© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Efficient Capital Raises by NOL Corporations

by Matthew J. Hofheimer

Matthew J. Hofheimer is tax counsel in the Chicago office of Skadden, Arps, Slate, Meagher & Flom LLP. He thanks Stuart Finkelstein, David Polster, David Rievman, and Lea Malewitz for their input.

In this report, Hofheimer explains how loss corporations can raise capital through stock issuances without triggering the net operating loss limitations of section 382. He also addresses tax reform's direct and indirect effects on section 382.

All views and any errors in this report are those of the author.

Copyright 2018 Matthew J. Hofheimer.
All rights reserved.

Table of Contents

I. Section 382 Overview 449
II. Capital Raises by Loss Corporations . . . 451
A. Debt 451
B. Plain Vanilla Preferred Stock 452
C. Options 453
D. Stock Issuances 453
III. Effects of Tax Reform 460
IV. Conclusion 461

Section 382 is one of many code provisions that can limit a corporation's ability to use its tax attributes. While some of those limitations require an inquiry into the underlying business purposes of a transaction, section 382 is largely mechanical in nature, and its rules generally apply regardless of the motivation of the corporation or its owners. As a result, section 382 may limit the ability of a loss corporation — a company with either net operating losses or specified built-in losses — to raise capital, even when there are otherwise genuine business purposes for a capital raise. Often, however, a corporation with meaningful amounts of NOLs or built-in losses has both an acute need for capital and limited means with which to raise it. Therefore, astute tax planning is needed to ensure that loss corporations can raise capital to meet their business needs without jeopardizing their valuable tax attributes.

I. Section 382 Overview

A detailed exploration of the (often byzantine) mechanics of section 382 is beyond the scope of this report.[1] However, some of the core provisions of section 382 are particularly relevant to a loss corporation's ability to raise capital through stock issuances.

Section 382 imposes a limitation on the use of NOLs and specified built-in losses following an ownership change.[2] The rules track ownership changes through shareholders that own 5 percent or more of the loss corporation's stock (5 percent shareholders).[3] An ownership change occurs if, during the testing period, the ownership of 5 percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders during the testing period.[4] The testing period for section 382 is generally a rolling three-year period,[5] and the testing date is any date on which there is an owner shift — that is, a change in the relative stock ownership of one or more 5 percent shareholders.[6]

Accordingly, on each testing date the loss corporation must compare the current stock

[1] Numerous works exist that do discuss section 382 in detail. *See, e.g.*, Mark J. Silverman, "Section 382," in 3 *Consolidated Tax Return Regulations* 3-765 (2017); and Lee G. Zimet, "Limitations on Corporate Tax Attributes: An Analysis of Section 382 and Related Provisions," in 25 *The Corporate Tax Practice Series* 374-1 (2016).

[2] Section 382(a) and (g).

[3] *See* reg. section 1.382-2T(g).

[4] Section 382(g)(1).

[5] Section 382(i).

[6] Section 382(g)(2); reg. section 1.382-2(a)(4).

For more *Tax Notes* content, please visit www.taxnotes.com.

ownership by each 5 percent shareholder with the 5 percent shareholder's three-year low and determine the amount of any increase. Then it must add together the amount of increase that each 5 percent shareholder experienced. If the aggregate owner shift contributed by 5 percent shareholders exceeds 50 percent, the loss corporation is treated as having undergone an ownership change.

The determination of what persons or groups of persons constitute 5 percent shareholders is complex and involves numerous constructive ownership rules.[7] Section 382 also uses the concept of public groups, which are groups of less-than-5-percent shareholders that are aggregated and collectively treated as a single direct or indirect 5 percent shareholder of the loss corporation.[8] Trading among members of a public group is generally disregarded, and as a result, the membership of a given public group can change over time without causing the loss corporation to recognize an owner shift.[9] This is true even if the loss corporation has actual knowledge of the transfers among members of a public group.[10]

However, some corporate transactions, such as stock issuances, are treated as segregation transactions, which create new public groups that the loss corporation must separately track as new 5 percent shareholders. Moreover, for an entity that owns more than 10 percent of the loss corporation, the segregation rules also apply at the entity level — meaning that equity issuances by owners of the loss corporation can similarly cause owner shifts.[11]

Because of these rules (and in contrast to many other antiabuse provisions of the code), the imposition of a section 382 limitation can depend in whole or in part on actions outside the loss corporation's control. From a policy perspective, this approach makes sense — if the provision is intended to prevent shareholders from trafficking in NOLs, it is necessary to ensure that acquiring shareholders who have not borne an economic loss be unable to benefit from the loss corporation's NOLs. However, this approach puts the loss corporation in the awkward position of not being able to fully control the availability of its own tax attributes.

As a result, capital raises by loss corporations must be undertaken with a view to (1) what future transactions may be taken by 5 percent shareholders and (2) what future capital needs the loss corporation will have. Regarding future actions undertaken by existing (or would-be) 5 percent shareholders, loss corporations can control (or at least influence) their fate by restricting transfers of stock in the corporation's charter or certificate of incorporation (charter restrictions)[12] or by adopting an NOL rights plan (an NOL poison pill).[13] Neither option gives complete control to the loss corporation. Charter restrictions are generally effective at preventing prohibited transfers, but they typically require a shareholder vote and are therefore difficult to impose on up-and-running corporations. An NOL poison pill merely discourages (albeit strongly) 5 percent shareholders from undertaking problematic transactions and does not negate any related section 382 consequences.[14]

As for the loss corporation's future capital needs — and assuming the loss corporation is confident it can control the actions of its

[7] *See* reg. section 1.382-2T(h).

[8] *See* reg. section 1.382-2T(g) and (j)(1).

[9] Reg. section 1.382-2T(e)(1)(ii).

[10] Reg. section 1.382-2T(e)(1)(iii), Example 6.

[11] Reg. section 1.382-2T(j)(3)(iii) and -3(j)(15).

[12] To the extent they are enforceable against holders of the loss corporation's stock, charter restrictions effectively police transfers by imposing transfer restrictions designed to prevent transactions from creating owner shifts. If the restrictions are violated, the loss corporation can invoke the charter to require a shareholder to dispose of the offending shares, and the acquisition is generally considered void *ab initio*. When loss corporations enforce their charter restrictions, the IRS has been willing to rule that any acquisition of stock in violation thereof will not be treated as an acquisition of stock for purposes of section 382. *See, e.g.*, LTR 200622013.

[13] An NOL poison pill is designed to discourage (but not prohibit) shareholders from becoming 5 percent shareholders or, for current 5 percent shareholders, from increasing their ownership. If the pill is triggered, shareholders other than the acquiring shareholder can, for example, purchase loss corporation stock at a significant discount (thus diluting the acquiring shareholder). However, the increase in percentage ownership by the investor who triggered the pill is not ignored for purposes of section 382 (nor is the issuance of stock under the NOL poison pill). Therefore, any section 382 consequences of the triggering transaction or from the resulting stock issuance remain outstanding.

[14] A shareholder can certainly bear the economic loss of the dilution as a result of an NOL poison pill and still cause an ownership change. *See Versata Enterprises Inc. v. Selectica Inc.*, 5 A.3d 586 (Del. S.Ct. 2010) (analyzing a transaction in which a hostile investor purposefully triggered a loss corporation's NOL poison pill and suffered dilution to "ruin the tax attributes" of the loss corporation).

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

shareholders — loss corporations must access the capital markets in ways that maximize the amount of capital they can raise without triggering an ownership change for purposes of section 382. For example, the loss corporation can incur indebtedness (assuming it is respected as debt for tax purposes) or issue plain vanilla preferred stock, neither of which is generally treated as stock for purposes of section 382 (and therefore neither of which causes any owner shift). Loss corporations frequently cannot use those options, however, because the tax losses that give rise to the NOLs are the result of real economic losses, meaning that many loss corporations are distressed and lack the capacity to issue debt (or debt-like preferred stock). Therefore, distressed loss corporations primarily raise capital through stock issuances in which section 382 considerations are paramount.

II. Capital Raises by Loss Corporations

A. Debt

Raising debt capital can be an effective way for loss corporations to avoid creating owner shift for purposes of section 382, and it is often the first avenue a loss corporation will pursue. However, many loss corporations cannot address all their capital needs by issuing debt.

When debt is issued, the determination of whether the instrument is debt for tax purposes is critical and depends on several factors.[15] An instrument that is debt in form but is recharacterized as equity for tax purposes will be treated as an issuance of stock by the loss corporation and (unless the debt qualifies as plain vanilla preferred stock) can result in the loss corporation recognizing an owner shift.

Even if the debt is respected as such for tax purposes, the loss corporation must also ensure that it is not recharacterized under the rules of reg. section 1.382-2T(f)(18)(iii). Under that provision, a non-stock instrument is recharacterized as stock when: (1) as of the time of its issuance or transfer to (or by) a 5 percent shareholder, the interest offers a potential significant participation in the growth of the corporation; (2) treating the interest as constituting stock would result in an ownership change; and (3) the amount of the pre-ownership-change losses (for example, NOLs) is more than twice the amount of the value of the loss corporation's stock multiplied by the long-term tax-exempt rate.[16]

Although section 382 authorizes Treasury to issue regulations that "treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock,"[17] the preamble to the regulations makes clear that "a financial instrument that generally is treated as debt for Federal income tax purposes nevertheless may be treated as stock under the temporary regulations if such debt offers a potential significant participation in the growth of the loss corporation."[18] The section 382 regulations do not explain what it means for a debt instrument to offer the potential for significant growth in the loss corporation, though similar language appears elsewhere in the code and regulations.[19]

Practitioners have struggled to delineate when a debt instrument is considered to have the potential to participate significantly in corporate growth. The broad language of the preamble combined with the IRS's implied willingness to apply the provision to debt instruments has caused practitioners to worry over the scope of the rule. One troubling situation is debt trading at a discount.

For example, if the loss corporation has a single class of debt outstanding that has a face amount of $100 but trades at $50, does the debt offer the potential to significantly participate in corporate growth? Under that fact pattern, the discounted trading price for the debt suggests that the implied equity value may be relatively low. If creditors are expecting the loss corporation

---

[15] Numerous articles analyze in great detail the various factors that have led courts to conclude that an instrument is either debt or equity for tax purposes. *See*, *e.g.*, William T. Plumb Jr., "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369 (1971).

[16] Reg. section 1.382-2T(f)(18)(iii). For a detailed discussion of this provision, see New York State Bar Association Tax Section, "Report on Application of Treasury Regulation Section 1.382-2T(f)(18)(iii) With Respect to Trading in Distressed Debt Instruments" (Jan. 23, 2012); and Andrew M. Eisenberg and Lori A. Hellkamp, "Expecting the Unexpected: Section 382 Ownership Changes in a Down Economy," 50 *Tax Mgmt. Memo.* 427 (2009).

[17] Section 382(k)(6)(B)(i).

[18] T.D. 8149.

[19] *See* section 1504(a)(4)(B); and reg. section 1.305-5(a).

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

to be able to satisfy a portion of the debt based on its current situation, any corporate growth or improvement in its financial health would first benefit those creditors before increasing the value of any stock of the loss corporation. Many businesses faced this uncertain situation in the years following the 2008 financial crisis, when they were generating significant NOLs (or discovered that they had significant net unrealized built-in losses) and found that their debt was trading at a heavy discount.

The IRS's rulings on the application of the regulations to debt instruments have generally been taxpayer favorable (if not always clear), at least when the complicating factor is that the debt is trading at a discount.[20] For example, in LTR 200938010, a loss corporation entered into a payment-in-kind (PIK) debt facility; however, as a result of market conditions and competition in its industry, the taxpayer's group had not enjoyed substantial growth, and it was unclear at the time of the ruling whether the taxpayer's common or preferred stock had any value. Also, the taxpayer believed that the PIK facility was trading at a significant discount. The taxpayer represented that when the facility was issued, "the financial projections of the [taxpayer group] indicated that [it] would be able to make all payments of principal and interest on the PIK Facility as they came due."

The IRS ruled that the PIK facility would not currently be treated as stock of the loss corporation under reg. section 1.382-2T(f)(18)(iii). It also ruled that the PIK facility would not be recharacterized as stock in the future, as long as (1) the taxpayer (or any related party) was not actively involved with placing the PIK facility with any acquiring party, (2) no person acquired more than 50 percent of the PIK facility, and (3) there was no material change to the terms of the PIK facility. The IRS stated that "no opinion is expressed under [reg. section] 1.382-2T(f)(18)(iii) if any of the foregoing events occur," suggesting that the IRS believes deviation from those three situations would merit additional scrutiny. Interestingly, as part of the ruling, the taxpayer also represented that the PIK facility did not entitle the holders to receive dividends, vote for directors, or receive liquidation proceeds, and that the holders of the PIK facility did not have control over the taxpayer or have influence over its management. This suggests that the IRS was focused on the absence of equity-like features on the debt.

Since the issuance of LTR 200938010, IRS and Treasury officials (speaking in their individual capacities) have also suggested a more limited application of the recharacterization provision and have suggested that such an approach could be adopted in future regulations.[21]

B. Plain Vanilla Preferred Stock

Preferred stock described in section 1504(a)(4) (plain vanilla preferred stock) is not treated as stock for purposes of section 382.[22] Plain vanilla preferred stock is stock that: (1) is not entitled to vote; (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (3) has redemption and liquidation rights that do not exceed the issue price of that stock (except for a reasonable redemption or liquidation premium); and (4) is not convertible into another class of stock.[23]

Again, the key question will often be whether the preferred stock participates in corporate growth to any significant extent. Thus, similar to

[20] *See*, *e.g.*, FSA 199910009 (finding that debt was not recharacterized under reg. section 1.382-2T(f)(28)(iii) even though the loss corporation was insolvent and the terms of its outstanding debt were modified because, to agree to modification, the lender must have expected the loss corporation to have sufficient ability to repay the debt under the modified loans without future growth); and LTR 200445020 (finding that a creditor's claim against a bankrupt loss corporation was not recharacterized as stock under reg. section 1.382-2T(f)(18)(iii) even though the creditor's claims exceeded the amount the loss corporation could likely satisfy at the effective time of the plan of reorganization).

[21] One IRS official stated that "generally speaking, public trading of impaired debt really shouldn't cause this reg to apply." *See* Amy S. Elliott, "IRS May Release Guidance on Expiration of Signing Date Rule," *Tax Notes*, Mar. 15, 2010, p. 1325; *see also* Elliott, "IRS Offers Insight Into Guidance on Fluctuations in Value," *Tax Notes*, Jan. 19, 2009, p. 305 (quoting IRS official stating that the section 382 bankruptcy and option rules "really should, in our view, be the rules that deal with these situations in the vast majority of cases," and that the IRS wants to provide guidance that "would cover 90 percent of the cases so most people are not going to have to worry about these issues that are just incredibly difficult to figure out").

[22] Section 382(k)(6). Note, however, that the stock is taken into account when determining the value of a loss corporation following an ownership change. Reg. section 1.382-2(a)(3).

[23] Section 1504(a)(4). Stock that is not described in section 1504(a)(4) solely because it is entitled to vote in the case of dividend arrearages is also not treated as stock for purposes of section 382. Reg. section 1.382-2(a)(3)(i).

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the above debt analysis, if the preferred stock's ability to receive dividends is contingent on the growth of a corporation rather than on available earnings, debt financing capacity, or existing asset liquidation values, the preferred stock itself could be viewed as participating in corporate growth.[24] But because loss corporations are often distressed, their ability to issue a meaningful amount of plain vanilla preferred stock is often limited, regardless of their ability to satisfy the section 382 rules. Given loss corporations' limited ability to access capital markets through an issuance of plain vanilla preferred stock, a detailed discussion of section 1504(a)(4) is also beyond the scope of this report.[25]

C. Options

In recent capital raises by loss corporations, particularly those involving a private equity sponsor, some loss corporations have issued warrants (or other instruments treated as options for tax purposes) in connection with the capital raise. Options present another avenue for loss corporations to raise capital. Under section 382, options are either treated as a current stock ownership in the loss corporation or are respected as a true option to acquire stock.[26] If the former treatment applies, the loss corporation must determine the consequences of issuing the options as though it were issuing stock. The issuance of options would be subject to the segregation rules (and any applicable exceptions), as described below. Conversely, if the option is respected as a true option, the loss corporation is not treated as issuing stock until the holder exercises the option. At that time, the loss corporation would be treated as issuing the underlying shares and would similarly be subject to the segregation rules. Thus, the application of the option provisions of section 382 primarily affects the timing of the stock issuance and does not necessarily provide a way for the loss corporation to avoid a segregation transaction.[27]

D. Stock Issuances

1. The segregation rules.

As noted above, the regulations under section 382 provide that some transactions undertaken by a loss corporation create new public groups that are segregated from any existing public groups.[28] Stock issuances are among these so-called segregation transactions.[29] Unless an exception applies, the issuance of stock by a loss corporation generally creates a new public group, which is treated as acquiring the newly issued shares. Moreover, the regulations contain a presumption that members of one public group are not members of any other public group.[30] Because this new public group is deemed to be composed of new investors who did not own any stock in the loss corporation before the issuance, the group's three-year low in the loss corporation would be 0 percent. Accordingly, shares issued to the new public group would create an owner shift, and the loss corporation would have to examine the ownership levels of all its public groups and other 5 percent shareholders to determine the cumulative amount of owner shifts that had occurred in the testing period. As a result, any stock issuance by the loss corporation has the potential to move a loss corporation closer to an ownership change.

The segregation rules (and the exceptions) apply only to the extent the loss corporation issues shares to persons or entities that would be treated as members of a public group. If, for example, the loss corporation is issuing shares to

[24] Richard L. Winston, "What Is Section 1504(a)(4) Preferred Stock?" *Tax Notes*, July 7, 1997, p. 111.

[25] For such a discussion, see *id.*; and Sandra K. Miller, "Special Nonvoting Preferred Rules for Affiliated Groups Offer Several Advantages," 74 *J. Tax'n* 4 (Apr. 1991).

[26] *See* reg. section 1.382-4.

[27] The timing of an owner shift can be critically important as well. Section 382 tests owner shifts over a rolling three-year period; as a result, issuing instruments treated as unexercised options for purposes of section 382 can allow a loss corporation to push any resulting owner shift into future testing periods. On the other hand, a loss corporation with options outstanding will need to preserve room for the issuance of the shares underlying the options.

[28] Reg. section 1.382-2T(j)(2).

[29] Reg. section 1.382-2T(j)(2)(iii)(B).

[30] Reg. section 1.382-2T(j)(1)(iii). As discussed below, a loss corporation can rebut this presumption if it has actual knowledge that members of one public group are also members of another public group. Reg. section 1.382-2T(k)(2).

For more *Tax Notes* content, please visit www.taxnotes.com.

a single individual or entity that already owns 5 percent of its stock, the issuance will not be treated as a segregation transaction. More important, however, when a group of investors has a formal or informal understanding to make a coordinated acquisition of stock, those investors will be aggregated and treated as a single shareholder (and thus potentially as a 5 percent shareholder) for purposes of section 382.[31] Care must be exercised in structuring a capital raise to ensure that investors are not aggregated under this rule, since that result would frustrate the loss corporation's ability to rely on the exceptions to the segregation rules.

Assuming the issuance is treated in whole or in part as a segregation transaction, a loss corporation's ability to raise equity capital will depend on (1) how much cumulative shift has occurred before a given capital raise (that is, how much "dry powder" the loss corporation has available to it) and (2) the careful navigation of the section 382 segregation rules and the exceptions.

2. Exceptions to the segregation rules.

Final and temporary regulations under section 382 provide several exceptions that allow loss corporations to avoid the often onerous calculations mandated by the segregation rules.[32] First, a loss corporation may use "actual knowledge" to rebut the presumption that there is no cross-ownership among members of a public group.[33] Second, the IRS provided two exceptions to the segregation rules in a regulatory package finalized in 1993: the small issuance exception and the cash issuance exception.[34] Both those exceptions can apply to a loss corporation's stock issuance and are potentially relevant to a loss corporation's capital-raising efforts. Third, the IRS has since issued regulations that reduce or eliminate the owner shift caused by some other segregation transactions. Those provisions do not directly affect the application of the segregation rules to stock issuances by the loss corporation and are beyond the scope of this report.[35] However, having less potential for owner shifts from other transactions gives loss corporations more capacity to raise additional capital through stock issuances.

a. The actual knowledge rule.

As noted above, the segregation rules are the chief source of owner shifts resulting from stock issuances that do not fall under one of the exceptions. This results from the regulatory presumption that members of one public group are not members of any other public group.[36] When the segregation rules operate to create a new public group, the three-year low of that group is 0 percent. However, the regulations allow a loss corporation to rebut that presumption if it has actual knowledge that members of one public group are members of another public group.[37] Use of the actual knowledge rebuttal is voluntary.[38]

The regulations do not define actual knowledge, and establishing it can be difficult, depending on the shareholder base of the loss corporation. For stock subject to regulation by the SEC, the loss corporation can rely on the presence or absence of Form 13D or Form 13G filings to determine what persons or entities are 5 percent shareholders on a given testing date. But for a public loss corporation, obtaining actual knowledge of the identity of its other direct and

[31] Reg. section 1.382-3(a)(1)(i). A principal element of determining whether a group of investors is treated as having a formal or informal understanding among themselves to make a coordinated acquisition of stock is whether the investment decision of any member of the group is based on the investment decision of one or more other members. *Id.*

[32] *See* T.D. 8490; and T.D. 9638.

[33] Reg. section 1.382-2T(j)(1)(iii).

[34] *See* reg. section 1.382-3(j)(2) and (3).

[35] T.D. 9638. This set of exceptions provided favorable rules for secondary transfers by 5 percent shareholders and for small redemptions. The rules also generally exempted first-tier and upper-tier entities that owned 10 percent or less of the loss corporation from having to apply the segregation rules at the first-tier or upper-tier level.

[36] Reg. section 1.382-2T(j)(1)(iii).

[37] Reg. section 1.382-2T(k)(2).

[38] *See, e.g.*, LTR 201350006 (not requiring taxpayer to apply its actual knowledge to rebut the presumption that there is no cross-ownership among members of different public groups).

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

indirect owners can be challenging because members of a public group are, by definition, small shareholders (who do not file Form 13D or Form 13G).[39] Accordingly, a loss corporation can perfect its actual knowledge most efficiently when the capital raise is structured in a way that ensures that the participating investors are already existing shareholders.

One strategy is to undertake a "stapled" rights offering.[40] In such a transaction, the loss corporation issues stock purchase rights to each of its shareholders. Those rights cannot be separated from the share of stock for which the right was distributed (that is, the right is "stapled" to the share). As a result, the only investors who can exercise the rights are those who are shareholders of the loss corporation when the right is exercised.

Although stapled rights offerings provide a way for the loss corporation to ensure that only current shareholders participate in the offering, several issues remain. First, the corporate mechanics of such a capital raise for publicly traded shares can be quite nettlesome. Moreover, for purposes of section 382, this structure is effective in providing the loss corporation with actual knowledge only if, after the right is exercised, the share is issued to a person who is still a shareholder (that is, if the investor cannot sell his existing share between when he subscribes for the new share and when the share is actually issued). Techniques are available to manage these issues, and care must be taken to ensure that the transaction is properly structured to achieve the loss corporation's goals.

Second, even if the loss corporation successfully navigates the corporate mechanics and is able to acquire actual knowledge, the offering will probably not result in a 0 percent owner shift. Although rights offerings typically allow the holder of a right to acquire shares at a discount to the share's current value, thus producing high levels of participation, the loss corporation will unlikely achieve 100 percent participation. As a result, the loss corporation must still evaluate the effects of its actual knowledge and determine the extent to which the offering resulted in an owner shift.

The regulations are not clear on how the loss corporation is supposed to use its actual knowledge in that case. A reasonable approach is for the loss corporation to divide its existing public group into two different public groups: one that participates in the offering and one that does not. The loss corporation would then measure the relative owner shift between those two groups. The regulations provide the following example:

> L is entirely owned by Public L. L commences and completes a public offering of common stock on January 22, 1988, with the result that its outstanding stock increases from 100,000 shares to 300,000 shares. No person owns as much as five percent of L stock following the public offering.[41]
>
> . . .
>
> L establishes that 60,000 shares of the newly issued L stock were acquired by its shareholders of record on the date of the stock issuance (i.e., members of Public L, referred to as Acquiring Public L) by persons owning 27 percent of the L stock immediately before the stock issuance. Accordingly, L has actual knowledge that New Public L acquired no more than 140,000 shares of L stock in the public offering. Under [reg. sections 1.382-2T(j)(2)(iii) and 1.382-2T(k)(2)], New Public L may be treated as having increased its ownership interest in L by

[39]For example, in LTR 201024037, the taxpayer made written inquiries to identified investors regarding:

> (i) Whether or the extent to which the Participating Entities were economic owners of Company's stock; (ii) The identity of potential indirect 5 percent shareholders of Company stock by reason of owning significant percentages of the economic rights in the Participating Entities; (iii) Any indirect shifting of Company stock among the owners of Company stock (*e.g.*, segregation rules as applied to Participating Entities through redemptions, issuances of equity rights, etc.); and (iv) Whether the Participating Entities might be viewed as a single 5 percent shareholder under the 'entity' rules of [reg. section] 1.382-3(a).

Following those inquiries, the taxpayer arranged for teleconferences between its tax adviser and the investors' representatives, and in some cases supplemented the discussions with additional emails confirming the taxpayer's understanding of the matters discussed. *See also* LTR 201110006.

[40]*See* LTR 200024047 (analyzing the section 382 consequences of a stapled rights offering).

[41]Reg. section 1.382-2T(j)(2)(iii)(B)(2), Example (3)(i) (cross-referenced in Example (4)).

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> 46⅔ percentage points (140,000 shares acquired in the offering/300,000 shares outstanding). L also has actual knowledge that the members of Public L owning 27 percent of L stock immediately before the stock issuance (27,000 shares/100,000 shares outstanding) own 29 percent of L stock immediately after such issuance ((27,000 shares + 60,000 shares acquired in the offering)/300,000 shares outstanding). Assuming that L chooses to take its actual knowledge into account for purposes of determining whether an ownership change occurred on January 22, 1988, Public L is segregated into two direct public groups immediately before the stock issuance so that the two percentage point increase in the ownership interest in L by Acquiring Public L is taken into account. The total increased ownership interest in L by New Public L and Acquiring Public L on the testing date over their lowest ownership interest during the testing period is 48⅔ percent. Thus, no ownership change occurs with respect to L.[42]

Third, in addition to whatever shift is caused by participation by some, but not all, of the public shareholders, the loss corporation will have to determine any other ownership consequences of the offering. For instance, the issuer will typically contract with an existing shareholder or new investor to sponsor the rights offering and backstop the offering. In that case, the sponsor will agree to purchase any unsubscribed-for shares, up to an agreed limit. For example, if the sponsor is an existing 5 percent shareholder and increases its ownership of the loss corporation (or if the sponsor becomes a 5 percent shareholder as a result of the offering), the backstop provisions can also result in an additional owner shift. Even if the sponsor is not (or does not become) a 5 percent shareholder, to the extent it purchases more than its pro rata share of the offering, an additional owner shift may result.[43]

Finally, stapled rights offerings may be viewed as economically coercive to shareholders. Because the rights allow the shareholders to purchase shares at a discount to their current value, any shareholder who does not participate will be diluted. Moreover, because the right is stapled to the underlying share of the loss corporation, the only way for a shareholder to prevent this dilution and capture the value inherent in the right (other than by participating) is to sell the underlying share of stock and the unexercised right.

As a result, there is often a strong preference to do an "unstapled" rights offering in which the stock rights can be separately traded without requiring the holder to sell the underlying share of stock. This prevents existing shareholders from having to choose between participating and selling their shares (they can instead simply sell their stock acquisition rights). However, the loss corporation will no longer have actual knowledge that the shares acquired were acquired by existing shareholders, since there is no longer a guarantee that those shareholders did not separate their stock purchase right from the underlying share. Thus, the loss corporation will no longer necessarily have actual knowledge that it is issuing its stock to current shareholders of record.

b. The small issuance exception.

Any small stock issuances conducted by the loss corporation may qualify for the small issuance exception if they do not exceed the "small issuance limitation."[44] The small issuance limitation for a given tax year is determined either (1) on a corporationwide basis, in which case it consists of 10 percent of the total value of the loss corporation's stock outstanding at the beginning

[42] Reg. section 1.382-2T(j)(2)(iii)(B)(2), Example (4).

[43] Also, a loss corporation must determine whether the backstop agreement constitutes an option for purposes of reg. section 1.382-4, and, if so, whether the option is treated as exercised at the time the backstop agreement is signed.

[44] Reg. section 1.382-3(j)(2)(ii).

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

of a tax year; or (2) on a class-by-class basis, in which case it consists of 10 percent of the number of shares outstanding in each class at the beginning of the tax year.[45] The loss corporation may choose which calculation it prefers for each tax year.[46] For these purposes, a class of stock means all stock with the same material terms.[47] The regulations also provide for proration for a short tax year and for adjustments to be made for stock splits, section 305(a) stock dividends, and recapitalizations.[48] Any related issuances are aggregated and treated as a single issuance in determining whether the issuance qualifies for the small issuance exception.[49] Otherwise, all small issuances qualify for the exception until the aggregate amount of small issuances exceeds the small issuance limitation.

As a result of those rules, any small issuance qualifies for the small issuance exception, up to the extent of the loss corporation's small issuance limitation for the year. By contrast, no portion of an issuance that is *not* a small issuance is exempted from the segregation rules under this exception, even if the loss corporation has not fully used its small issuance limitation.

If the small issuance exception applies, the normal segregation rules are turned off. Instead of creating a new public group, the shares exempted will be treated as being proportionately acquired by each direct public group of the loss corporation existing immediately before the issuance.[50] The loss corporation may treat direct public groups existing before the issuance as acquiring in the aggregate more stock than the amount the groups would be deemed to acquire under the small issuance exception if the loss corporation has actual knowledge of the amount of stock acquired by the existing public groups.[51]

Example 1: LossCo has 100 shares of common stock outstanding at the beginning of its tax year and has no other class of stock outstanding. As a result, LossCo's small issuance limitation for the year is 10 shares.

- On February 1 LossCo issues six shares. Because the number of shares issued is less than LossCo's small issuance limitation, the issuance is a small issuance, and all the shares are exempted and treated as acquired by the loss corporation's existing public groups.
- On March 1 LossCo issues 11 shares. Because the number of shares issued is greater than the small issuance limitation, the issuance is not a small issuance, and no portion qualifies for the small issuance exception (even though LossCo has not fully used its small issuance capacity for the year). These shares will be subject to the normal segregation rules unless another exception applies.
- On June 1 LossCo issues another five shares. Because the number of shares issued is less than the small issuance limitation, the issuance is a small issuance. However, LossCo has now issued a total of 11 shares in small issuances, even though its small issuance limitation is 10. As a result, only the

[45] Reg. section 1.382-3(j)(2)(iii)(A).

[46] *Id.* However, the corporation may not determine the limitation on a class-by-class basis if, during the tax year, more than one class of stock is issued in a single issuance. Reg. section 1.382-3(j)(2)(iii)(D).

[47] Reg. section 1.382-3(j)(2)(iii)(B).

[48] Reg. section 1.382-3(j)(2)(iv) and (iii)(C). The provision making adjustments for recapitalizations may have particular importance for a company that emerges from bankruptcy in the middle of a tax year. In those transactions, the pre-emergence equity is typically canceled, with some group of creditors and other claimholders receiving equity in the reorganized corporation. As a result, the value of the common stock (which is tested on the first day of the tax year) is effectively wiped out and arguably makes the small issuance limitation zero (10 percent * 0) for the portion of the tax year following the company's emergence from bankruptcy. Consequently, even small issuances may result in an owner shift for the remainder of the tax year. However, because the emergence transaction itself typically causes an ownership change (thus resetting the cumulative owner shift to 0 percent), the chance of any such small issuance itself causing a problem is minimal.

[49] Reg. section 1.382-3(j)(8). Two or more issuances are treated as a single issuance if (1) the issuances occur at approximately the same time under the same plan or arrangement or (2) a principal purpose of issuing the stock in separate issuances rather than a single issuance is to minimize or avoid an owner shift. *Id.*

[50] However, the number of shares that potentially qualify for the small issuance exception cannot exceed the number of shares issued to non-5-percent shareholders in the transaction. Reg. section 1.382-3(j)(4). Therefore, only those shares issued to non-5-percent shareholders are eligible for the exception. *Id.*

[51] Reg. section 1.382-3(j)(5)(ii). The language of the small issuance exception does not imply that it is elective; however, under the cash issuance exception (discussed below), the IRS has ruled that a loss corporation may use its actual knowledge to allocate newly issued shares among public groups in a manner that is less favorable than the result that would follow from the application of the exception. *See* LTR 201024037.

For more *Tax Notes* content, please visit www.taxnotes.com.

six shares issued on February 1 and four of the five shares issued on June 1 (10 shares total) will qualify for the small issuance exception. The other share issued on June 1 will be subject to the normal segregation rules, unless another exception applies.

The small issuance exception does not prevent small issuances from causing an owner shift; because existing public groups are treated as acquiring stock in the issuance, the size of the public group increases relative to any 5 percent shareholders whose ownership decreases from the dilution. So absent a situation in which public groups own 100 percent of the loss corporation, the public groups that are treated as acquiring shares will increase their ownership in the loss corporation over their three-year lows.

Also, as a result of the small issuance exception, the order in which stock issuances occur in a given year can affect the amount of owner shift caused, even when the aggregate number of shares issued is the same.

Example 2: The facts are the same as Example 1. Also, LossCo is 100 percent owned by a single public group whose three-year low is 100 percent.

- On February 1 LossCo issues six shares that are exempted by the small issuance exception. As a result, all shares are treated as acquired by the existing public group. The public group owns all 106 shares (100 percent); therefore, no owner shift has occurred.
- On March 1 LossCo issues 11 shares that do not qualify for the small issuance exception. Assuming no other exception applies, the shares are treated as being acquired by a new public group. The original public group owns 106 out of 117 shares (90.6 percent). The new public group owns 11 out of 117 shares (9.4 percent). Because the new public group's three-year low is 0 percent, there is a 9.4 percent owner shift.
- On June 1 LossCo issues another five shares, four of which qualify for the small issuance exception. The shares are treated as being acquired proportionally by the public groups existing immediately before the issuance; the original public group acquires 3.62 shares, and the March new public group acquires 0.38 shares. The remaining share goes into a second newly created public group. The original public group owns 109.62 shares out of 122 (89.86 percent). The remaining 12.38 shares (10.14 percent) are held by new public groups that have a three-year low of 0 percent, so the issuances have resulted in a 10.14 percent owner shift.

Consider the same transactions, however, if the second and third issuance are reversed:

Example 3: The facts are the same as Example 2.

- On February 1 LossCo issues six shares that are exempted by the small issuance exception. The public group owns all 106 shares (100 percent), so no owner shift has occurred.
- On March 1 LossCo issues another five shares, four of which qualify for the small issuance exception. All four exempted shares are treated as being acquired by the original public group (the only group existing immediately before the issuance). The original public group owns 110 shares (99.1 percent). The remaining share is treated as being acquired by a new public group (0.9 percent).
- On June 1 LossCo issues 11 shares that do not qualify for the small issuance exception. Assuming no other exception applies, the shares are acquired by a new public group. The original public group owns 110 out of 122 shares (90.16 percent). The two newly created public groups together own 12 out of 122 shares (9.84 percent). Because the new public groups' three-year low is 0 percent, there is a 9.84 percent owner shift. Thus, as a result of the order in which these transactions occurred, they contribute 0.31 percent less owner shift than the transactions in Example 2, which had a 10.14 percent owner shift.

Given its size limitations, the small issuance exception typically does not help loss corporations efficiently raise capital. Instead, loss corporations commonly use the exception to ensure that shares issued to management and in other non-capital-raising issuances do not create new public groups under the segregation rules.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

Yet because the small issuance exception is recalculated at the beginning of each tax year, it may become increasingly useful over time — whenever the loss corporation issues shares (whether in a small issuance or otherwise), the number of shares that can potentially qualify for the small issuance exception will increase. After the transactions described in examples 1 through 3, LossCo has 122 shares outstanding. As a result, in year 2 its small issuance limitation will increase from 10 shares to 12.2 shares.

c. The cash issuance exception.

The cash issuance exception applies to issuances that are solely for cash.[52] When the exception applies, a percentage of the stock issued is treated as being acquired by the existing direct public groups of the loss corporation. The percentage treated as being so acquired is equal to half the aggregate percentage ownership of all direct public groups.[53] As with the small issuance exception, the number of shares that potentially qualify for the cash issuance exception cannot exceed the number of shares issued to non-5-percent shareholders in the transaction.[54]

Example 4: An individual owns 40 shares (40 percent) of LossCo. Also, Public Group 1 owns 40 shares (40 percent) of LossCo, and Public Group 2 owns 20 shares (20 percent) of LossCo.

- LossCo issues 100 shares solely for cash to investors, none of whom own 5 percent or more of LossCo after the issuance. Because the aggregate ownership by direct public groups before the issuance is 60 percent, 30 percent of the issuance (half of 60 percent) is treated as being acquired by the existing public groups.
- Accordingly, 30 of the 100 shares are treated as being acquired proportionately by the two public groups existing immediately before the issuance. The balance of the shares would follow the normal segregation rules. Unless purchased by a 5 percent shareholder, the remaining 70 shares would be treated as being acquired by a new public group.
- After the offering, the individual will own 40 out of 200 shares (20 percent), Public Group 1 will own 60 out of 200 shares (30 percent), Public Group 2 will own 30 out of 200 shares (15 percent), and the new public group will own 70 out of 200 shares (35 percent). LossCo will determine its cumulative owner shift based on those ownership levels. Absent the application of the cash issuance exception, all 100 shares would be treated as being acquired by a new public group with a three-year low of 0 percent.

The utility of the cash issuance exception chiefly depends on the size of the loss corporation's public groups. Thus, if public groups own 10 percent of a loss corporation, only 5 percent of any issuance will be treated as being acquired by existing public groups. Conversely, if public groups own 90 percent of the loss corporation, 45 percent of each cash issuance will be treated as being acquired by existing public groups. As a result, the order in which transactions occur can affect the extent to which the cash issuance exception applies. If an unrelated transaction increases the aggregate ownership of the loss corporation by its direct public group (for example, if a 5 percent shareholder sells its shares to the public), a subsequent cash issuance will result in a larger percentage of shares being allocated to existing public groups. By contrast, an unrelated transaction that reduces ownership by direct public groups will result in a smaller percentage of shares being acquired by the existing public groups.

Moreover, issuances that qualify for the cash issuance exception will always dilute existing public groups. Because existing public groups are deemed to acquire less than their proportionate ownership of the loss corporation, their relative

[52]Reg. section 1.382-3(j)(3)(iii). If a portion of an issuance does not qualify for the small issuance exception, the nonqualifying portion can still qualify for the cash issuance exception. *Id.*; reg. section 1.382-3(j)(3)(i). An issuance is not treated as being made solely for cash if either (1) the acquirer of the share, as a condition of acquiring a share for cash, is required to purchase other stock for consideration other than cash or (2) the share was acquired upon the exercise of an option that was not issued solely in exchange for cash. Reg. section 1.382-3(j)(3)(ii). Also, two or more issuances are treated as a single issuance for purposes of testing whether the issuance was solely for cash if (1) the issuances occur at approximately the same time under the same plan or arrangement or (2) a principal purpose of issuing the stock in separate issuances rather than a single issuance is to minimize or avoid an owner shift. Reg. section 1.382-3(j)(8).

[53]Reg. section 1.382-3(j)(3)(i).

[54]Reg. section 1.382-3(j)(4).

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

ownership will always decrease after the acquisition (either because a new public group was formed or because a nonpublic group 5 percent shareholder acquired shares). Thus, like the small issuance exception, the cash issuance exception will not prevent an issuance from creating an additional owner shift. However, under the right circumstances (and particularly when a nonpublic group 5 percent shareholder is willing to participate in an offering), the cash issuance exception can allow a loss corporation to raise a significant amount of capital.

Example 5: Individual A owns 30 shares of LossCo (30 percent). The remaining 70 shares of LossCo (70 percent) are owned by a single public group. A has a three-year low of 15 percent (that is, there is a 15 percent owner shift). The public group has a three-year low of 70 percent (that is, there is no owner shift).

- LossCo issues 900 new shares solely for cash. A agrees to purchase his pro rata share of the offering (30 percent, or 270 shares). The balance of the shares is purchased by small unrelated shareholders, none of whom becomes a 5 percent shareholder (including under the regulatory provisions treating investors making a coordinated acquisition as a single entity[55]). Under the cash issuance exception, 35 percent of the shares (315 shares) are treated as being acquired by the existing public group. The remaining 315 shares are treated as being acquired by a new public group.
- After the offering, A owns 300 out of 1,000 shares (30 percent). Because A's three-year low is 15 percent, A still has a 15 percent owner shift. The original public group owns 385 shares (38.5 percent) and still has no owner shift (because its ownership decreases). The new public group owns 315 shares, and its three-year low is 0 percent, so it has a 31.5 percent owner shift.

This exception is valuable. Following the transaction, LossCo goes from a 15 percent cumulative owner shift to a 46.5 percent cumulative owner shift, even though it issued shares equal to nine times its pre-issuance shares.

[55] *See* reg. section 1.382-3(a)(1).

As shown in Example 6, the result would be the same if A had increased his percentage ownership in LossCo and purchased all the shares that would otherwise be deemed to be issued to the new public group (that is, half the amount owned by the public group).

Example 6: The facts are the same as Example 5.

- When LossCo issues 900 new shares solely for cash, A purchases 585 shares, leaving 315 other shares issued in the offering. Under the cash issuance exception, all those remaining shares are deemed to be acquired by the existing public group (that is, 35 percent of 900).
- Because all the shares are accounted for, no shares are deemed to be issued to a new public group. After the transaction, A owns 615 shares (61.5 percent), and the original public group owns 385 shares (38.5 percent). Because A's three-year low is 15 percent, A now has a 46.5 percent owner shift.

As with the small issuance exception, if the loss corporation has actual knowledge of the amount of stock acquired by the direct public groups that existed before the issuance, it may treat them as acquiring in the aggregate more stock than they would be deemed to acquire under the cash issuance exception.[56]

III. Effects of Tax Reform

The general operative provisions of section 382 were not amended as part of the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). However, the TCJA made several changes that directly affect existing or future NOLs of loss corporations. Other provisions of the new law affect the generation of NOLs and thus have an indirect impact on loss corporations.

The net effect on existing NOLs depends primarily on two factors. On the one hand, existing NOLs are less valuable now that the corporate tax rate has been reduced to 21 percent. On the other hand, the TCJA repealed the corporate alternative minimum tax. Before 2018 a loss corporation could use NOLs to offset only 90

[56] Reg. section 1.382-3(j)(5)(ii). *See also* LTR 201024037 and related discussion, *supra* note 51.

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

percent of its alternative minimum taxable income.[57] As a result, 10 percent of its income would be subject to tax at the AMT rate of 20 percent, effectively resulting in a 2 percent tax on the loss corporation's taxable income. That 2 percent tax will no longer apply to loss corporations, allowing them to shield 100 percent of their income with NOLs arising in tax years beginning before 2018. Also, NOLs arising in tax years that end before 2018 can be carried forward up to 20 years.[58]

The TCJA's amendments to section 172 will apply to NOLs arising in tax years ending after 2017.[59] Those NOLs cannot be carried back to prior tax years but can be carried forward indefinitely.[60] However, a loss corporation will be permitted to offset only 80 percent of its taxable income with NOLs arising in tax years beginning after 2017. This will result in the new 21 percent corporate tax rate being applied to 20 percent of the corporation's income, or a 4.2 percent tax. The new law also decreases the present value of future NOLs because it extends the time over which a loss corporation can use them (by increasing the amount of taxable income a loss corporation must generate to absorb the NOLs). By the same token, this change will likely increase the length of time over which loss corporations will have to navigate section 382.

Other substantive provisions of the TCJA will likely affect a corporation's generation of NOLs. Two provisions in particular are worth noting. First, under new section 163(j), taxpayers will be entitled to deduct net business interest expense to the extent of 30 percent of their earnings before interest, taxes, depreciation, and amortization (and, for tax years beginning after 2021, to the extent of 30 percent of their EBITDA).[61] As a result, highly leveraged corporations that previously generated NOLs through interest deductions may no longer be able to fully use their interest deductions. However, any excess interest expense can be carried forward indefinitely, and those carryforwards will be subject to section 382.[62]

Second, under amended section 168(k), corporations will be entitled to fully expense some capital investments made between 2018 and 2023 (with a phasedown occurring after that). Those additional deductions may increase the likelihood that corporations generate NOLs. As a result of that provision, and because section 163(j) carryforwards will be subject to section 382, section 382 will continue to be of critical importance for many taxpayers.

IV. Conclusion

Though section 382 continues to impose constraints on loss corporations' ability to raise equity capital, a substantial amount may still be raised without triggering an ownership change. Moreover, loss corporations can do so in a way that does not violate the purposes of section 382. That is, capital can be raised from existing and small investors, making it unlikely that nonhistoric owners will acquire the loss corporation and divert income-producing opportunities to it.

To maximize the amount of stock that can be issued (or to minimize the amount of owner shift that results from an issuance), loss corporations must chart a careful course through the provisions described above. With careful planning, a loss corporation can often raise enough capital to accomplish its business needs while at the same time preserving the use of its tax attributes. ■

[57] Section 56(d).

[58] Section 172(b)(1)(A)(ii).

[59] P.L. 115-97, section 13302.

[60] *Id.* at section 13302(b)(1).

[61] *Id.* at section 13301.

[62] Section 382(d), as amended by P.L. 115-97.

For more *Tax Notes* content, please visit www.taxnotes.com.