Bankruptcy-Proximate Owner Shift? Loss Corporation Beware

by Michael Q. Cannon

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In this article, Cannon examines a key condition for loss corporations seeking to qualify for benefits under section 382(l)(5).

Corporations in financial distress face a slew of nontax challenges, including the acute struggle of continuing to operate in the face of cash constraints. Given these pressing and often all-consuming challenges, it can be easy for a corporation's management team to overlook tax considerations when working through a cash crunch. Tax advisers to distressed corporations can add substantial value, however, as they help distressed corporate clients navigate through cash shortfalls while preserving the value of the corporation's net operating losses and other tax assets (collectively, NOLs), which can be among a distressed corporation's most valuable assets.

Distressed company tax advisers must help their clients understand that the value of these tax attributes can easily be impaired without proper planning, including under the complicated rules of section 382. Section 382 generally limits a corporation's ability to use its NOLs whenever the corporation undergoes an ownership change.[1] Common transactions, including stock issuances or stock sales, can result in such an ownership change, impairing the value of a loss corporation's NOLs.[2] Section 382(l)(5), however, provides a useful exception to the general ownership change rule for some corporations that experience an ownership change in a "title 11 [bankruptcy] or similar case."

When applicable, section 382(l)(5) is a powerful tool, permitting a corporation to undergo an ownership change without its NOLs becoming limited, but section 382(l)(5) is available only if specific conditions are satisfied. One of these conditions, which is the subject of this article, is that the "shareholders . . . of the old loss corporation (determined immediately before the ownership change)" must "own (after such ownership change *and as a result of being shareholders . . . immediately before such change*)" at least 50 percent of the stock of the new loss corporation.[3]

After providing background about NOLs, section 382, and section 382(l)(5), this article considers what it means to own stock as a result of being a shareholder immediately before an ownership change. Despite the apparent simplicity of the requirement of being a post-ownership-change stockholder "as a result of being a shareholder . . . immediately before such change," corporations with NOLs and their tax

[1]Under section 383, these limitations are extended to some capital losses and tax credits. *See generally* section 383.

[2]For a discussion of several types of transactions that can give rise to an ownership change (and for a policy critique of the rules), see Sam Dimon, "Limit My Practice Instead: Thoughts on Reforming Section 382," *Taxes* 65-97 (Mar. 2010).

[3]Section 382(l)(5)(A)(ii) (emphasis added). The requirement is that the pre-ownership-change shareholders and qualified creditors (in respect of qualified indebtedness) must collectively own at least 50 percent of the stock of the loss corporation following the ownership change. *Id.* The focus of this article, however, is on pre-ownership-change shareholders.

advisers must tread with caution whenever there are fresh infusions of capital or other changes in ownership around the time of a contemplated section 382(l)(5) transaction.

I. Background: NOLs, Section 382 and 382(l)(5)

A. NOLs

Corporate NOLs arise when a corporation's allowable tax deductions exceed its taxable gross income.[4] In effect, NOLs represent negative taxable income.[5]

NOLs are valuable to a corporation to the extent the corporation can use them in taxable periods other than the one in which they were generated, either through a carryback to a prior period (permitting recoupment of tax previously paid) or through a carryover to a future period (reducing cash taxes otherwise payable in a profitable period).[6] The extent to which NOLs may be carried back or over has varied over time; liberal carryback and carryover rules afford companies needed liquidity, while more restrictive rules result in corporations paying more tax.[7]

Because NOLs can give rise to refunds of previously paid taxes or future cash tax reductions, a corporation with NOLs (often referred to as a loss corporation) has a strong financial incentive to safeguard its NOLs.

B. Section 382

Section 382 imposes significant limitations on a loss corporation's ability to use its NOLs if the corporation undergoes an ownership change.[8] After an ownership change, a loss corporation is subjected to an annual limitation on NOL usage equal to the value of the stock of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt rate (the federal long-term rate determined under section 1274(d), which is generally a low rate).[9]

An ownership change occurs if the percentage of a loss corporation's stock owned as of a "testing date" by one or more of its "5 percent shareholders" has increased by 50 percentage points over the lowest percentage of stock of the loss corporation owned by such shareholders at any time during the applicable "testing period."[10]

There are extraordinarily detailed rules for determining what constitutes stock, when a testing date has occurred, and the identity of a loss corporation's 5 percent shareholders.[11] In general, however, stock is all of a loss corporation's equity other than so-called straight preferred stock;[12] a testing date occurs any time

[4] Section 172(c).

[5] Section 172(d) prescribes various rules that apply in calculating a corporation's annual NOL.

[6] The ability to use NOLs to offset income in a year other than the year in which those losses were generated is an exception to the general principle that taxable income or loss is based on an annual accounting period. *See* section 441.

[7] For a good discussion on the history of NOL carrybacks and carryforwards (and the policy rationale for permitting losses generated in one year to offset income generated in another year), see Mark S. Hoenig, "Trafficking in Net Operating Losses: What's So Bad?" *Tax Notes*, Nov. 24, 2014, p. 919. During the current financial crisis precipitated by the COVID-19 pandemic, Congress liberalized the rules related to NOL carrybacks. *See* Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), section 2303.

[8] *See* section 382(g) (defining ownership change). Other rules, including section 269 and the consolidated return regulations (*e.g.*, the SRLY rules of reg. section 1.1502-21(c)), also can limit a loss corporation's ability to use its NOLs.

[9] *See* section 382(b) (describing the basic calculation of the limit on a corporation's ability to use its NOLs (a section 382 limitation)); section 382(e) (explaining how to determine the value of a loss corporation); section 382(f) (describing how to determine the long-term tax-exempt rate). The annual NOL usage limitation can be affected by built-in gains and losses. *See generally* section 338(h); *see also* Notice 2003-65, 2003-2 C.B. 747 (offering several alternative approaches for the identification of built-in gains); New York State Bar Association Tax Section, "Report on Proposed Regulations Under Section 382(h) Related to Built-in Gain and Loss" (Nov. 11, 2019) (report on Sept. 9, 2019, proposed regulations under section 382(h) that were issued Sept. 9, 2019). A detailed discussion of these rules is beyond the scope of this article.

[10] *See* section 382(g). In general, the testing period is the three-year period before a testing date. Section 382(i)(1). However, the testing period generally restarts any time there has been an ownership change (*see* section 382(i)(2)) and begins no earlier than the first day of the first tax year in which the loss corporation recognizes a loss giving rise to an NOL that is being carried forward (*see* section 382(i)(3)).

[11] For a detailed discussion of these issues, see Lewis T. Barr, "Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269 (Portfolio 780)," Bloomberg Tax and Accounting, 780-4th T.M.; *see also* Mark J. Silverman, "Section 382," in 3 *Consolidated Tax Return Regulations* 3-695, at 3-728 (2019).

[12] Section 382(k)(6)(A). Straight preferred stock for this purpose is stock described in section 1504(a)(4). The general stock rules are subject to several antiabuse rules that permit the IRS to treat some stock as non-stock and some non-stock as stock. For the stock as non-stock rules, see reg. section 1.382-2T(f)(18)(ii). For the rules permitting the IRS to treat non-stock as stock, see reg. section 1.382-2T(f)(18)(iii).

there is a change in the ownership of a loss corporation's stock that affects the percentage of stock owned by a 5 percent shareholder;[13] and 5 percent shareholders are people (either individually or as a group) who (applying attribution rules and rules that generally look through entities to find individuals) own 5 percent or more of a loss corporation's stock (based on value) at any time during the testing period.[14]

C. Section 382(l)(5) Exception

Given the substantial limitations that can be imposed on a loss corporation's NOLs if it undergoes an ownership change, loss corporations generally have strong incentives to avoid all ownership changes. When section 382(l)(5) applies, however, an ownership change does not give rise to a section 382 limitation. Under section 382(l)(5), if a loss corporation undergoes an ownership change while it is in a title 11 or similar case (for example, a bankruptcy)[15] and its pre-ownership-change shareholders and specific creditors own, after the applicable ownership change "and as a result of being shareholders or creditors immediately before such change," at least 50 percent of the stock of the post-ownership-change loss corporation, the ownership change does not result in a limitation on the loss corporation's NOLs.[16]

The loss corporation also benefits from a fresh start (that is, the cumulative amount of "owner shift" — for purposes of measuring whether there has been an ownership change — becomes 0 percent),[17] and the normal rule requiring the loss corporation to maintain continuity of business enterprise for the two years after an ownership change does not apply.[18]

These benefits can be substantial. Often a loss corporation is subject to meaningful capital constraints. But raising new capital could result in an owner shift and an ownership change giving rise to a section 382 limitation. Section 382(l)(5), however, can make it possible for a loss corporation to raise new money in the course of the bankruptcy proceeding (when raising that money would otherwise have given rise to a section 382 limitation) and emerge from bankruptcy with a 0 percent cumulative owner shift (enabling future equity raises).

But those benefits are conditioned on meeting the requirements of section 382(l)(5), particularly the requirement that 50 percent of the stock of the corporation after bankruptcy must be owned as a result of being a qualified creditor or shareholder. For stock received by a former creditor of a loss corporation to be taken into account under these rules, the indebtedness exchanged by that creditor must meet strict requirements, including that the indebtedness either was held by the creditor for at least 18 months before the bankruptcy was filed or that the indebtedness arose in the ordinary course of the trade or business of the loss corporation and has not been transferred.[19] On the other hand, stock received by a former shareholder of the loss corporation is subject to relatively fewer restrictions; it is good section 382(l)(5) stock as long as it is received as a result of being a shareholder immediately before the ownership change. These rules are discussed in greater detail below.

[13] Section 382(g)(2); reg. section 1.382-2(a)(4). A testing date can also be triggered when some options are issued or transferred. Reg. section 1.382-2(a)(4).

[14] Section 382(k)(7); reg. section 1.382-2T(g), (h), (j), and (k).

[15] In particular, a "Title 11 or similar case" is a case under title 11 of the United States Code (which is the bankruptcy code) or a "receivership, foreclosure, or similar proceeding," either in federal or state court. *See* section 382(l)(5)(F) (incorporating the definition from section 368(a)(3)(A)).

[16] In determining whether this 50 percent ownership requirement is satisfied, a special option attribution rule that applies only for this purpose requires that some options are deemed exercised if the deemed exercise would prevent satisfaction of the 50 percent ownership requirement. Reg. section 1.382-9(e).

[17] Section 382(g), (i)(2), and (l)(5)(A). This "fresh start" results from the interplay of two rules. First, section 382(l)(5) does not prevent an ownership change. It provides that the limitations of section 382(a) do not apply to an ownership change to which section 382(l)(5) applies. Second, section 382(i)(2) provides that once an ownership change has occurred, the testing period for determining if a second ownership change occurs does not begin before the first day following the date of the earlier ownership change.

[18] *See* reg. section 1.382-9(m).

[19] Section 382(l)(5)(E). *See* reg. section 1.382-9(d) (providing rules for determining who is a qualified creditor and what qualified indebtedness that person holds, including some helpful presumptions making it more likely that debt will qualify as qualified indebtedness).

II. Ownership As a Result of Being a Shareholder

A. Background

As explained above, it is not enough for the shareholders and creditors of a loss corporation to emerge from a bankruptcy as owners of at least 50 percent of the loss corporation's stock. Rather, they must emerge from bankruptcy as the owners of the requisite amount of stock as a result of (that is, because of) being shareholders or qualified creditors immediately before the ownership change.

But what does this mean? When a loss corporation emerges from bankruptcy and former shareholders maintain a continuing stake post-bankruptcy, it is generally possible to articulate some "but for" link between the shares that are owned before the bankruptcy and the shares that are owned after it, both in the sense that at least some of the post-bankruptcy shares are often exchanged for shares held pre-bankruptcy and in the sense that being a shareholder can facilitate the shareholder's having a seat at the table in connection with the bankruptcy proceeding (and often permits the shareholder to be the proponent of the bankruptcy). But is it enough that a shareholder is able to articulate a link between its pre-ownership-change share ownership and its post-bankruptcy stake, or is a more direct nexus (something akin to proximate cause[20]) required?

As discussed below, while the available authority is limited, it suggests that ownership "as a result of" being a shareholder demands a more meaningful (that is, akin to proximate cause) relationship (including proportionality) between the shares held pre-bankruptcy and those held when the loss corporation emerges from bankruptcy. Thus, when a loss corporation's owners change either before (for example, from an injection of fresh equity capital) or shortly after (for example, from a contemplated post-bankruptcy emergence stock redemption) a transaction that is intended to qualify for protection under section 382(l)(5), the loss corporation must tread carefully.

B. Legislative History Illumination

The "as a result of" requirement in section 382(l)(5) was added by the Technical and Miscellaneous Revenue Act of 1988. The legislation modified section 382(l)(5)(A)(ii) by adding the requirement that to be counted in the numerator for purposes of determining if the 50 percent section 382(l)(5) threshold is satisfied, a shareholder must be a shareholder "as a result of being [a] shareholder . . . immediately before such change."[21]

While the statute does not define "as a result of," the House Ways and Means Committee report explained the reason for this change, noting that it was intended to clarify that "for purposes of the 50-percent test, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock . . . that was held immediately before the ownership change."[22]

The report further clarified:

> Thus, for example, stock received by a former stockholder for new consideration, such as the provision of funds to the corporation, a guarantee of corporation obligations, or any other consideration, is not taken into account. Similarly, stock purchased from other stockholders in the transaction is not counted.[23]

Thus, the legislative history clarifies, the "as a result of" requirement demands that the post-bankruptcy stock actually be received in exchange for stock held before the ownership change (that is, there must be proportionality between "good" section 382(l)(5) stock owned post-bankruptcy and pre-bankruptcy stock that is held). Stock received for any other reason in connection with the ownership change (including as a result of a fresh capital infusion or a stock purchase as part of the bankruptcy) is not counted.

However, the legislative history does not clarify the meaning of the "immediately before such change" aspect of the "as a result of" rule. That is, it does not clarify whether stock acquired

[20] *See generally* Fleming James Jr. and Roger F. Perry, "Legal Cause," 60 *Yale L.J.* 761 (1951) (discussing causation, including "but for" causation and proximate cause).

[21] *See* P.L. 100-647.

[22] H.R. Rep. No. 100-795, at 51 (1988).

[23] *See id.*

shortly before an ownership change (or stock that is disposed of shortly following the change) counts.

C. IRS's Position Clarified — ILM 200915033

In ILM 200915033, the IRS provided insight into its view of the meaning of being a post-bankruptcy shareholder "as a result of being a shareholder immediately before" the ownership change occurring in connection with a bankruptcy.

The memorandum involved a creeping acquisition by Acquiring of Target, a loss corporation. Acquiring began by purchasing a small (less than 5 percent) amount of Target's stock; this purchase did not occur in the context of a bankruptcy. Later that same year, Acquiring entered into a stock purchase agreement with Target and its principal creditor. Acquiring agreed to purchase additional Target shares from Target for cash, and Target agreed to solicit acceptances from its shareholders for a "prepackaged" bankruptcy plan.[24] The prepackaged plan (which included the stock purchase agreement) was approved by the bankruptcy court and became effective. In connection with the plan's effectiveness, (1) Acquiring closed on its acquisition of the Target shares it had agreed to purchase under the stock purchase agreement and (2) nearly all shares of Target held by the public and by one of the three other substantial shareholders were redeemed (presumably using the proceeds of Target's issuance of stock to Acquiring).

Acquiring, taking into account the small amount of stock purchased pre-bankruptcy and the larger amount bought under the stock purchase agreement, owned more than 50 percent of Target's stock (thereby triggering an ownership change). Historic (pre-bankruptcy) Target shareholders (treating, for this purpose, Acquiring as a historic shareholder of the Target shares that Acquiring purchased pre-bankruptcy) collectively owned "just over 50 percent of Target's stock" (thereby literally satisfying the 50 percent threshold of section 382(l)(5)).

Within three weeks, Target redeemed all its shareholders other than Acquiring, leaving Acquiring as the owner of 100 percent of Target's outstanding stock. Acquiring took the position that Target's pre-change losses could be used, without limitation, to offset post-change income, contending that the requirements of section 382(l)(5) had been satisfied.

The IRS disagreed that section 382(l)(5) was available, providing several alternative rationales. Among them was that Acquiring, at the time it purchased shares under the stock purchase agreement, had paid a price that was much higher than the price that Target paid (nearly contemporaneously) to redeem identical shares held by other shareholders. Had the price paid by Acquiring accorded with economic reality, Acquiring would have received *eight* times as many shares, and the old shareholders would have held just 10 percent of Target's stock immediately following the closing of the bankruptcy (thereby making the benefits of section 382(l)(5) unavailable).

The IRS concluded that it was appropriate to apply section 382(l)(5) in a way that was consistent with economic reality, focusing on the fact that Acquiring suffered no detriment from initially accepting a smaller number of shares than the money it spent suggested it should have received because of Target's post-bankruptcy redemption of its other shareholders (in accordance with what appeared to be a prearranged plan).

In the IRS's view, section 382(l)(5) did not apply because when the dust settled shortly following Target's emergence from bankruptcy, Acquiring owned all of Target, and most of the stock that Acquiring owned was received in exchange for a fresh infusion of capital in connection with the bankruptcy. This stock that was received in exchange for that fresh capital did not count as good stock for purposes of section 382(l)(5), and Target's pre-ownership-change losses were therefore subject to a section 382 limitation.

ILM 200915033 is significant in several respects. First of all, it reinforces the exchange requirement articulated in the legislative history.

[24] *See* United States Courts, "Chapter 11 — Bankruptcy Basics" (explaining that a "prepackaged" bankruptcy plan is one in which "the debtor negotiates a plan with significant creditor constituencies before filing for bankruptcy") (last visited on May 5, 2020).

That is, to be counted as "good" stock for purposes of section 382(l)(5), that stock must be received for an equivalent portion of pre-ownership-change stock. Second, the memorandum indicates that the IRS viewed the commencement of bankruptcy as a significant date in applying the "immediately before" requirement. In the memorandum, the IRS accepted (without issue) that the post-bankruptcy stock that Acquiring held in respect of the relatively small amount of stock that it held before bankruptcy was good stock for section 382(l)(5) purposes, at least when there was no evidence of linkage between the purchase and the bankruptcy.

It did not matter, for example, that the stock had been acquired during the same year in which the ownership change occurred. But stock that the IRS viewed Acquiring as having acquired (functionally, taking into account the post-bankruptcy redemption) in the bankruptcy did not count as good stock for section 382(l)(5) purposes. Third, the memorandum clarifies that the IRS believed that the section 382(l)(5) rule should be applied by taking into account the economic substance of all contemplated stock-related arrangements (whether occurring before, during, or after bankruptcy). Thus, for example, what appeared to be a contemplated post-bankruptcy redemption of shares was relevant in determining whether section 382(l)(5) was satisfied.

D. Putting It All Together: The Rule

So is the rule that the only stock that qualifies as good section 382(l)(5) stock is post-bankruptcy stock received in exchange for an equivalent amount of stock held before the declaration of bankruptcy? In short, no. While such post-bankruptcy stock generally should qualify as good section 382(l)(5) stock, a careful reading of the relevant authorities suggests that the rule is more nuanced.

The legislative history and the memorandum indicate that the focus of the section 382(l)(5) inquiry is whether the requisite quantity of post-bankruptcy stock (at least 50 percent) held by actual post-bankruptcy shareholders (determined based on economic substance) is owned in respect of stock that was held before the bankruptcy became effective (by such actual, post-bankruptcy shareholders), subject to an articulable, nonspeculative risk of not ultimately turning into post-bankruptcy shares (meaning that there must be a realistic possibility that the shares held before the bankruptcy becomes effective will not turn into post-bankruptcy shares).

That was the case, for example, for the shares that Acquiring purchased pre-bankruptcy in ILM 200915033. These shares were acquired in open-market purchases. While it is likely that Acquiring intended to cause Target to declare bankruptcy when it purchased those shares, there was no guarantee that Acquiring's plan would be accepted or successful. On the other hand, Acquiring's later acquisition of shares occurred in accordance with a stock purchase agreement in connection with a prepackaged bankruptcy plan (and what seemed to be a contemplated post-bankruptcy redemption). There was never any appreciable risk that these shares would not turn into a post-bankruptcy ownership stake in the business; this was guaranteed. As a result, because all the shares (other than the ones that Acquiring purchased pre-bankruptcy) had functionally been acquired by Acquiring in connection with the bankruptcy, the 50 percent requirement of section 382(l)(5) was not satisfied.

Thus, the available authorities indicate that the section 382(l)(5) rules are economic-substance-driven, and while the date on which a bankruptcy proceeding begins is certainly relevant for purposes of applying the rules, it is not a bright-line marker. Even for shares acquired before bankruptcy is commenced, appropriate caution must be exercised. If loss corporation stock is acquired shortly before bankruptcy is declared but under an agreement under which all the other major shareholders and creditors of a loss corporation agree to support a "prepackaged" bankruptcy plan, the IRS may take the position that the post-bankruptcy shares received in respect of those shares do not count as good section 382(l)(5) stock.

Similarly, if shares have been held for a meaningful amount of time before bankruptcy emergence, but are disposed of shortly post-emergence (especially if the facts suggest that the disposition occurred in accordance with a plan in place at the time of bankruptcy emergence), there

is a material risk that those shares will not be counted as good stock for purposes of meeting the 50 percent section 382(l)(5) requirement.

In confronting bankruptcy-proximate changes in loss corporation stock ownership, tax advisers must holistically assess the economic substance of the loss corporation's stock ownership (taking into account stock-related transactions occurring shortly before and during bankruptcy, and any transactions contemplated to occur post-bankruptcy), and being mindful of the concepts of proportionality and pre-bankruptcy-effectiveness economic risk, determine whether section 382(l)(5)'s requirement of 50 percent post-bankruptcy ownership "as a result of" being a shareholder "immediately before" an ownership change is satisfied.

III. Conclusion

A loss corporation's NOLs can be one of its most valuable assets. Section 382(l)(5) can be a powerful tool for preserving those attributes in a bankruptcy restructuring, but that tool is not unlimited, and tax advisers must be aware that changes in stock ownership that occur around the time of a bankruptcy filing (including, for example, one resulting from pre-bankruptcy capital infusions or post-bankruptcy redemptions) may jeopardize the availability of section 382(l)(5) to be able to help their clients avoid what could be a disastrous limitation on the loss corporation's NOLs. ■