

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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LEGEND

LossCo =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

First Investors =

Investor 1 =

Investor 2 =

Investor 3 =

Investor 4 =
a =
b =
c =
d =
e =
f =
g =
h =
i =

This memorandum responds to your request for assistance in the above named case. This advice is based on the facts that you have previously sent to us and may not all be reproduced here. This advice may not be used or cited as precedent.

SUMMARY

Since LossCo was a loss corporation at the end of its first taxable year after formation, it is subject to the loss limitation rules of section 382 in that year. In that year, acquisitions of LossCo stock occurred on Date 1, Date 2, Date 3, and Date 4. The regulations count all stock acquisitions after the first one as a testing date from which to measure the amount of the percentage of owner shift (measured by value) caused by the stock acquisition. LossCo argues that its first three stock acquisitions should be integrated and treated as one acquisition because they were part of a plan to provide the initial capitalization for LossCo and they occurred before LossCo engaged in any business activity. (LossCo agrees that Date 4 was after the start of business activity.) The change of ownership of 5 percent shareholders from each stock acquisition in this case, is such that, if the acquisition on Date 3 is treated separately from those on Dates 1 and 2, Date 3 will be a testing date within the testing period of Date 5, and LossCo will have an ownership change on Date 5. But, if the stock acquisitions on the three dates are treated as one acquisition, Date 3 will not be a testing date, and so Date 3 will not be within the testing period of Date 5, and LossCo will not have had an ownership change on Date 5.

ISSUES

Did LossCo experience an ownership change on Date 5 under section 382?

CONCLUSIONS

This memorandum discusses the relevant provisions of section 382, its legislative history, and its regulations, as well as other relevant law. The memorandum also provides guidance as to relevant factual development and litigation hazards. The memorandum does not make a final recommendation as the inquiry involved is fact dependent.

FACTS

On Date 1, prior to the issuance of any LossCo stock, LossCo entered into an agreement (“the Agreement”) with First Investors to sell them convertible preferred stock. This convertible preferred stock was issued on Date 1 for \$a. This amount was deposited in a money market account the next day. The Agreement gave Investor 1 and Investor 2 an option to purchase convertible preferred stock.

On Date 2, LossCo issued restricted common stock to four employees/consultants pursuant to employment agreements entered into three to four weeks before Date 1. These four individuals are unrelated to the First Investors and not involved in the Agreement. (Date 2 will not be mentioned hereafter since the relative value of the common stock to the convertible preferred stock is so low; it turned out to have had no effect on when LossCo had an ownership change.)

On Date 3, pursuant to the option in the Agreement, LossCo issued b shares of convertible preferred stock to Investor 1 in exchange for \$c. If Investor 1 had not exercised its option to purchase convertible preferred stock then the First Investors would have been obligated to purchase 75 percent of the amount of stock Investor 1 purchased on Date 3.

On Date 4, pursuant to the option in the Agreement, Investor 2 purchased d shares for \$e.

LossCo was a “loss” corporation for the tax year that included Date 1 through Date 4. LossCo claims that Date 3 was the date it commenced business operations.

On Date 5, f shares of convertible preferred stock were issued to new or existing 5 percent shareholders for \$g. Investor 3 and Investor 4, two new 5 percent shareholders, purchased h shares of this total for \$j.

LAW AND ANALYSIS

Section 382(a) generally limits the amount (the “section 382 limitation”) of a loss corporation’s loss carryovers and built-in losses that can be offset against the corporation’s taxable income in years after an “ownership change.” The “section 382 limitation” is defined by section 382(b) as the loss corporation’s value (before the ownership change) multiplied by the applicable long-term tax-exempt bond rate (defined in section 382(f)). A “loss corporation” is defined by section 382(k)(1) as a corporation with a net operating loss or “net unrealized built-in loss” (as defined by section 382(h)(3)).

The pivotal event that triggers the operation of section 382 is an “ownership change,” which occurs under section 382(g) whenever, immediately after (i) an owner shift involving a 5 percent shareholder or (ii) any equity structure shift, the percentage of stock of the loss corporation owned by one or more 5 percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period. Under section 382(k)(6)(A), preferred stock which is convertible into another class is considered stock for purposes of section 382. As provided in section 382(k)(6)(C), determinations of the percentage of stock held by any person is made on the basis of value. Under section 382(i), the testing period is generally the three-year period ending on the day of any owner shift involving a 5 percent shareholder or equity structure shift.

For an ownership change to occur there must be an increase of 50 percentage points by one or more 5 percent shareholders. The increase of each 5 percent shareholder is determined separately, comparing the 5 percent shareholder’s percentage of stock ownership immediately after the close of the testing date with that shareholder’s lowest percentage ownership during the testing period. All increases during the testing period are aggregated to determine whether the 50 percentage point increase has occurred during the testing period. Treas. Reg. § 1.382-2T(c)(1).

Section 382(i)(3) states that a testing period shall not begin before the earlier of the first day of either the first taxable year from which there is a carryforward of a loss (or of an excess credit) to the first post-change year, or the taxable year in which the transaction being tested occurs. Similarly, Treas. Reg. § 1.382-2T(d)(3) states that the testing period may begin on the first day of the first year in which a loss occurs. Under Treas. Reg. § 1.382-2(a)(4)(i), a loss corporation is required to determine whether an ownership change has occurred immediately after any owner shift, or issuance or transfer. Each date on which a loss corporation is required to make a determination of whether an ownership change has occurred is referred to as a testing date. All computations of increases in percentage ownership are to be made as of the close of the testing date.

Under these facts, convertible preferred stock was first issued on Date 1 and convertible

preferred stock was issued on Date 3 and other dates up to and including Date 5. If Date 3 is a testing date because it is viewed separately from Date 1, (which would mean the testing period for Date 5 would include Date 3) an ownership change will have occurred on Date 5. If instead Date 3 is not a testing date, because it is viewed as integrated with Date 1 as part of the initial capitalization of LossCo, then the integrated transaction could not be either an owner shift or equity structure shift as defined in Treas. Reg. § 1.382-2T(e)(1), because at the beginning of the transaction LossCo had no 5 percent shareholders from which to measure whether a 50 percent increase in percentage of stock ownership had occurred. Thus, the testing period for Date 5 would not include Date 3 and LossCo would not have an ownership change on Date 5.

For example, assume stock of a start-up was issued on two different dates two months apart by a loss corporation where both issuances of stock were part of the initial capitalization of the loss corporation, and they both occurred before business activity had started. These facts do not present the abuse of trafficking in net operating loss carryovers, that section 382 was designed to prevent. Congress was concerned with situations where the shareholders who bore the economic burden of NOLs no longer hold a controlling interest in the corporation. H. Rept. 99-426, at 256 (1985), 1986-3 C.B. (Vol. 2) 1, 256. In this example, the shareholders who purchased stock on the two different dates were both the initial investors under the taxpayer's plan for the corporation's initial capitalization and both equally bore the economic burden of the NOLs arising after business activity commenced. The purpose of the statute would not have been served by treating the second acquisition as a testing date within the testing period of a subsequent testing date.

LITIGATION HAZARDS

Please call (202) 317-5362 if you have any questions.