 1, 1990, P acquired all of L's assets in a reorganization described in Section 368(a)(1)(A). A receives 30 percent of P stock. There has been an ownership change in L because the percentage of L stock owned by B following the equity structure change (70 percent) has increased by more than 50 percentage points over the lowest percent of L stock owned by B at any time during the 3-year period prior to September 1, 1990 (0 percent).

d. OWNERSHIP CHANGE CAUSED BY MULTIPLE TRANSACTIONS:

(i) Even if an owner shift involving a 5 percent shareholder and an equity structure shift standing alone would not constitute an ownership change, together they may constitute an ownership change.

Example:

Individual I owns all of the stock of profitable corporation P. On January 1, 1990, I purchases 40 percent of the stock of the loss corporation L. After I's purchase, the remaining stock of L is held by 25 shareholders. None of the 25 shareholders owns 5 percent of L stock.

On July 1, 1990, P acquires all of the assets of L in a reorganization within the meaning of Section 368(a)(1)(A). The L shareholders together receive 60 percent of P stock. I receives 24 percent of the P stock and the 25 shareholders receive 36 percent of the P stock. L has undergone an ownership change because the percentage of stock owned by I in P after the reorganization (64 percent) has increased by more than 50 percentage points over the lowest percentage of stock in L owned by I during the 3-year period prior to July 1, 1990 (0 percent prior to January 1, 1990).

3. AMOUNT OF THE LIMITATION ON NOLs:

a. A limitation is placed on taxable income which can be offset by NOLs after an ownership change.

(i) The limitation is the value of the loss corporation multiplied by the long-term tax-exempt rate. An unused limitation can be carried forward and increases the limitation for the subsequent year subject to the normal NOL carryforward period.

(ii) The value of the loss corporation is the value of its stock immediately before an ownership change. Under regulations, warrants, options, contracts to acquire stock, convertible debt and similar interests may be treated as stock. Regulations are also to provide for when stock will not be treated as stock.

(iii) If a redemption occurs in connection with an ownership change, the value of the loss corporation is determined after taking the redemption into account.

(iv) Any capital contribution which is made as part of a plan the principal purpose of which is to increase a limitation is not taken into account. Unless regulations provide otherwise, any capital contribution which is made within 2 years of an ownership change is presumed to have been made as part of a plan to increase a limitation.

(v) The value of a corporation is reduced if the corporation has substantial nonbusiness assets. A corporation has substantial nonbusiness assets if at least one-third of the value of the total assets of such corporation consists of assets held for investment. The reduction equals the fair market value of the investment assets less the indebtedness of the corporation that is applicable to these assets. In computing the nonbusiness assets, stock or securities in a 50 percent (vote and value) or more owned subsidiary shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets.

b. ADJUSTMENTS TO THE LIMITATION:

(i) The limitation is increased by the amount of the unrealized built-in gain of the loss corporation which is recognized during the taxable year and within the recognition period provided the net unrealized built-in gain exceeds the date of an ownership change.

(ii) The unrealized built-in loss of the corporation which is recognized during the taxable year and within the recognition period is treated in the same manner as if such loss were subject to the NOL limitation provided the net unrealized built-in loss exceeds the threshold amount. The same recognition period applies.

(iii) The regulations provide that certain deductions accrued before the change date are built-in losses. However, depreciation is not a built-in loss.

(iv) Built-in gain and loss are determined with reference to the fair market value and adjusted basis at the time of the ownership change. However, if the net unrealized built-in gain or loss is not greater than the threshold amount, (25 percent of the fair market value of the assets, less any cash or cash items, of the corporation immediately before the ownership change), the limitation should not be adjusted.

(v) The limitation is increased by any Section 338 gain.

4. LOSS OF THE USE OF NOLs:

   a. If the continuity of business enterprise test for reorganizations is not satisfied at all times during the 2-year period following the change of ownership, the NOLs can only be used to offset recognized built-in gains and gain by reason of a Section 338 election.

   b. Section 269, and the limiting rules of the consolidated return regulations (SRLY and CRCO) continue to apply. However, the "Libson Shops" doctrine is no longer applicable to NOLs.

5. ORDERING RULES FOR UTILIZATION OF NOL's:

   a. The NOLs subject to the Section 382 limitation are utilized before any other available NOLs.

6. SPECIAL RULES ARE PROVIDED FOR BANKRUPT COMPANIES AND CERTAIN FINANCIAL INSTITUTIONS.

7. LIMITATION ON OTHER CARRYFORWARDS:

   a. The new law applies similar rules to carryforwards other than NOLs, such as general business credits, net capital losses and excess foreign tax credits.