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Protecting tax attributes

The increased likelihood of companies generating net operating losses ("NOLs"), coupled with depressed stock prices for those companies resulting from recent economic disruptions, companies' executives and tax professionals may be considering implementing defensive measures, such as stock transfer restrictions or "poison pills," to protect NOLs and other tax attributes from the adverse impacts of an "ownership change."

What is an ownership change?

For purposes of section 382, an "Ownership Change" is generally defined as a greater than 50 percentage point increase in the stock ownership of "5% Shareholders" (that is, shareholders who own directly or indirectly 5% or more of the stock of the corporation) within a rolling three-year period. Because the threshold for purposes of testing an Ownership Change depends upon the stock ownership of 5% Shareholders, it is the purchases or sales by these individuals or entities that can result in an Ownership Change.

If an Ownership Change occurs, section 382 imposes an annual "base limitation" on the utilization of NOLs and other tax attributes (including built-in losses and section 163(j) carryovers). This limitation is generally equal to the value of the corporation's stock immediately before the Ownership Change multiplied by the applicable federal long-term tax-exempt rate (AFR). The AFR has hovered around 2% for the past few tax years. As a result, the annual base limitation is generally quite low—even for companies with relatively high equity values.

Alternatives for protecting NOLs and tax attributes

Many publicly traded companies may be subject to an Ownership Change that is out of their control. As such, many executives are considering defensive measures to protect NOLs from the adverse impacts of an unwanted Ownership Change.

There are two approaches that publicly traded companies typically consider: stock transfer restrictions and poison pills. Because the mechanics of the two approaches are very different, each approach can have different economic, corporate law, and tax consequences. These tax differences are contrasted below.

A. Stock transfer restrictions

A stock transfer restriction is typically implemented through an amendment to a corporation's charter. This amendment would add a provision that prohibits, and treats as ineffective, any transfer of shares that would increase the transferee's ownership above a percentage that is somewhat less than the 5% Shareholder threshold (e.g., 4.9%, taking into account indirect or attributed ownership). The charter restriction is intended to prevent a 5% Shareholder from coming into existence for purposes of the section 382 rules. For corporations without existing 5% Shareholders, trading would be allowed only among less than 5% Shareholders who are not taken into account for purposes of the Ownership Change test. Occasionally, such restrictions are made effective only after the loss corporation's ownership percentage shifts for purposes of section 382 have reached a threshold percentage (e.g., 30%).

The Internal Revenue Service (IRS) has considered the effect of a charter-based stock transfer restriction involving a corporation that emerged from bankruptcy with valuable NOLs it wanted to protect.[1] The loss corporation, which was publicly traded, adopted a charter restriction that prohibited and declared ineffective any transfer that would increase that transferee's ownership above 4.5% (including certain indirect or attributed ownership) and provided a mechanism for undoing transfers that violated this restriction.

The IRS held that:

- Provided that the charter restriction was enforceable under state law, a purported transferee acquiring shares in violation of the provision would not be treated as acquiring ownership from the transferor; and
- If the charter amendment was declared unenforceable *ab initio*, then ownership of stock in violation of the restriction will be treated as having been acquired on the date actually acquired.

As some legal commentators have noted, charter-based restrictions are typically difficult to implement. These restrictions generally require approval through a shareholder vote and may raise challenges from a corporate governance perspective. Due to these complexities, charter restrictions are most commonly implemented only in cases of bankruptcy.

B. Poison pills

Alternatively, some public companies have adopted poison pill plans to protect NOLs and other tax attributes.

Poison pills are generally triggered when a shareholder (referred to as the "triggering shareholder") reaches a certain threshold ownership percentage. Once triggered, the poison pill dilutes the interest of the triggering shareholder, typically by giving each shareholder other than the triggering shareholder the right to purchase additional shares of the company at a significant discount (for example, 50% of the value).

For poison pills designed to prevent an Ownership Change, the threshold is typically just under 5%. This is designed to limit the number of shareholders whose ownership is considered for purposes of the Ownership Change test. Some plans may also contain a mechanism to deter further accumulation of shares by existing 5% Shareholders.

Compared to a charter restriction, which requires shareholder approval, one advantage of a poison pill is that it is generally implemented by a corporation's board of directors. By not having to obtain shareholder approval, a poison pill plan provides the loss corporation the ability to put a plan in place quickly and the flexibility to rapidly change the plan to adjust to changing circumstances.

However, it is important to note that a poison pill operates to deter, rather than prevent, Ownership Changes. As opposed to a charter restriction, which precludes an Ownership Change by rendering void ab initio any acquisition of stock in excess of a specified threshold, a poison pill merely provides a financial disincentive to becoming a 5% Shareholder. Notably, poison pill plans also generally do not contain a mechanism to prevent existing 5% Shareholders from selling stock, which can also result in an Ownership Change.

The IRS has considered the tax consequences of a poison pill adopted as a takeover defense, but there are no IRS precedents involving a poison pill plan adopted to prevent an ownership change. The IRS has ruled that the creation of a poison pill plan and the associated rights distribution are not taxable to the shareholders.[2] In addition, the poison pill generally should not cause an owner shift under the section 382 option rules.[3] Moreover, in 2010, a Delaware court upheld the validity of a poison pill plan adopted to avoid a section 382 ownership change.[4]

If a company is considering whether to implement a poison pill plan, it should be prepared to support its actions by demonstrating the negative consequences of a section 382 Ownership Change. This can be achieved by showing that the company has significant tax attributes (e.g., NOLs, section 163(j) business interest carryovers) and that these attributes would be significantly impaired by an Ownership Change.

Conclusion

Companies considering how to protect their valuable tax assets from the adverse consequences of an Ownership Change should consult with their tax advisors to evaluate alternative approaches to do so.

Want to learn more?
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Endnotes

1. PLR 8949040 (September 11, 1989). See also PLR 9351011 (September 23, 1993); PLR 200024047 (March 21, 2000) and PLR 200622013 (January 27, 2006).
2. Rev. Rul. 90-11, 90-1 C.B.10.
3. See Treas. Reg. § 1.382-4(d).
4. 2010 Del. Ch. LEXIS 39 (Del. Ch. February 26, 2010), aff'd Versata Enterprises, Inc. v. Selectica Inc., 5 A. 3d 586 (Del. October 4, 2010).