Capital Contributions and Code Sec. 382

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These days, any time you talk about having a "principal purpose," you may begin to feel the hairs stand up on the back of your neck. At least that's my reaction. The rejoinder to a "principal purpose" is usually something that sounds dastardly, such as a "principal purpose of tax avoidance." In the case of our subject in this article, a "principal purpose to avoid or increase the Code Sec. 382 limitation," it may not sound as dastardly, but it's still something you know intuitively it would be best to avoid.

Code Sec. 382, a provision we all know and a few may even love, limits the use of net operating losses following an ownership change. Under Code Sec. 382, if an ownership change of a loss corporation occurs, the corporation's taxable income for any post-change tax year can generally be offset by pre-change loss carry-overs only to a limited extent. That limit, the vaunted Code Sec. 382 limitation, is used to limit the NOLs, built-in losses and even capital losses recognized by the loss corporation after the ownership change.

Moreover, the Code Sec. 382 limitation even counts for purposes of applying the Code Sec. 383 credit limitation on a loss corporation's use of excess foreign taxes, general business credit and unused minimum tax credit.

Formula One

The Code Sec. 382 limitation for any post-change year is generally the fair market value of the stock of the loss corporation immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate. The latter is a very small number, so even if the value of the loss corporation is large, you are then condemned to chip away at what may be a very big NOL just a little bit at a time. It may take you 20 years to use up the NOL, or you may never get there before the NOL expires.

This sad state of affairs can create an undeniable incentive to stuff in some more value into the loss corporation, as a way of pumping up the value, thus making (or attempting to make) the formula not quite as punitive. However, any capital contribution received by a loss corporation as part of a plan, a principal purpose of which is to avoid or increase any limitation under Code Sec. 382, is *not* taken into account. [*See* Code Sec. 382(l)(1)(A).] Not only that, but any capital contribution made during the two-year period ending on the change date is (except as provided in the regulations) treated as part of such a dastardly plan.

Kinder and Gentler

With this background, M&A TAX REPORT readers should be pleased with Notice 2008-78, IRB 2008-41, Sept. 2, 2008. The IRS there states that a capital contribution will *not* be presumed to be part of a plan a principal purpose of which is to avoid or increase the Code Sec. 382 limitation *solely* because it is made during the two-year period ending on the change date. The IRS announced in this Notice that it intends to issue regulations to set out these rules. In the meantime, though, you can rely on the Notice.

A capital contribution received by an old loss corporation will be taken into account (and it will not reduce the value of the old loss corporation for purposes of Code Sec. 382(e)(1)) unless the contribution is part of a plan a principal purpose of which is to avoid or increase a Code Sec. 382 limitation. This is supposed to be determined based upon all the facts and circumstances, unless the contribution falls within one of several safe harbors.

Safe Zone

The safe harbors provide that a capital contribution will not be considered part of a bad plan in the following situations:

- **Safe Harbor 1 (no related party; over six months).** The contribution is made by a person who is neither a controlling shareholder, nor a related party, if no more than 20 percent of the loss corporation's outstanding stock is issued in connection with the contribution, and if there was no agreement, understanding, arrangement or substantial negotiations (at the time of the contribution) regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution.
- **Second Safe Harbor (related party; over one year).** The contribution is made a related party, but no more than 10 percent of the total value of the loss corporation's stock is issued in connection with that contribution, *or* the contribution is made by a person other than a related party, and in either case there was no agreement, understanding, arrangement or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.
- **Third Safe Harbor.** The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Reg. §1.355-7(d)(8) or (9).
- **Fourth Safe Harbor.** The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss), or it is received before the first year from which there is a carry-forward of an NOL, capital loss, excess credit or excess foreign taxes (or in which a net unrealized built-in loss arose).

If the value of the old loss corporation is subject to reduction under both Code Sec. 382(l)(1) and (4) (dealing with a reduction in value where a loss corporation has substantial nonbusiness assets), appropriate adjustments should be made to ensure the value reduction is not duplicated.

Reliance

Another piece of good news is that taxpayers can rely on the rules contained in Notice 2008-78 with respect of any capital contribution that occurs in any tax year ending on or after September 26, 2008. The IRS is requesting comments on these rules and the safe harbors, and even on the topic of whether additional safe harbors may be needed. In the meantime, though, the Notice provides a nice safety net from the nitty-gritty and uncertainty associated with the overall facts and circumstances test.