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Using A Rights Plan to Protect Your NOL Assets

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Pursuant to Section 382 of the Internal Revenue Code, an “ownership change” is trigged if one or more 5 percent shareholders of the subject corporation increase their ownership in the corporation by more than 50 percent during the shorter of (i) the prior three-year period or (ii) the period since the date of the last ownership change. These determinations are potentially complex, and special rules apply, including that entities acting in concert be treated as a 5 percent shareholder if they meet the 5 percent threshold in the aggregate. If an “ownership change” occurs, the ability of the corporation to use NOLs to offset future taxable income is subject to limitations that can severely impair the value of the NOL asset.

Since Section 382 tracks 5 percent shareholders, an NOL rights plan typically has a lower trigger (often 4.99 percent) as compared to the 10-20 percent threshold, which is more typical in a traditional rights plan. Since boards may be concerned that an NOL rights plan may adversely impact investment in the company’s stock, such rights plans may also include provisions to avoid an unwanted triggering if there is no threat to the NOL asset. For example, a board may waive the application of the trigger if it determines that an acquisition is unlikely to limit the value of the NOL asset.

It is worth noting that, although NOL rights plans are certainly protective, they cannot prevent a stockholder from acquiring additional shares; they merely act as a deterrent. In addition, they do not prevent or restrict stock sales that may also trigger an ownership change under the tax rules. However, if a significant risk exists that the ability of a corporation to use NOL carryforwards may be impaired, a board should carefully consider its options, including a rights plan, to protect this valuable asset.

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