Monetizing Life Science Company Net Operating Losses

BY MICHAEL F. SOLOMON

As in most high-risk businesses, tax losses are an important consideration for life science startups. Indeed, given that only one company in 20 or 30 ultimately succeeds, a tax loss is frequently the only asset the company generates. How well that card is played can make a big difference in mitigating investor losses. In some circumstances, accumulated net operating losses (NOLs) can even serve as the keystone of a successful successor company.

However, tax losses are easy to lose without careful planning. Section 382 of the Internal Revenue Code, the section that sets out the rules relating to the limitations on the use of NOLs when a change in control of the loss company occurs, was designed specifically to keep profitable companies from buying unprofitable companies simply to harvest their accumulated losses.

For starters, your company needs to be incorporated as a C corporation. S corporations and partnership losses pass through to the shareholders. Losses of S corporations and partnerships are not corporate losses that carry over as NOLs and which are available to offset future income. You will also need to be careful about taking on new investors. Section 382 sets out very specific limits on using existing NOLs after a change of control of the C corporation that generated the losses. If one or more 5% shareholders (shareholders with less than 5% are grouped together and treated as one 5% shareholder) raise or lower their stake by more than 50% in any three-year period, Section 382 specifies that a change in control has occurred.

If a change in control does occur within that three-year period, the amount of the NOL that remains available to the loss company will be subject to two limitations. First, the total NOL that a company may carry over into future years after a change in control is limited to the total fair market value of the company on the date of the change in control. For example, if the company has $100 of NOLs, but the fair market value of the company on the date of the change in control is only $60, the available NOLs are reduced to $60.

The second limitation is that, whatever total NOL is determined to carry over under the fair market value limitation described immediately above, the portion of that remaining NOL which can be used in any given future year is limited to the product of that total NOL multiplied by the long-term tax-exempt bond rate. A 4% bond rate at the time of the change, for example, would make the annual usable value of the NOL equal to 4% of the remaining $60 value, as determined under the first limitation.

The NOL that carries over following a change in control is also affected by the company's net unrealized built-in gains (NUBIG) or net unrealized built-in losses (NUBIL), *i.e.*, the amount by which the fair market value of the company's assets exceeds or fall short of the company's total tax basis in the assets. A loss corporation with a NUBIG in its assets may generally add the NUBIG to its available NOL (after the two limitations described above are imposed) if such built in gains are recognized within five years of the change in control. Conversely, a loss corporation with a NUBIL in its assets must treat those losses as if they were pre-change net operating losses subject to the two-prong Sec. 382 limitations described above.

However, the rules regarding NUBIGs and NUBILs are in transition right now. If, as is likely, the IRS adopts a new set of proposed regulations this year, that company will need to file a consolidated return that recalculates the NUBIG or NUBIL by including the gains or losses of subsidiaries' stock holdings that occurred within five years after the change of control, once those gains or losses are recognized. Assuming they are adopted the new NUBIG and NUBIL rules will affect any transaction that occurs after Oct. 24, 2011.

Fortunately, a number of planning strategies can mitigate the impact of Section 382 and preserve some or all of the value of your NOLs. The easiest thing to do is to never cross the 50% investment threshold until each three-year testing period is over. The NOLs are then completely available to the company without limitation. This method to retain the value of NOLs requires close scrutiny to any new equity issuances.

Another way to avoid the Section 382 change of control limitations is to have the change of control occur in the context of a Chapter 11 bankruptcy. The IRS has ruled that when a company emerges from Chapter 11 with a more than 50% change in ownership but 50% of those new owners are former shareholders or creditors who took shares as partial settlement of their claims (and have held their debts for over 18 months prior to the bankruptcy), the company does not lose its NOLs.

Finally, if the cash hasn't run out when the company decides to stop its development activities, it is sometimes possible to use the NOL in a strategic way by selling all the assets and using the remaining cash to buy profitable income streams in the same line of business (*i.e.*, life sciences). This is effectively an arbitrage strategy in which an acquisition is made at a taxable discount rate, but application of the NOLs makes the acquisition's income non-taxable. This technique has been used in the life sciences context by loss companies that acquired with leverage pharma royalty streams at a taxable discount rate but subject to the NOL shelter. At a 40% state and federal tax rate, this adds 40% unleveraged cash flow and significantly greater returns on a leveraged basis.

State NOL rules may offer other opportunities as well. New Jersey, in particular, has favorable NOL rules that give life science companies more flexibility in handling their losses. In New Jersey, life science companies with NOLs are allowed to sell their NOL claims to profitable companies as tax shields. This rule has freed millions in NOL assets that might otherwise have been lost and created thousands of new jobs. Of course, the New Jersey rules do not carry over to allow these losses to be used without the two limitations described above under the Federal tax rules, and they are only for use in New Jersey.

Look out for the possibility of IRC changes in the future too. The success of this rule in New Jersey as a way to generate new jobs has led some industry observers to suggest that it might work on the national level as well. They argue that a simple rule change could generate billions in new biotech investment, greatly expanding the money now available for life science research and development.

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