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New Tax Regulations Make NOL-limiting (Net Operating Loss) Ownership Changes a Little Easier to Track and a Little Less Likely to Occur

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On October 22, 2013, the IRS issued final regulations that make modest changes in the way a loss corporation determines whether it has had an ownership change under Internal Revenue Code Section 382, which limits the use of net operating losses (NOLs) following an ownership change. An ownership change occurs if 5% shareholders increase their percentage ownership of the loss corporation stock by more than 50% during the three years prior to the testing date (or, the prior period back to the day after the most recent ownership change, if that is less than three years). The 50% increase is measured by adding up the separate increases of each 5% shareholder over the lowest percentage owned by that 5% shareholder at any time during the testing period. Increases in both direct and indirect ownership are taken into account. Shareholders who own less than 5% are aggregated into a group (called a "public group") that is treated as one 5% shareholder. Additi onal public groups are generally created when a loss corporation (or an entity that owns more than 5% of the loss corporation) issues or redeems stock (or engages in a transaction that disproportionately increases or decreases the outstanding loss corporation stock).

Exception for entities that own 10% or less. Prior to the new regulations, additional public groups were created whenever there was an issuance or redemption by an entity that owned 5% or more of the loss corporation. The new regulations increase this threshold to 10%, so that issuances and redemptions by entities that are loss corporation shareholders do not create additional public groups unless the entity making the issuance or redemption owns more than 10% of the loss corporation (subject to an anti-abuse rule).

Prior regulations had an exception for small issuances—the loss corporation did not have to create additional public groups for issuances of up to 10% per year of the loss corporation's stock. A similar exception applied to issuances by entities that directly or indirectly owned stock in the loss corporation. The new regulations clarify that in applying this 10% small issuance exception to entities that are indirect loss corporation shareholders, 10% is measured by reference to the issuing entity, rather than the indirect percentage of the loss corporation. For example, if corporation P owns 50% of the loss corporation, it is now clear that the small issuance exception does not apply to an issuance of more than 10% of P's stock, even though 10% of P is only a 5% indirect interest in the loss corporation.

Thus, the new regulations reduce the circumstances in which the 50% ownership change threshold has to include issuances and redemptions by entities that are direct or indirect shareholders of the loss corporation. Under the new rules, these issuances and redemptions are taken into account only if the entity directly or indirectly owns more than 10% of the loss corporation and the amount issued is more than 10% of the interests in the entity.

Small redemption exception. Under the new rules, redemptions from less-than-5% shareholders create additional public groups only if more than 10% is redeemed. This applies to redemptions of up to 10% of the loss corporation's stock and to redemptions of up to 10% of the interests in an entity that owns, directly, indirectly, actually or constructively, more than 10% of the loss corporation (entities that own less than 10% of the loss corporation are exempted under the prior paragraph, regardless of the amount redeemed).

Sales by 5% Shareholders. Under the pre-existing regulations, additional public groups were created whenever a 5% shareholder sold a direct or indirect interest in the loss corporation to less-than-5% shareholders. Under the new rules, additional public groups are not created when a 5% shareholder sells to less-than-5% shareholders. Instead, the stock acquired from a 5% shareholder is treated as acquired proportionately by the existing public groups.

Effective date. These rule changes are generally effective for testing dates after October 21, 2013. The loss corporation may apply the new regulations retroactively from the beginning of any testing period ending after October 21, 2013 (and that would have ended after October 21, 2013 without regard to the new rules).

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