

# Availability of Net Operating Losses - Ownership Change Overview

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## **Availability of NOL's - Ownership Change - Brief Overview**

Under IRC § 382 "the amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the § 382 limitation for such year."

Under prior law, the general approach was to limit or reduce the amount of NOL carryovers in certain acquisitions. Under current laws as enacted in the '86 Act and further refined in TAMRA '88, the carryovers remain intact but the post-acquisition income against which they can be applied is limited. The theory of the law is that the post-acquisition use of the carryovers should be limited to the use that the old loss corporation could have made of them if the acquisition had not occurred. It is assumed that the old loss corporation could have earned income each year equal to a reasonable return on its value, and the post-acquisition income against which the old loss corporation's carryovers can be applied is therefore limited each year to a percentage of the old loss corporation's value on the acquisition date deemed to represent a reasonable rate of return.

- A. Section 382 applies only after a change, however effected, in ownership of more than 50 percent of the stock (by value) in a loss corporation over a prescribed period of time. See section 382(g).

Example: Deff Fix-It Company has 100 outstanding shares of stock. Fifty-one shares are owned by Abbott, 26 shares are owned by Babbit, and 23 shares are owned by Cabot. If Abbott purchases all of Babbit's shares, then Abbott's personal ownership has increased by 51% (from 51 shares to 77 shares) even

though Abbott's increase is only 26 percentage points. If Abbott also purchases all of Cabot's shares, Abbott's personal ownership has increased by 96% (from 51 to 100 shares), but Abbott's increase is only 49 percentage points. There is no ownership change within §382.

- (1) Such a change is referred to as an "ownership change." The date on which an ownership change occurs is referred to as the "change date." See section 382(j).
- (2) There are essentially five "sub-elements to an ownership change: (i) the testing date; (ii) the transaction; (iii) the ownership increase; (iv) the testing period; and (v) the shareholders.
- (3) The ownership change calculation is made at the close of any testing date. Treas. Reg. § 1.382-2T(a)(1). In general, a testing date occurs on any date on which occurs an "owner shift involving a 5-percent shareholder," an "equity structure shift" or certain issuances or transfers of options to acquire loss corporation stock. Treas. Reg. § 1.382-2T(a)(2)(i); 26 USC §382(g)(1).
  - (a) An option generally is viewed as any right on the part of the holder to acquire stock. Under Treas. Reg. § 1.382-2T(h)(4)(v), an option includes interests similar to an option, such as warrants, convertible debt, put options and contracts to acquire or sell stock.
    - i) Under the Service's view, an offer that cannot be withdrawn as a legal or practical matter is an option. LTR 89300045; LTR

8929018; LTR 8917007; LTR 8903043; LTR 8841038.

- ii) A tender offer for stock may constitute an option. See LTR 8822074. Similarly, an offer to exchange debt for new debt and stock is an option. LTR 8834086. A plan of merger also is an option. LTR 8923021.
  - iii) A nonbinding letter of intent is not an option. LTR 8847067.
  - iv) Under Notice 88-67, 1988-1 C.B. 555, convertible stock (issued after July 19, 1988) otherwise described in section 1504(a)(4) is treated as an option and not as stock.
- (b) As indicated above, the issuance or transfer of an option generally is a testing date and an ownership change calculation must be made as of the close of that day.
- i) However, under Treas. Reg. § 1.382-2T(h)(4)(vi)(B), if the actual exercise of the option occurs within 120 days after the date on which the option is treated as being exercised, the loss corporation may elect to disregard the option attribution rule and take into account only the actual exercise of the option.
- (4) In general, a "loss corporation" is a corporation entitled to NOL carryovers or is entitled to use

a carryforward of disallowed interest. See section 382(k)(1).

- B. The change in ownership of the loss corporation generally must occur within a three-year testing period ending on the day of any owner shift or equity structure shift. Section 382(i)(1). A shorter testing period applies where a previous change has occurred during the testing period, or where the loss corporation's losses have all originated after the beginning of the normal three-year period. See sections 382(i)(2) and (3).
- C. Under the statute, the loss corporation must track the stock ownership of 5 percent shareholders.
  - (1) To determine who are its 5 percent shareholders, the loss corporation first must determine which ownership interests in the corporation constitute "stock." See section 382(k)(6); Treas. Reg. § 1.382-2T(f)(18).
  - (2) For purposes of determining whether an ownership change has occurred, the term "stock" means all stock other than stock described in section 1504(a)(4). Section 382(k)(6)(A); Treas. Reg. § 1.382-2T(f)(18)(i). See LTR 8945055. In general, section 1504(a)(4) describes stock which is nonvoting, nonparticipating, nonconvertible, limited and preferred as to dividends, and not entitled to an unreasonable redemption or liquidation premium.
  - (3) Under sections 382(k)(6)(A) and (k)(6)(B)(ii), Treasury has authority to exclude from the definition of "stock," interests which otherwise qualify as stock. Treasury exercised this authority in drafting Treas. Reg. § 1.382-

2T(f)(18)(ii), which provides that an ownership interest that would otherwise constitute "stock" will not be treated as stock if:

- (a) As of the time of its issuance or transfer to (or by) a 5 percent shareholder, the "likely participation" of such interest in future corporate growth is "disproportionately small" when compared to the value of such stock as a proportion of total value of the outstanding stock of the corporation;
  - (b) Treating the interest as not constituting "stock" would result in an ownership change; and,
  - (c) The amount of pre-change loss (determined as if the testing date were the change date and treating any net unrealized built-in loss as a pre-change loss) exceeds a certain threshold amount -- twice the product of the value of the loss corporation as of the testing date and the long term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs (i.e., essentially double the section 382 amount for a single 365-day post-change year).
- (4) In addition, under Treas. Reg. § 1.382-2T(f)(18)(iii), an ownership interest that would not be treated as stock under the general rules will nevertheless be treated as stock if:
- (a) As of the time of its issuance or transfer to (or by) a 5 percent shareholder such interest "offers a potential significant



participation in the growth of the corporation";

- (b) Treating the interest as constituting stock would result in an ownership change; and
  - (c) The amount of pre-change loss (determined as if the testing date were the change date and treating any net unrealized built-in loss as a pre-change loss) exceeds a certain threshold amount -- twice the product of the value of the loss corporation on the testing date and the long term tax exempt rate (as defined in section 382(f) for the calendar month in which the testing date occurs.
- (5) Treas. Reg. § 1.382-2T(f)(18)(iv) states that "stock" of the loss corporation includes stock as that term is defined by Treas. Reg. § 1.382-2T(f)(18) and, as the context may require, includes any indirect ownership interest in the loss corporation.

D. Once a corporation's "stock" interests have been identified, the corporation must then determine who owns such stock. For purposes of determining stock ownership, the constructive ownership rules of section 318 apply with certain modifications. See section 382(1)(3)(A); Treas. Reg. § 1.382-2T(h).

- (1) Under the option attribution rules, an option will be treated as being exercised on any testing date if such exercise would trigger an ownership change. Treas. Reg. § 1.382-2T(h)(4)(i).



- (2) The loss corporation must disregard the fact that an option is contingent or is not currently exercisable. Treas. Reg. § 1.382-2T(h)(4)(iii).
- E. Once the constructive ownership rules have been applied, the corporation can determine its 5 percent shareholders based on the percentage of stock that they own.
  - (1) A 5 percent shareholder is any person holding 5 percent or more (by value) of the loss corporation stock at any time during the testing period. Sections 382(k)(6)(C) and (7); Treas. Reg. § 1.382-2T(g).
  - (2) Shareholders who own less than 5 percent are aggregated and treated as one 5 percent shareholder. Section 382(g)(4); Treas. Reg. § 1.382-2T(j)(1).
  - (3) One or more groups of non 5 percent shareholders may be aggregated separately as a result of certain segregation transactions, such as public stock offerings, mergers and redemptions. Treas. Reg. §§ 1.382-2T(j)(2) and (3).
- F. An ownership change has occurred if the stock ownership of any one or more of the 5 percent shareholders has increased by more than 50 percentage points during the testing period.

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