NOL Carryforward Use Limitations After An Ownership Change Transaction

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Notice 2010-50 provides needed guidance to NOL corporations with multiple classes of stock — and to their tax and valuation advisors. However, questions regarding the section 382 NOL use limitation after a change of ownership are still complex.

THE ECONOMIC TROUBLES of the last few years have had far-reaching effects for a number of businesses, with many industrial and commercial taxpayer corporations having incurred net operating losses (NOLs). (For purposes of this discussion, such a taxpayer corporation is referred to as an NOL corporation.) In addition, many of these NOL corporations have also had to raise new debt or equity capital in order to survive the last few years. These capital formations may include the sale of common or preferred stock or the issuance of debt with an equity “kicker” (such as a stock warrant or an equity conversion feature).

An NOL is typically considered to be a federal income tax benefit. This is because an 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 returns to profitability). This tax benefit is 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 (I.R.C) section 382 limits the amount of income that the NOL corporation may offset by the use of its pre-change NOL carryforward. That annual limitation is generally equal to an amount determined by multiplying the fair market value of the taxpayer corporation equity by the federal long-term tax-exempt rate in effect on the ownership change date. See I.R.C. §382(b)(1).

Ownership Change Can Limit the Use of the NOL Carryforward • Two kinds of taxpayer corporation ownership change can trigger the section 382 NOL income offset limitation:
  • An ownership change involving a five percent shareholder; and
  • Any tax-free reorganization (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. See Temp. Treas. Reg. 1.382-2T. The second kind of NOL limitation ownership change is usually more obvious. If the stock of the NOL corporation is acquired or merged in a tax-free transaction structure (such as cash for stock purchase, stock for stock swap, and so on), the section 382 NOL limitation applies. The first type of NOL limitation ownership change is not always so obvious. For example, ownership change triggering events could include the private placement (or public offering) of relatively small amounts of equity, an equity investment by a private equity fund, the exercise of stock options by company employees, and the like.

Either public or private capital placements may result in an “ownership change” in the NOL corporation as defined under the section 382 provisions. And, the section 382 determination of an “ownership change” is based on a valuation calculation, as discussed below.

Particularly after a capital formation event, the NOL corporation may have several classes of stock (such as voting and nonvoting, common and preferred, and so on) outstanding. For an NOL corporation with multiple classes of stock outstanding, any price fluctuations in the stock price (for a public corporation) or the stock value (for a private corporation) complicate the determination of whether the future use of the NOL carryforward may be limited.

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 NOL corporation (and its tax and valuation advisors) have had little professional guidance related to an issue that directly affects the taxpayer corporation’s ability to use its NOL. In prior years, the Internal Revenue Service (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 classes of stock.

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

Since 2004, the Service has issued a series of letter rulings addressing 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 five percent shareholding, the value of such shareholder’s stock, rela-
tive 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 limitations due to a change of ownership in a complex (i.e., multiple class of equity) capital structure is beyond the scope of this discussion. However, the HCP and the current Service interpretation of section 382(l)(3)(C) — as outlined in Notice 2010-50 — are discussed below.

**Internal Revenue Service Notice 2010-50**

On June 11, 2010, the Service provided interim section 382(l)(3)(C) guidance to NOL corporations with the issuance of Notice 2010-50, 2010-2 C.B. 12. This Notice appears to be the first guidance from the Service that 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 purposes of the section 382 NOL limitation.

In the Notice, the Service states that it will accept certain valuation methods for taking into account, or not taking into account, fluctuations 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 any NOL limitation for a corporation with multiple stock classes. These two valuation methods are the full value method (FVM) and 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 the fair market value of the stock owned by that individual shareholder relative to the total fair market value of the NOL corporation 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 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 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, when an NOL corporation has multiple classes of stock outstanding, then: