

Proposed Regs. Deal With NOLs in Insolvency

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As most practitioners are aware, Section 382(l)(5) provides that the Section 382 limitation on the use of NOLs does not apply to a loss corporation that has an ownership change if the loss corporation's pre-change shareholders and qualified creditors (determined immediately before the ownership change) own at least 50% of the value and voting power of the loss corporation's stock immediately after the ownership change and as a result of being pre-change shareholders or qualified creditors. This critical provision has been the subject of regulations.

But what about Section 382(l)(6)? As enacted in the Tax Reform Act of 1986, Section 382(l)(6) provided that if Section 382(l)(5) did not apply to any reorganization described in Section 368(a)(1)(G) or any exchange of debt for stock in a Title 11 case, the value of the loss corporation under Section 382(e) was the value of the loss corporation immediately after the ownership change. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") amended this rule to provide that the value of the loss corporation under Section 382(e) is increased to reflect the increase (if any) in value of the loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.

Proposed Rules

Now, proposed regulations have been issued under Section 382(l)(6). Since the purpose of the TAMRA amendments to Section 382(l)(6) was to allow an increase in the value of the loss corporation's stock to the extent attributable to a conversion of debt into stock, but to deny an increase in value attributable to the infusion of fresh capital, the proposed regulations address whether an increase in the value of the loss corporation's stock is attributable to the conversion of debt into stock or the infusion of fresh capital. That may seem to be a simple inquiry, but the proposed rules are far from simple.

The main thrust of the rules is straightforward, however. When Section 382(l)(6) applies, the value of the loss corporation for purposes of Section 382 is the *lesser* of:

1. The value of the stock of the loss corporation immediately after the ownership change; or
2. The value of the loss corporation's assets (determined without regard to liabilities) immediately before the ownership change.

The first of these rules is known as the "stock value test," while the second is the "asset value test." The effect of this two-pronged approach is that all increases in the value of the loss corporation resulting from a bankruptcy reorganization are treated as attributable to the conversion of debt into stock. But under the asset value test, if the value of the loss corporation's stock exceeds the value that would have resulted if the loss

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corporation's creditors had exchanged all of their debt for stock, the excess cannot be from the direct or indirect conversion of debt into stock. In this case, the value of the loss corporation is limited to a value that approximates the value of the loss corporation's stock if the loss corporation's creditors had exchanged all of their debt for stock.

Interaction With Stock-For-Debt Exception

The stock-for-debt exception—much talked about nowadays in Congress—obviously can interact with these rules. The proposed regulations therefore state that they apply solely for purposes of Section 382(l)(6), and not under the common-law stock-for-debt exception. Thus, if an insolvent debtor or a debtor in a Title 11 case issues its stock for cash and uses that cash to satisfy its indebtedness for less than the amount owing, the stock-for-debt exception does not apply.

Other Implications

Various other Code provisions, of course, may impact the value of the loss corporation. Section 382(e)(2) deals with redemptions and other corporate contractions; Section 382(e)(3) with foreign corporations; Section 382(l)(1) with capital contributions; and 382(l)(4) with substantial nonbusiness assets. Under the proposed regulations, these rules generally still apply when Section 382(l)(6) does. Various coordination provisions are included in the rules, however, so that these provisions operate consistently.

Interestingly, Section 382(l)(1) contains a special limitation that the proposed regulations make inapplicable to Section 382(l)(6). Under Section 382(l)(1), capital contributions made within the two-year period immediately preceding an ownership change of a loss corporation are removed from the value of the loss corporation for purposes of determining the Section 382 limit. If the Section 382(l)(6) value rule were used and a second ownership change occurred within the two-year period immediately following the first ownership change, Section 382(l)(1) would reduce the value of the loss corporation with respect to the second ownership change by the amount of debt converted into stock that was already taken into account under Section 382(l)(6) on the first ownership change.

However, the proposed regulations provide that Section 382(l)(1) will not apply to any increase in value of the loss corporation previously taken into account under Section 382(l)(6). The idea of this rule is that the purposes of Section 382(l)(6) are not frustrated.

Anti-abuse Rule

Like most regulations issued these days, the proposed rules contain an anti-abuse rule. The rule provides that the amount determined under the stock value test is reduced by the value of stock that is issued with a principal purpose of increasing the Section 382 limitation without subjecting the investment to the entrepreneurial risks of corporate business operations. The idea is to prevent deliberate artificial increases in the value of the loss corporation attributable to stock that is not subject to these risks.

Stock Value Cap

An overall limit applies to stock value. The value of the loss corporation's stock issued in connection with an ownership change in a Title 11 or similar case cannot exceed the amount of cash plus the value of any property (including indebtedness of the loss corporation) received by the loss corporation in consideration for the issuance of that stock. This will presumably obviate taxpayer arguments that the stock has intrinsic value in excess of the amount paid for it (*e.g.*, because of a higher market-stabilized trading price).

Section 382(l)(5)(H) Election

This election allows the taxpayer to obviate the normally desirable provisions of Section 382(l)(5). The proposed regulations specify that the election is made on the return of the loss corporation for the taxable year including or ending with the change date, and is irrevocable. The good news, though, is that the loss corporation qualifying under Section 382(l)(5) has time to analyze the situation and to determine whether it is best to use Section 382(l)(5). The big trap, of course, is Section 382(l)(5)(D), under which the Section 382 limitation is zero if an ownership change occurs in the two-year period immediately following an ownership change to which Section 382(l)(5) applies. The way out is to make the election after the second ownership change, or to make a protective election that is revoked after the expiration of the two-year period.

Effective Dates

The proposed rules do not apply to ownership changes until after the date that final regulations are published. However, a loss corporation can elect to apply the rules in the final regulations in their entirety to any ownership change that occurs on or before that date. This includes ownership changes to which Section 382(l)(5) applies. ■

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