Protecting Your NOL Carryforward with a Poison Pill

As a result of the recent downturn in the economy, many companies have been incurring significant operating and tax losses. At the same time, corporate stock values have plunged. This confluence of events creates the potential for a company to lose the potentially valuable future tax benefits that may be realized from federal tax net operating loss (NOL) carryforwards.

Over an extended period of economic weakness, NOL carryforwards can become one of the largest assets on a company’s balance sheet. Under normal circumstances, the NOLs can serve to offset future taxable income, resulting in tax savings as the company begins to be profitable. However, current tax laws impose significant limits on the ability to use NOLs to offset taxable income in the event of an ownership change. Thus, a company can be in a situation in which one of its largest assets can become impaired if ownership changes. Recent steep declines in equity markets have made it less expensive for investors to acquire significant percentages of a company’s publicly traded stock, aggravating the risk of a possible limitation.

Section 382 limits a loss corporation’s ability to use its tax net operating losses following an “ownership change.” An ownership change is triggered if one or more 5-percent shareholders of the loss corporation increases their ownership in the aggregate by more than 50 percentage points during a testing period. Once an ownership change has occurred, the amount of NOLs that the corporation may use to offset taxable income in any year is limited to the “Section 382 limitation” resulting from the ownership change. Thus, corporations with large NOL carryforwards are concerned with monitoring shareholder shifts that might trigger an ownership change and impair the NOL asset on their books. Boards of directors of publicly traded companies with large NOL carryforwards are increasing their efforts to protect this asset, and some companies are adopting “poison pill” plans to restrict the ability of shareholders to take actions that could trigger a Section 382 ownership change.
Poison Pills

Since the 1980s, corporate America has used “poison pills” as a tool to discourage hostile and unsolicited investors from taking large stakes in a corporation’s publicly traded stock. Most corporate poison pills take the form of a stockholder rights plan where purchase rights are distributed to existing shareholders, entitling them to acquire one share of common stock (or a preferred stock equivalent) for each share owned, at a specified purchase price that exceeds the market price on the date of adoption. The key deterrent effect of the plan is realized if any investor (herein the “hostile investor”) acquires beneficial ownership of more than a specified trigger amount. In that event, in exchange for payment of the purchase right’s exercise price, all shareholders other than the hostile investor are permitted to purchase shares of common stock (or preferred stock equivalents) having a fair market value equal to two times the exercise price. This effectively allows the public shareholders to buy common shares at a 50 percent discount, while denying the hostile investor the same benefit. A trigger of the poison pill will thus significantly dilute the percentage of the company’s common stock owned by the hostile investor, making it more expensive for the hostile investor to acquire control of the company.

Typically, the anti-dilution rights in a poison pill are set to be triggered once a shareholder acquires beneficial ownership of more than a 10, 15 or 20 percent stake in the corporation. Since Section 382 is concerned with tracking the increases in 5-percent shareholders, many of the NOL poison pills have a lower triggering percentage ranging from 4.75 to 4.99 percent. These lower threshold triggers are designed to deter further acquisitions by stockholders whose share purchases or sales might affect the ownership change calculation. Some NOL poison pills include additional provisions imposing an outright prohibition against exceeding the threshold percentage of beneficial ownership without obtaining pre-approval for a proposed share acquisition.

Some loss corporations have been reluctant to adopt rights plans with low triggering percentage levels, fearing it will discourage future investment in their stock. The existence of a low percentage trigger, as exists in NOL rights plans, is thought by some to dissuade institutional investors from taking a position in the stock. To avoid an unwanted trigger of the rights plans and encourage investment, some companies have included discretionary controls in

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speakers’ corner continued

Debt Buybacks Are Financially Lucrative through In-Depth Grasp of Tax and Legal Ramifications.” Mr. Schneidman will speak on a panel titled, “Regulatory and Rule Roundtables: Evaluate Impact of Financial Crisis on Tax Practices for PE Funds and Ensure You Are in Compliance.”

- On June 20, Steven Bortnick will present “Avoiding ECI in Funds and Carried Interest Legislation Update” at a client training session in London, England.

- Steven Bortnick will speak on “Acquiring Portfolio Company Debt” at a client training session in London, England on June 20.

quotable

- Todd Reinstein was quoted in the May 29 issue of Tax Notes Today regarding current issues in Section 382.

webinar

- Leonard Schneidman will speak at a live webcast on “FY2010 Budget Greenbook Proposes Sweeping Changes to the International Tax Provisions of the Internal Revenue Code.” This event is being presented by The Knowledge Congress on July 14, from 12:00 to 2:00 p.m. (EDT). For more information, visit www.knowledgecongress.org/event_2009_bluebook.html.
the plans. Many shareholder rights plans also provide for automatic termination of the plans if the board determines that the NOLs have been fully used to offset taxable income. Other plans include rules allowing a board to waive the application of the discount purchase provisions upon a triggering acquisition at the discretion of the board.

Rights Plans under the Option Rules

Under Section 382, an option to acquire stock is treated as exercised if the exercise would result in an ownership change. The regulations provide an extensive set of rules for option attribution. Generally, the option attributions rules reverse the presumption that an option is deemed exercised, if doing so causes an ownership change, and treats only options issued for a principal purpose of avoiding or accelerating the impact of an ownership change as deemed exercised and counted as stock under Section 382. These attribution rules can bring about unfortunate results when a seemingly benign equity issuance can be counted for Section 382 owner shift purposes. For example, the shareholder rights distributed to the existing shareholders under a poison pill are considered options under the regulations and thus, an analysis must be performed to determine whether or not they would be considered exercised for Section 382 purposes.

In Revenue Ruling 90-11, the IRS ruled that certain rights issued to shareholders to acquire loss-corporation stock at a reduced price pursuant to a poison pill adopted to fend off a hostile takeover are not subject to the option attribution rules. The ruling holds that such rights would be exempted from option attribution as long as the loss corporation could redeem the rights for little or no consideration without shareholder approval, a standard provision in poison pills. Although the ruling holds that the distributions of rights did not constitute stock for Section 382 purposes, corporations implementing NOL plans need to be careful when drafting their poison pills and work to ensure that rights to be granted under such plans do not carry with them attributes of equity ownership that would cause the rights to be treated as outstanding equity. These can include the right to vote, a seat on the board, a deep in the money exercise price, etc.

Selectica Case

Before creating an NOL poison pill, companies should note a pending case, Selectica, Inc. v. Versata Enterprises, Inc., in the Delaware Court of Chancery involving the intentional triggering of an NOL poison pill. Selectica, Inc., a microcap company that provides enterprise software solutions, amended its conventional shareholder rights plan in 2008 in order to protect its NOL carryforwards from possible impairment, by lowering the triggering percentage under the plan from 15 percent to 4.99 percent. Selectica’s rights plan grandfathered all then-existing 5-percent or greater shareholders and provided that the plan would not be triggered unless they were to acquire beneficial ownership of at least an additional 0.5 percent of the common stock. Two existing shareholders – commercial competitors of Selectica that were engaged in ongoing business disputes with the company – thereafter announced that they had purchased more than the number of additional shares necessary to trigger Selectica’s rights plan. In response, Selectica exercised the exchange feature of its rights plan, issuing an additional share for each share held by every shareholder other than the triggering shareholders, in exchange for the cancellation of all outstanding rights under the plan. This doubled the number of shares held by all shareholders other than the triggering shareholders and effectively diluted the ownership percentage of the triggering shareholders by approximately half. Selectica also renewed its NOL poison pill and distributed a new purchase right to all of the non-triggering shareholders. Finally, Selectica filed a lawsuit in the Delaware Chancery Court seeking a declaratory judgment confirming the validity of its rights plan.

Aside from the obvious disruption and expense resulting from the triggering of the poison pill and the resulting litigation, Selectica suffered the additional insult of having the trading in its common stock suspended for a month while the company and its transfer agent sorted out which shareholders were entitled to receive the distribution of free shares as a result of the exchange feature, and which were affiliated with the triggering shareholders and were thus not so entitled. The word of caution here is that although
most poison pills will serve as an effective deterrent to the acquisition of triggering share percentages, one or more shareholders with other than purely share-related motives, such as competitors, can subvert the intention of the rights plan and “buy through” the triggering percentage of shares, thereby putting at risk the loss corporation’s NOL carryforwards. This was the case with Selectica, and the matter is currently being litigated in Delaware.

**Pepper Perspective**

An NOL poison pill can be an effective tool for loss corporations looking to protect their NOL carryforward assets. Loss corporations, however, should carefully think through all of the possible ramifications, including the potential consequences associated with the administration of the plan if the pill is triggered, and the potential effect of the ownership limitation imposed by the plan on the attractiveness of their stock in the market.

**Endnotes**

1 Unless otherwise stated, all references to “Section” are to the Internal Revenue Code of 1986 (the Code), and all references to “Treas. Reg. Sec.” are to the Treasury Regulations promulgated thereunder (the Regulations).

2 Section 382(g).

3 The Section 382 limitation is a formulaic calculation that is basically equal to the product of the value of the loss corporation (subject to certain adjustments) and the long-term tax-exempt rate. The long-term tax-exempt rate is published on a monthly basis by the IRS and can be found in IRS publications, including the Internal Revenue Bulletin. Taxpayers are required to use the long-term tax-exempt rate for the month in which the ownership change occurs when calculating their Section 382 limitation for any ownership change. For example, the long-term tax-exempt rate for June 2009 was 4.61 percent per Rev. Rul. 2009-16, 2009-23 IRB.

4 Recently, a number of companies have adopted rights plans to protect against limitations in their ability to use their net operating loss carryforwards. See Sirius XM Radio, Inc. Form 8-A filed with the SEC on April 29, 2009.


6 Rev. Rul. 90-11, 1990-1 C.B. 10. Note that this Rev. Rul. was issued before the option attribution rules were substantially changed by T.D. 8440, 10-2-92.

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In Rev. Proc. 2009-25, the IRS modified the no-rule provisions that apply to reorganizations and other transactions that occur in the context of a Section 355 transaction and certain aspects of the Section 355 requirements to allow for taxpayers to request private letter rulings on a single legal issue or issues. These new rules allow taxpayers to seek “single issue” rulings and, therefore, the taxpayer is not required to go through the process of submitting all of the information usually required to obtain rulings on the entire transaction. This new process is available to taxpayers whose transaction raises issues that are within the IRS Associate Chief Counsel’s responsibility. Thus, the taxpayer cannot ask for resolution of issues that relate to partnership issues or international tax issues and still qualify for the “single issue” ruling process under Rev. Proc. 2009-25.

As an example of the relaxation of the no-rule policy in this area, the IRS notes that it will address certain redemption issues under Section 355(e) if “an adverse ruling on such question would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under Section 355(e).” In addition, even if an aspect of the transaction is in the general no-rule area, such as whether certain steps of an overall transaction qualify under Section 351, the IRS will nevertheless rule on the significant issue under Section 351 if a negative resolution of the 351 issue would cause some aspect of the overall transaction to fail one or more of the requirements of Section 355. Also, in the case of a request for a ruling on an issue under Section 351, for example, the IRS will require the taxpayer to submit the relevant representations as contained in Rev. Proc. 83-59, 1983-2 C.B. 575, that relate only to the significant issue, as well as to provide a general representation that the other requirements of Section 351 are met.

Mandatory Pre-Submission Conference and Other Logistics

The IRS requires that the taxpayer call its Associate Chief Counsel (Corporate) and request a pre-submission conference to see if the IRS agrees that the taxpayer’s situation warrants a ruling under this new procedure. As a practical matter, most taxpayers seek a pre-submission conference in the Section 355 ruling process because of the many nuances involved with the IRS’ interpretation of some of the more factual issues raised in a Section 355 spin-off transaction and the time and expense necessary to assemble and discuss all the information that is required to support a request for a private letter ruling under Section 355. Taxpayers generally seek to identify very early in the process any issues that might be raised by their particular facts that would cause the IRS to refuse to rule, or seek an alternative structure or another change in certain terms of the transaction in order to proceed with processing a ruling.

Rulings under this Rev. Proc. will be processed under the expedited rulings procedures. This addition to the processing of these types of limited rulings indicates that the IRS is hoping to address situations in which taxpayers do not have the time to apply for and go through the entire process needed for a full set of rulings on a Section 355 transaction, but where they still need help resolving a particularly difficult legal issue raised in the transaction in order to close their business deal. Generally, filing, processing, and generating a ruling letter for most Section 355 rulings takes between four to six months. Therefore, certain taxpayers may not be able to take advantage of the letter ruling process because of the specific business need to get their transaction completed. While it is possible to obtain a ruling on a Section 355 transaction after the spin-off is completed, the level of protection afforded to
a taxpayer who comes under IRS exam on that transaction is not as favorable.

Pepper Perspective

Rev. Proc. 2009-25 represents a step toward flexibility by the IRS in helping taxpayers find certainty in their corporate transactions in a timeframe that is responsive to the taxpayer’s business needs. It allows the IRS more leeway in providing targeted guidance if it chooses to do so, without being restrained by the very broad no-rule provisions of Rev. Proc. 2009-3. However, it is up to the IRS to allow a particular taxpayer to take advantage of this new process, because a taxpayer must be pre-approved for the process prior to submitting a ruling request that seeks a single or limited issue ruling.

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Endnotes