When there has been a change in ownership in a corporation, the use of pre-change net operating loss (NOL) carryovers can be significantly limited to offset future earnings for federal tax purposes. These tax rules were enacted in the Internal Revenue Code originally in 1954 to prevent perceived abuses in “trafficking” in loss corporations. They were completely rewritten as part of the reenactment of the Internal Revenue Code of 1986.

In the event of an ownership change of more than 50% of the company, the annual limitation on the use of the NOL loss carryover is the “fair market value” of the stock of the company at the time of the ownership change multiplied by the “long-term tax exempt rate,” otherwise known as the Sec. 382 limitation. For example, if the stock of the company is valued at $10M at the time of the change and the long-term tax exempt rate at that time is 2.5%, the annual limitation on the net operating loss is $250,000 per year. IRS publishes the long-term tax exempt rates monthly in Revenue Rulings and the most recent rate is 2.61% (December 2015, Rev. Rul. 2015-25). Unused net operating loss carryovers are available in future years subject to the Sec. 382 limitation and the 20-year carryover period. NOLs not utilized within the 20 year period are cancelled.

The term “Fair Market Value” is defined in Rev. Rul. 59-60 as follows:

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Assumptions common to Fair Market Value include:

- The buyer and seller are typically motivated and both are hypothetical parties.
- The buyer and seller are able and ready as well as willing.
- Both are well informed or well advised, and acting in their own best interests.
• The payment is in cash or cash equivalents.

• A reasonable time has elapsed in which the property was for sale in the market.

• Neither party is affected by synergies, strategic advantages, special financing or other considerations that could materially distort price compared to this standard of value.

• No consideration is given to unforeseen future events. However, events which have not yet occurred but which were expected or reasonably anticipated as of the Valuation Date may be considered a relevant fact within the knowledge of the parties.

An ownership change occurs when new owners acquire or increase their ownership in a corporation with unused net operating loss carryovers by more than 50%. There are numerous, complex rules to determine which shareholder interests are tested, what constitutes a triggering event and the time period is tested. Ownership considers both direct and indirect interests and the percentage change is measured based on the fair market value of the specific shareholder interests tested as a percentage of the fair market value of the outstanding stock of the company.

The IRS has been granted broad regulatory authority to determine what types of ownership interests are to be included or excluded in the ownership change determination. Preferred stock is generally excluded for purposes of determining ownership changes. To be excluded it must have the following characteristics:

• It must be non-voting.

• It must be limited and preferred as to dividends and without any significant growth participation.

• It must have limited redemption and liquidation rights.

• It must be non-convertible.

However, preferred stock can be included in the ownership change determination if, for example, preferred dividends are significantly above market rates. In addition, other forms of equity or equity participation can be considered stock for purposes of the ownership change determination. These may include options, warrants and similar interests.

Preferred stock is, however, included in the determination of the fair market value of the stock of the loss corporation. The value of all stock is included in the value of the loss corporation. This produces a favorable result since the earnings of the preferred stock can absorb a portion of the NOL.
Changes in stock ownership among family members is generally ignored for purposes of the change of ownership since stock held by specific family members are aggregated for this purpose. Siblings are not considered family members unless their parents or grandparents own stock. Indirect ownership is also considered.

The rules for determining ownership changes are numerous and complex. If you have a change in ownership and pre-change loss carryforwards, you should consult with a qualified tax adviser familiar with those rules. Of course, you will also need to engage the services of a qualified business appraiser to perform a valuation of the loss corporation.

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