NET OPERATING LOSSES: A VALUABLE ASSET WORTH PRESERVING

Author
Philip R. Hirschfeld

Tags
Carryback
Carryforward
Code §172
Code §382
Code §269
Consolidated Tax Return
Net Operating Loss
Separate Return Limitation Year

OVERVIEW

Every cloud has a silver lining. This expression also applies to the world of tax. Troubled companies that incur significant operational and interest expenses may find that they have generated significant net operating losses ("N.O.L.'s"). Those N.O.L.'s can be carried back up to two years or carried forward for up to 20 years to reduce taxable income,[1] although an alternative minimum tax imposed at a 2% effective rate[2] plus state franchise tax and local business taxes based on methods other than income[3] may reduce the benefit somewhat. The reduction in tax attributable to the utilization of N.O.L.'s creates cash flow that is just as valuable as cash flow generated from running the business.

As a result, substantial N.O.L.'s can be valuable corporate assets that make a company an inviting target to acquire. However, U.S. Federal tax law contains three stumbling blocks that may apply when stock in a company with N.O.L.'s is sold or exchanged. In these cases, Code §§382 and 269, as well as the separate return limitation year ("S.R.L.Y.") provisions of the consolidated return regulations,[4] may limit a company's ability to benefit from the use of N.O.L.'s. To preserve N.O.L.'s, acquisitions must be carefully reviewed before stock is sold, exchanged, or issued.

CODE §382 LIMITATIONS

Code §382 limits the use of N.O.L.'s once an ownership change of a specific magnitude takes place in the company that generated the loss. In broad terms, an ownership change requires a 50-percentage point change in stock ownership of 5% shareholders[5] over a three-year testing period.[6] The focus is only on 5% shareholders to simplify the analysis.

If an ownership change occurs, the future use of an N.O.L. in any year is restricted

---

1 Code §172(b)(1)(A).

2 Code §55(b)(1)(B) imposes a tentative alternative minimum tax on corporations at the rate of 20%. The N.O.L. is subject to a cap when applied to the A.M.T. Under Code §56(d)(1)(A)(i)(II), only 90% of the alternative minimum taxable income may be reduced by a N.O.L.

3 New York City imposes an alternative tax based on capital if that tax is greater than the tax on income. New Jersey has an alternative minimum corporate income tax that can be as much at 0.8% of gross profits above $37.5 million.

4 Treas. Reg. §1.1502-21(c)(1)(i).

5 A 5% shareholder includes any person who owns 5% or more of the loss corporation. Code §382(k)(7).

6 Code §§382(g)(1), (i).

by the Code §382 limitation.[7] This limitation is equal to the product of (i) the value of the loss corporation on the date of the ownership change multiplied by (ii) the long-term tax-exempt rate for that month (or if larger, any of the two preceding months).[8]

Ownership Change

An ownership change is defined to mean any shift in ownership with respect to one or more 5% shareholders where, after the change, the percentage of stock that the 5% shareholders own in the loss corporation is increased by more than 50 percentage points over the lowest percentage of stock owned by those 5% shareholders during the testing period.[9] The testing period is the three-year period which ends on the date of the change.[10] The computation is made on the basis of the value of the shares[11] so that the limitation applies once stock representing more than 50 percentage points in value has changed within the testing period. Value refers to the fair market value.[12]

A 5% shareholder is defined as any person holding 5% or more of the stock of the corporation at any time during the testing period.[13] Rules of attribution apply in determining whether an ownership change has occurred:[14]

- All members of a family (*viz.*, husband, wife, children, grandchildren, parents) are aggregated and treated as a single person.
- Shares owned by a corporation or partnership are considered to be owned by its shareholders or partners.
- Shares owned by a trust are considered to be owned by its beneficiaries in proportion to their actuarially determined interests in the trust.[15]

Once an ownership change triggers application of the limitation,[16] the new ownership level becomes the base against which subsequent ownership changes are evaluated. As a result, the testing period for subsequent changes cannot take into account ownership that existed on or before the day on which the limitation is triggered.

The Limitation

If the limitation applies, the amount of the N.O.L. carryover that may be claimed

---

[7] This limitation does not apply to certain ownership changes occurring in a bankruptcy proceeding or when the company is insolvent. Code §§382(l)(5), (6).

[8] Code §382(b)(1). Also, the N.O.L. will be eliminated if the loss corporation does not continue to carry on its business.

[9] Code §382(g)(1).

[10] Code §382(i).

[11] Code §382(k)(6)(C).

[12] Code §382(k)(5).

[13] Code §382(k)(7).

[14] Code §382(l)(3)(A).

[15] Code §318(a), except that attribution from corporations is not limited to persons who own 50% or more of the corporation.

[16] Code §382(i)(2).

every year as a deduction is limited to the value of the corporation immediately prior to the change in ownership multiplied by the long-term tax-exempt rate.[17] The long-term, tax-exempt rate is an interest rate that is published periodically by the I.R.S. and is based on the average yield of tax-exempt instruments.

"There is no abuse in acquiring the shares of the corporation and utilizing the N.O.L. to shield future income to the extent the tax benefit of the N.O.L. in any year does not exceed the tax-free yield on the bonds."

The theory for this approach is that a purchaser of a corporation having an N.O.L. could have invested in municipal bonds generating tax-free income. Instead, it acquired shares of the corporation with an N.O.L. Viewed in this light, there is no abuse in acquiring the shares of the corporation and utilizing the N.O.L. to shield future income to the extent the tax benefit of the N.O.L. in any year does not exceed the tax-free yield on the bonds.

In determining the limitation, the long-term tax-exempt rate for the month in which the ownership change takes place (or if greater, the rate for either of the preceding two months) is the rate that is used during the entire carryover period. In May 2017, the rate was 2.09%.[18]

If the company has a net built-in loss in its assets on the date of an ownership change, then the Code §382 limitation also applies to the future use of the built-in losses.[19] A net built-in loss exists where a loss has economically occurred, but has not yet been realized. An example is a single asset in the company where the tax basis in the asset is $5 million but its fair market value is $1 million on the date of the ownership change. There, the net built-in loss is $4 million. A $4 million loss recognized on a later sale of that asset will be subject to the limitation. An example where a sale of an asset produces an ordinary loss would be the sale of depreciable property used in a trade or business and held for more than 12 months. When these assets are sold at a loss, they produce an ordinary loss, but when sold at a gain, the gain is given capital treatment.[20]

Lastly, if the limitation applies, the loss company must carry on the business that existed before the change in ownership for the two-year period that begins with the date of the change. If the business is not carried on for all days within that two-year period, no portion of the N.O.L. carryover may be claimed as a deduction.[21]

CODE §269 LIMITATIONS

Code §269 applies only to the extent that control of a corporation is acquired and tax avoidance is *the* principal purpose for the acquisition. Control means ownership of stock representing 50% or more of the value of all company stock or 50% or more of the vote of all company voting stock. Where either of those facts exist, Code §269 denies deductions or credits such as N.O.L. carryforwards of the acquired company.

The regulations under Code §269 provide that certain fact patterns are indicative of the presence of a tax avoidance motive. One such fact pattern is (i) the acquisition, (ii) by a profitable corporation, (iii) of control of a target corporation, (iii) having

---

[17] Code §382(b)(1).

[18] Rev. Rul. 2017-11.

[19] Code §382(h).

[20] Code §1231.

[21] Code §382(c)(1).

net operating losses, (v) followed by the transfer of business assets to the loss corporation, (vi) in a transaction that brings profits and losses into one entity. Where those facts exist, the burden of proof is on the taxpayer to demonstrate the existence of a business reason for the transaction which outweighs the tax reduction motive.

CONSOLIDATED RETURN REGULATIONS: S.R.L.Y.

The consolidated tax return regulations allow two or more corporations that meet certain requirements to join in the filing of a consolidated tax return.[22] As a result, the losses and credits of one company generally can be used to offset the profits or taxes of another company within the group.

The consolidated tax return regulations are legislative regulations, meaning that the I.R.S. was granted broad authority by Congress to draft the rules controlling the computation of income and tax for a group.[23]

Under that broad grant of authority, the regulations limit a group's use of loss or credit carryovers attributable to a group member that filed a separate tax return in the year when the loss or the unused credit first arose. The losses that are not available to the group are known as separate return limitation year, or S.R.L.Y., losses.[24]

"Generally, losses of a member of an affiliated group which arose in an S.R.L.Y. may not be offset against the income of other group members."

An S.R.L.Y. is any year in which a corporation either (i) filed a separate Federal income tax return or (ii) was a member of one affiliated group in the year the loss was incurred and a member of another affiliated group in the year to which the loss is carried.[25] Generally, losses of a member of an affiliated group which arose in an S.R.L.Y. may not be offset against the income of other group members. However, the S.R.L.Y. loss may continue to offset the income of the corporation that generated those losses.[26]

OVERLAP BETWEEN CODE §382 AND S.R.L.Y. RULES

The S.R.L.Y. rules do not apply if they overlap with the Code §382 limitations.[27] This occurs for an N.O.L. if a corporation becomes a consolidated group member within six months of a Code §382 ownership change with respect to the loss.[28] In practice, the overlap rule will often eliminate the need to deal with the S.R.L.Y. limitation.

---

22 Treas. Reg. §1.1502-75(a).

23 Code §1502.

24 Treas. Reg. §1.1502-21.

25 Treas. Reg. §1.1502-1(f). There are exceptions such as for losses arising in S.R.L.Y.'s of the common parent corporation. Treas. Reg. §1.1502-1(f)(2).

26 Treas. Reg. §1.1502-21(c). A similar rule applies to unused credits that arise in an S.R.L.Y. and to losses that economically accrued in an S.R.L.Y. S.R.L.Y. losses and credits may be used only to reduce the income or the tax of the corporation, itself, and no other members of its group.

27 Treas. Reg. §1.1502-21(g)(1).

28 Treas. Reg. §1.1502-21(g)(2)(ii)(A). If the S.R.L.Y. event follows the §382 event, the overlap rule also applies to any "interim" N.O.L. Treas. Reg. §1.1502-21(g)(2)(ii)(B).

CONCLUSION

N.O.L.'s are valuable corporate assets that are worth preserving. However, when stock in a company that has an N.O.L. is acquired, three potential traps exist for the unwary that may limit the future use of the N.O.L.'s. The potential acquirer must consider Code §382, Code §269, and the S.R.L.Y. rules under the consolidated return regulations. With proper care, the limitations can be managed with planning prior to the stock acquisition.

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*