NOL Carryforward Use Limitation After the Ownership Change of a Multiple Stock Class Corporation

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In recent years, many taxpayer corporations have accumulated net operating loss (NOL) carryforward income tax benefits. Internal Revenue Code Section 382 limits the taxpayer corporation's use of the NOL tax benefit when there is a change of ownership. Some change in ownership transactions (e.g., mergers and acquisitions) are obvious. Other change in ownership transaction (e.g., private equity investments, debt private placements with equity conversion features) are less obvious. This discussion summarizes some of the current valuation rules related to an ownership change in NOL corporations that have multiple classes of stock outstanding.

Introduction

Many industrial and commercial companies have been affected by the current economic recession. Due to the impact of this prolonged recession, many taxpayer corporations have incurred a net operating loss (NOL) for federal income tax purposes. For purposes of this discussion, such a taxpayer corporation (whether closely held or publicly traded) is referred to as an "NOL corporation."

Many of these NOL corporations have also had to raise new debt or equity capital in order to survive during the prolonged recession.

These capital formations may include (1) the private sale or public offering of common or preferred stock or (2) the issuance of debt instruments with some type of an equity feature (such as a stock warrant or an equity conversion feature).

An NOL is typically considered to be a federal income tax benefit to a taxpayer corporation. This is because the NOL can be used by the taxpayer corporation to offset federal taxable income in future years (presumably when the economy improves and the subject company once again earns taxable income).

Accordingly, this tax benefit is considered to be the taxpayer corporation's ability to use the NOL to offset future taxable income. This tax benefit is called an "NOL carryforward."

However, after an ownership change, Internal Revenue Code Section 382 limits the amount of income that the NOL corporation may offset by the use of its pre-change NOL carryforward.

That annual income offset limitation is generally equal to an amount determined by multiplying (1) the fair market value of the taxpayer corporation equity by (2) the federal long-term tax-exempt rate in effect on the ownership change date.[1]

An Ownership Change Can Limit the Use of an NOL Carryforward

Two kinds of taxpayer corporation ownership changes can trigger the Section 382 NOL income offset limitation:

1. an ownership change involving a five percent shareholder

2. any tax-free reorganization of the corporation (with a few exceptions)

In either case, a five percent shareholder must have increased his or her ownership percentage in the NOL corporation by more than 50 percent (over his or her lowest pre-change ownership percentage) within three years of the ownership change event.[2]

The second kind of NOL limitation ownership change event is usually more obvious. If the stock of the NOL corporation is merged or acquired in a tax-free transaction structure (e.g., a cash for stock purchase, a stock for stock exchange, etc.), then the Section 382 NOL limitation applies.

The first type of NOL limitation ownership change event is not always so obvious. For example, an ownership change triggering event could include the private placement (or the public offering) of a relatively small amount of equity, an equity investment by a private equity fund, the exercise of stock options by the taxpayer corporation employees, or other similar event.

Either public or private capital placements may result in a Section 382 "ownership change" in the NOL corporation. And, the Section 382 determination of an "ownership change" by a five percent shareholder is typically based on a valuation calculation, as discussed below.

Particularly after a capital formation event, the NOL corporation may have several classes of stock outstanding (voting and nonvoting stock; common and preferred stock; class A and class B common stock; etc.).

For an NOL corporation with multiple classes of stock outstanding, any price fluctuation in the stock trading price (for a public corporation) or in the stock fair market value (for a closely held corporation) will complicate the determination of whether the future use of the NOL carryforward may be limited.

Multiple Stock Class NOL Corporations

Section 382(l)(3)(C) specifically addresses the issue of fluctuations in stock price/value (depending on whether the stock is public or private) for an NOL corporation with multiple classes of stock outstanding.

Section 382(l)(3)(C) states: "Except as provided in regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account."

However, the regulations do not specifically address how to apply Section 382(l)(3)(C). Therefore, the multi-stock class NOL corporation (and its tax and valuation advisers) have little professional guidance related to a valuation issue that directly affects the taxpayer corporation's ability to use its NOL.

In prior years, the Internal Revenue Service indicated its position on this change of ownership issue through the issuance of private letter rulings.

Most recently, the Service issued Notice 2010-50 regarding the NOL limitation related to a change of corporate ownership for a taxpayer corporation with multiple stock classes.

Prior Guidance on Section 382(l)(3)(C)

Since 2004, the Service issued a series of letter rulings that have addressed the application of Section 382(l)(3)(C).

The earlier letter rulings generally indicated that: "on any testing date, in determining the ownership percentage of any 5% shareholder, the value of such shareholder's stock, relative to the value of all other stock of a loss corporation issued subsequent to such acquisition date shall also be considered to remain constant since the acquisition date."

In the more recent letter rulings (e.g., Letter Rulings 201017004, 200952004, and 200901003), the Service adopted a valuation procedure that is

commonly referred to as the hold constant principle (HCP).

For example, in Letter Ruling 201017004, the Service concluded that the "[t]axpayer may apply a method employing the Hold Constant Principle to determine the increase in percentage ownership of each of its 5% shareholders on each of its testing dates . . . for purposes of Section 382."

A comprehensive explanation of the NOL use limitations due to a change of ownership in a multiple stock class corporation is beyond the scope of this discussion.

However, (1) the application of the HCP and (2) the current Internal Revenue Service interpretation of Section 382(l)(3)(C)—as outlined in Notice 2010-50—are discussed below.

Internal Revenue Service Notice 2010-50

Recently, the Service provided Section 382(l)(3)(C) interim guidance to multiple stock class NOL corporations with the issuance of Notice 2010-50. This Notice appears to be the first guidance from the Service that actually provides specific application guidance for Section 382(l)(3)(C).

In particular, this Notice describes the acceptable valuation methods to account for any fluctuations in the value of one class of the NOL corporation stock relative to another class of the NOL corporation stock for the purpose of determining the Section 382 NOL limitation.

In the Notice, the Service states that it will accept certain valuation methods for taking into account, or for not taking into account, any fluctuation in the NOL corporation stock value.

As summarized below, the Notice describes two valuation methods that the Service will accept in the application of Section 382(l)(3)(C) to quantify the NOL limitation for a multiple stock class corporation.

These two valuation methods are called:

1. the full value method (FVM) and
2. the HCP.

The Full Value Method

Under the FVM, the determination of the ownership percentage in the NOL corporation stock owned by any shareholder is based on:

1. the fair market value of the stock owned by that individual shareholder relative to
2. the total fair market value of the NOL corporation total outstanding stock on a testing date.

Accordingly, under the FVM, all of the NOL corporation shares are effectively marked to market. This is true regardless of whether the individual shareholder actively participates in—or is otherwise a party to—the change of ownership transaction.

This valuation method provides for a very narrow interpretation of Section 382(l)(3)(C). That is, this FVM valuation method gives effect to the Section 382(l)(3)(C) statutory language by not requiring an accounting for the daily fluctuations in fair market value between the different classes of the NOL corporation stock that may occur between testing dates.

The Hold Constant Principle

In contrast, the HCP gives effect to the Section 382(l)(3)(C) statutory language by factoring out fluctuations in the fair market value of the NOL corporation stock held by passive shareholders across multiple testing dates.

In the Notice, the Service states:

> . . . 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.

In other words, under the HCP, for an NOL corporation with multiple stock classes outstanding:

- The fair market value ratios between and among the various NOL corporation stock classes are fixed, or "held constant," on the date that the particular share is acquired.
- Any change in ownership that is attributable solely to fluctuations in the relative fair market values of the different classes of NOL corporation stock is not taken into account when determining an ownership change.
- The "factoring out" process generally continues for the particular share—until the shareholder is no longer treated as owning the tested share for Section 382 purposes.

In contrast to the FVM, the HCP is individualized for each individual stock acquisition by each individual shareholder.

And, under the HCP, the ownership percentage of each tested share is adjusted for:

1. the dilutive effects of any stock issuances and
2. the accretive effects of any stock redemptions subsequent to the original share acquisition date.

Notice 2010-50 provides the following illustrative example of the application of the HCP:

> Example 1: Upon formation, X Corp. issues $20 of convertible preferred stock to A and two shares of common stock to B for $80, such that A and B own 20% and 80% of X, respectively. X's fortunes 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 that sale, X is a loss corporation. On that testing date, although A actually owns 80% of X's value, A will be treated as owning 20% of X's value for purposes of Sec. 382(g) under the HCP.

As explained in this illustrative example, under the HCP, the increase in shareholder A's ownership percentage interest (i.e., 60%) is attributed solely to fluctuations in the relative fair market value of the NOL corporation common stock.

The only share that is marked to fair market value is the one share that is acquired by shareholder C. That one share represents 10% of the NOL corporation's total equity value on the date of the stock acquisition.

When determining an ownership change under the HCP, the ownership percentage increase as a consequence of the acquisition by shareholder C is only 10%. Therefore, according to the HCP, no ownership change has occurred.

This HCP application illustrative example is consistent with the Service's previous position in the prior letter rulings related to Section 382(l)(3)(C).

There are two valuation procedures that implement the HCP valuation method specifically outlined in Notice 2010-50. These two alternative valuation procedures are summarized below.

Alternative Procedure No. 1—Look-back from the Testing Date

This valuation procedure recalculates the HCP represented by the tested share in order to factor out any changes in its relative fair market value since that share's acquisition date.

Under alternative procedure 1, the percentage interest represented by a tested share on a testing date is determined at the beginning with the fair market value of the tested share on the testing date.

Then, the percentage interest is adjusted by the subsequent changes in the fair market value of the tested share relative to the changes in the total fair market value of all the NOL corporation stock that have occurred since the tested share's acquisition date.

Alternative Procedure No. 2—Ongoing Adjustments from the Acquisition Date

This valuation procedure tracks the percentage interest represented by the tested share from the date of acquisition forward. This valuation procedure adjusts for:

1. any subsequent stock dispositions and
2. the subsequent issuance or redemption of other stock.

Under alternative procedure 2, to the extent a particular shareholder does not engage in any stock acquisitions or dispositions, then the percentage ownership calculation "rolls over" from one testing date to another.

Under alternative procedure 1, the NOL corporation generally determines the relative fair market value of its stock shares:

1. at the beginning of the testing period or
2. at an earlier date.

In contrast, this valuation procedure may not necessarily be the case under alternative procedure 2. Therefore, alternative procedure 2 may involve fewer calculations on any particular testing date than alternative procedure 1.

Common Elements of Both of the HCP Valuation Procedures as Described in Notice 2010-50

First, under either of the HCP alternative valuation procedures, an NOL corporation does not factor out fair market value fluctuations related to an acquisition.

Instead, for any share that is acquired, the NOL corporation determines the percentage interest related to that share by comparing its fair market value to the fair market value of all NOL corporation outstanding stock on the acquisition date.

Second, under either of the HCP alternative procedures, a shareholder's increase in proportionate interest during a testing period will be reduced by any share dispositions.

The Notice describes two valuation methods that may be used to account for such share dispositions:

1. the fair market value method
2. the share equivalent method

Under the fair market value method, the effect of a shareholder's share disposition is based on the percentage ownership that the sold share represents on the date of its disposition—as opposed to the percentage represented by that share on the date of its acquisition.

Under the share equivalent method, the effect of a share disposition is based on the percentage ownership that the sold share represented on another testing date during the testing period in which the selling shareholder acquired shares.

The Notice provides the following illustrative example of the application of the share equivalent method:

> Example 2: A purchases 10 shares of X's common stock for $10 on testing date 1, when each share of common stock represents 1% of X. X is a loss corporation. On testing date 1, A also holds two shares of participating preferred stock, with each share valued at $2 and each preferred share representing 2% of X. On testing date 2, A disposes of one share of the preferred stock. Under a share equivalent method, A may 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.

Third, the Notice states that (1) if an NOL corporation determines the effect of a share disposition based on the percentage represented by the sold share on the share acquisition date, and (2) if a five percent shareholder has made multiple share acquisitions and dispositions of the NOL corporation stock, then—under either of these two valuation methods—the NOL corporation must also determine the source of the shares that were disposed of.

"Using either current or historical fair market values can produce substantially different outcomes for purposes of determining whether an ownership change has occurred."

In that case, the NOL corporation may treat the sold shares:

1. as being sourced pro rata from all share acquisitions,
2. as being sourced first from the most recent share acquisition (LIFO), or
3. as being sourced first from the first share acquisition (FIFO).

Fourth, to the extent that a shareholder remains as an owner of the NOL corporation (or of its successor), the original acquisition date and any other hold constant characteristics are preserved.

In addition, the NOL corporation is not treated as disposing of—or acquiring—the NOL corporation stock. The Notice states that this principle applies to value-for-value recapitalizations in which a shareholder exchanges his or her NOL corporation stock for other NOL corporation stock.

This principle also applies to certain reorganizations and holding company formations.

Fifth, Section 382 also takes into account NOL corporation stock redemptions and issuances by the NOL corporation for purposes of tracking five percent shareholder ownership percentages.

For Section 382 purposes, a stock redemption constitutes a pro rata acquisition by a nonredeeming shareholder of the redeemed shares.

For Section 382 purposes, a stock issuance constitutes:

1. a pro rata sale of shares by a shareholder who holds stock immediately before the issuance
2. to a shareholder who purchases shares in the stock issuance.

In applying the HCP in a stock redemption or issuance, the effect of both situations on the preexisting shares could be determined by reference to current or relative historical fair market values.

Using either current or historical fair market values can produce substantially different outcomes for purposes of determining whether an ownership change has occurred. In addition, even if historical fair market values are used, then applying the two HCP alternative valuation procedures may produce different outcomes.

Summary and Conclusion

The prolonged recession has caused many industrial and commercial companies to incur an NOL during recent years. Section 382 provides limitations on the taxpayer corporation's future use of the NOL in certain conditions, such as a change of ownership.

Some taxpayer corporation ownership changes are obvious, such as a merger or acquisition that is structured as a tax-free exchange transaction. Some taxpayer corporation ownership change transactions are less obvious, such as raising equity capital from private equity sources.

When the taxpayer corporation has multiple stock classes outstanding (which is very common after a capital raising transaction), the determination of an ownership change for Section 382 NOL limitation purposes becomes particularly complicated.

Notice 2010-50 provides needed guidance to an NOL corporation with multiple stock classes—and to its tax and valuation advisers. However, questions regarding the Section 382 NOL use limitation after a change of ownership are still complex.

This conclusion is particularly true for the taxpayer corporation (whether public or private) with multiple stock classes that experience fluctuating stock valuations.

And, as more industrial and commercial companies experience the negative effects of the prolonged recession, there are more taxpayer corporations that will have to deal with these (and other) complex NOL use limitation issues.

Notes:

1. See Section 382(b)(1).
2. See Temporary Regulation 1.382-2T.

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