

A Practical Look at Section 382

Tax Executive Institute

Cleveland

Annette Ahlers
Todd Reinstein
213.928.9825
202.220.1520
ahlersa@pepperlaw.com
reinstet@pepperlaw.com

October 17, 2019

Pepper Hamilton LLP
Attorneys at Law

Agenda

- ▶ Overview of Section 382
- ▶ Tax Due Diligence
- ▶ Determination of an Ownership Change
- ▶ Section 382 Limitation
- ▶ Determination of Built-in Gains and Losses
 - Proposed Treasury Regulations 1.382-7
- ▶ Appendix
 - New NOL rules
 - Refundable AMT Credits
 - Issues IRS is looking at
 - Rights Plans
 - Filing Requirements

Tax Due Diligence – Why Section 382 Matters

- ▶ In a transaction, purchase price modeling will need to account for any historic and/or anticipated limits on NOLs
 - Management may ask the tax department to evaluate various models of a proposed transaction, seeking to determine the benefit, if any, of one or more party's NOLs.
 - A Target corporation may wish to be “paid” for the future value of their NOLs.
 - Section 382 will be important if the transaction is a stock acquisition (with no 338 election if taxable) or a qualifying tax-free reorganization (Section 381 applies), or any transaction in which equity is issued and one or more parties is a loss corporation.
 - Practice Tips: Ask for a cooperation clause in the purchase agreement if there is no documentation. Make sure the recitals indicate the type of transaction (i.e., taxable stock purchase, tax-free reorganization under Section 368(a), asset sale, etc.) so it is clear whether or not the NOLs are intended to survive the transaction. There may be a need to model the use of “old NOLs” and “new NOLs” taking into account changes made in the Tax Cut and Jobs Act (“TCJA”)
- ▶ Cumulative annual limitations may be so severe that a portion of the NOL carryforward will expire unused
 - Might need to write down DTA
 - Practice Tip: DTA write down is generally easier as a purchase accounting adjustment in an acquisition.

If a 382 Study Analysis is in the Data Room

- ▶ Examples of the types of documents/information you should expect to review:
 - An equity roll forward” schedule that shows each of the equity events (“testing dates”) that occurred for that corporation from the first day it was a loss corporation
 - This schedule should also include a list of all shareholders (including any “public groups” that are treated as 5% shareholders for purposes of Section 382), and the number of shares they own on each testing date.
 - A cap table that lists stock issuances by date and to whom.
 - Ideally, this information will also identify any shareholders who are “related parties”.
 - A detailed description of the equity, including any preferred stock, stock options, warrants, convertible debt instruments, etc, including the value of such equity interests.
 - A calculation of the “percentage increase” in the ownership of each of the 5% shareholders on each testing date.

If a 382 Study Analysis is in the Data Room

- If an ownership change occurs:
 - A calculation schedule showing each of the components of determining the Section 382 limitation for each ownership change date (value of the stock, significant cash on the balance sheet or other non-business assets, etc).
 - A NUBIG/NUBIL schedule that compares the tax basis of the assets with the FMV of such assets in order to determine if the corporation is in a NUBIG or NUBIL on the change date.
 - An analysis of the application of Notice 2003-65, if it was applied to increase the Section 382 limitation (or determine how to take into account RBILs).
 - A “tiered” schedule showing the impact on the availability of NOLs and other tax attributes taking into account successive ownership changes, and taking into account changes to utilization under the TCJA.
- A file memo or “study” that documents the application of the relevant Section 382 rules.

Overview of Section 382

Purpose of Section 382:

- Limits ability of a corporation to offset future income using NOLs generated prior to a “change in ownership” and certain built-in losses recognized post-change

Policy:

- Enacted to prevent “trafficking” in NOLs
- Is designed to prevent abuses involving the acquisition of loss corporation stock followed by the contribution of income-producing assets or diversion of income-producing opportunities to the corporation.
- Other limitations on attributes may apply in addition to Section 382, including Section 269, SRLY, disallowance of the NOLs based upon a review of their origin, 1.1502-36, etc...

Section 382 Definitions

- ▶ Limits a “loss corporation”
- ▶ That undergoes an “ownership change”
 - An ownership change occurs if immediately after an **owner shift** or an equity structure shift - The percentage **by value** of stock of the loss corporation owned by one or more **5-percent shareholders** has increased by more than **50 percentage points** over the lowest percentage ownership of such shareholders
- ▶ During a 3-year “testing period”
- ▶ From utilizing “pre-change losses” or other tax attributes
- ▶ Against “post-change” income

Determining LossCo and Testing Period

Loss Corporation

- NOL, tax credit, capital loss, or other attribute carryforward
- Net Unrealized Built-In Loss (“NUBIL”)

Testing period

- Begins on the first day of the tax year when carryforward begins
- 3-year “rolling” period unless an ownership change occurs or less than three years as a loss corporation

Determination of an Ownership Change - Equity Under 382

What generally counts as “equity” when determining a Section 382 ownership change?

- Common stock
- Convertible preferred stock
- Voting preferred stock
- Can include non-stock equity instruments

Equity Under 382

- ▶ What generally does NOT count as “equity” when determining a Section 382 ownership change?
- ▶ Plain vanilla preferred stock (Section 1504(a)(4) stock)
 - Not entitled to vote
 - Not convertible
 - Limited and preferred as to dividends
 - Does not participate in corporate growth
 - Redemption and liquidation rights do not exceed issue price
- ▶ Most stock options
 - But must test under the option attribution rules
- ▶ Debt, including most convertible debt
 - The convertibility feature creates an option to acquire stock

Section 382 – Treatment of options

Option:

- Warrant, option, put, option to acquire an option
- Convertible debt
- Stock subject to substantial risk of forfeiture (restricted)
 - Check for 83(b) election

* Note that warrants issued deeply in the money could be treated as stock for Section 382 purposes.

Sample Timeline

Date	Equity Event	Type of Equity	# of Shares	Info Source
1/1/13	Initial Capitalization	Common	1,000	Audited Financials
4/1/13	Investor	Series A Preferred	100	Private Placement Memorandum
2/1/14	Public Offering and Preferred Conversion	Common	400	Audited Financials and Form S-1
12/31/14	Exercise of Stock Options	Common	20	Audited Financials and Option Plan
2/1/15	Acquisition by Investment Advisor	Common	200	Schedule 13G
3/1/15	Public Offering	Common	200	Audited Financials and Form S-1

1st Event: Formation

On or about January 1, 2013 the Company issued 1,000 common shares

On January 1, 2013 the Company issued 1,000 shares of Company common stock to Founder as part of the Company's initial capitalization. The common stock was valued at \$1.00 per share.

Initial Capitalization

5% S/Hs	# of Common Shares	# of A Pfd Shares	Initial Capital: Common	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	0	0	1,000	\$1.00	\$0	\$1,000	100%	100%	0%
TOTALS	0	0	1,000			\$1,000	100%	100%	0%

Measuring Shifts

The determination of the percentage of stock owned by a person shall be made on the basis of the *relative fair market value* of the stock owned by such person to the total fair market value of the corporation's outstanding stock

2nd Event: Convertible Preferred Stock Issuance

On or about April 1, 2013 the Company issued 100 shares of Series A preferred stock

- ▶ On April 1, 2013 the Company issued 100 shares of Series A preferred stock to Investor A in exchange for \$200 (or \$2.00 per share).
- ▶ This class of preferred stock is treated as stock for Section 382 purposes because it is convertible into common stock at a 2-to-1 ratio.
- ▶ The value of \$2.00 per share used for the Series A preferred stock on this testing date is based on the issuance price paid for such stock.
- ▶ Investor A is treated as a separate 5% shareholder on the issuance of the 100 shares of Series A preferred stock under the segregation rules of Reg. Section 1.382-2T(j)(2)(iii)(B).
- ▶ Based on an issue price of \$2.00 per Series A preferred share (and holding the value of the common stock constant from the date of issuance at \$1.00 per share) the cumulative owner shift as of April 1, 2013 was 16.7%.

Convertible Preferred Stock Issuance

5% S/Hs	# of Common Shares	# of A Pfd Shares	Testing Date #2: New Pfd	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0		\$1.00	\$2.00	\$1,000	83.3%	83.3%	0%
Investor A	0	0	100	\$1.00	\$2.00	\$200	16.7%	0%	16.7%
TOTALS	1,000	0	100			\$1,200	100%	83.3%	16.7%

Changes in Value

Any change in proportionate ownership which is attributable **solely** to fluctuations in relative FMV of different classes of stock is not taken into account (Section 382(l)(3)(C))

Change in Value (cont'd)

Notice 2010-50 issued on June 11, 2010

Full Value Methodology

- Mark to market shares

Hold Constant Principle

- The equity shift is calculated by factoring out fluctuations in the relative values of classes
- Alternative 1
 - Look Back Method
- Alternative 2 can be applied in two separate ways
 - Proportionate Reduction Method
 - Purchase Reduction Method
- Issuances and Redemptions could have different results under all 3
- On May 8, 2012, ABA Section of Taxation proposed another methodology under the Hold Constant Principle which is designed to ensure that the results do not differ regardless of whether shareholders participate in over-the-top transactions

Aggregation Rules

Aggregation rules generally apply to shareholders who each own less than 5% of Loss Co

- Shareholders who own less than 5% of the stock collectively are treated as a “public group”

Certain groups of people acting in concert such that they are treated as an “entity” under the rules can be a separate 5% shareholder

Segregation Rules in General

- The segregation rules cause a “split” of certain public groups for specified transactions. A portion of the public group is “segregated” into a new separate group
- Application of the segregation rules creates additional public groups and may increase the owner shifts.

Transactions include:

- Share issuances (1032 transactions)
 - Small issuance exception
 - Cash issuance exception
- Redemptions

3rd Event: IPO and Preferred Conversion

On or about February 1, 2014, the Company issued approximately 400 common shares in a public offering and converted all Series A preferred stock into common stock

- On or about February 1, 2014, the Company issued 400 shares of common stock to the public for total consideration of approximately \$400 (or \$1.00 per share). In addition, all of Investor A's Series A preferred stock was converted 2-for-1 into the Company's common stock.
- Public Group 1 was created pursuant to the aggregation and segregation rules of Reg. Section 1.382-2T(j) to account for the issuance of common stock. Shareholders who own less than 5% of the loss corporation on a testing date are aggregated under Reg. Section 1.382-2T(j)(1) and treated as a single 5-percent shareholder, referred to as a "public group" under Reg. Section 1.382-2T(f)(13).
- Based on an issue price of \$1.00 per common share the cumulative owner shift as of February 1, 2004 was 37.5%.

Preferred Conversion

5% S/Hs	# of Common Shares	# of A Pfd Shares	Testing Date #3: Common	Testing Date #3: Pfd	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0			\$1.00	\$2.00	\$1,000	83.3%	83.3%	0%
Investor A	0	100	200	(100)	\$1.00	\$2.00	\$200	16.7%	0%	16.7%
TOTALS	1,000	100	200	(100)			\$1,200	100%	83.3%	16.7%

IPO

5% S/Hs	# of Common Shares	# of A Pfd Shares	Testing Date #3: IPO	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0		\$1.00	n/a	\$1,000	62.5%	62.5%	0%
Investor A	200	0		\$1.00	n/a	\$200	12.5%	0%	12.5%
Public Group 1	0	0	400	\$1.00	n/a	\$400	25.0%	0%	25.0%
TOTALS	1,200	0	400			\$1,600	100%	62.5%	37.5%

Small Issuance Exception

Exempts “small issuances” from the normal segregation rules to the extent the amount of stock issued in that issuance and other issuances in which the limitation is applied during the year do not exceed the remaining small issuance limitation on that date

Limitation is equal to 10% of the total value of the corporation’s stock outstanding at the beginning of the year

- Can also be done on a class-by-class basis
- Doesn’t apply to equity structure shift transactions, including tax-free mergers
- Must combine entire issuance, including amounts issued to 5% shareholders to determine application or not

Effect: stock is treated as acquired proportionally by existing public groups

4th Event: Stock Option Exercises

During the tax year ended December 31, 2014, the Company issued approximately 20 shares of common stock pursuant to its employee stock option plan

- ▶ During the tax year ended December 31, 2014, the Company issued 20 shares of common stock to employees upon the exercise of options. None of these employees was a 5-percent shareholder as defined in Section 382(k)(7).
- ▶ The Company's issuance of 20 shares of common stock upon the exercise of options is considered a small issuance under Section 382. The total issuance valued at \$20 does not exceed the small issuance limitation of \$120 (based on the value of the Company's common and preferred stock at January 1, 2014 of \$1,200 times 10%). The segregation rules of Treas. Reg. Section 1.382-2T(j)(iii)(B) do not apply to the option exercise because it does not exceed the small issuance limitation. Pursuant to Treas. Reg. Section 1.382-3(j)(5), each of Company's existing direct public groups should be treated as having acquired a proportionate number of the shares issued. Since Company had only one public group on the relevant date, all of the shares were allocated to that public group.
- ▶ The cumulative owner shift as of December 31, 2014 was 38.3%.

Small Issuance Exception Illustrated

Small Issuance Limitation (based on value)			
<i>Calculation of Limitation:</i>			
Common Stock at 1/1/14	1,000 shares	x \$1.00 =	\$1,000
Preferred Stock at 1/1/14	100 shares	x \$2.00 =	\$200
Total Value at 1/1/14			\$1,200
Small Issuance Limit %			10%
LIMITATION			\$120
<i>Limitation Used:</i>			
Stock Option Exercises			(\$20)
REMAINING LIMITATION			\$100

Stock Option Exercises

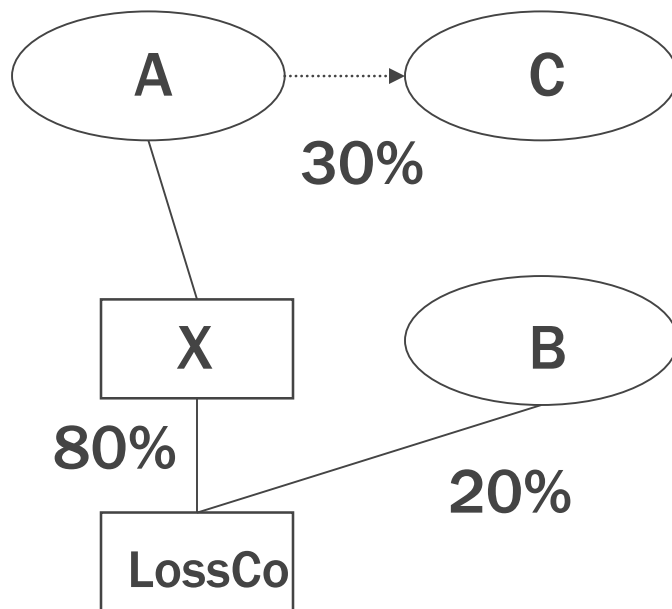
5% S/Hs	# of Common Shares	# of A Pfd Shares	Testing Date #4: Options	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0		\$1.00	n/a	\$1,000	61.7%	61.7%	0%
Investor A	200	0		\$1.00	n/a	\$200	12.3%	0%	12.3%
Public Group 1	400	0	20	\$1.00	n/a	\$420	26.0%	0%	26.0%
TOTALS	1,600	0	20			\$1,620	100%	61.7%	38.3%

What or Who is a 5% Shareholder?

Any individual who owns directly or indirectly an amount of the loss corporation stock that aggregates to a 5% ownership interest by value

Include indirect 5% shareholders

- Trying to get to “arms and legs”



A is indirect 5% shareholder of LossCo

A sells 30% of X stock to C

24% shift in LossCo (30% multiplied by 80%) even though shareholder X still owns 80%

What is a 5% Shareholder? (cont'd)

Review SEC information:

- “Reliance” on the existence or absence of Schedules 13D & 13G
 - What about Schedule 13F?
- No obligation to inquire or to determine if actual facts are consistent with the ownership
 - IRS has moved away from this view in recent PLRs and is now requiring more inquiry by the loss corporation
- “Actual knowledge” can always be taken into account
- Other SEC information:
 - Forms 3 and 4
 - DEF 14A – Proxy Statement
 - 10Qs
 - 10Ks

Investment Advisors

Investment advisors may not count as 5% shareholders

- PLRs distinguish between a person who has the right to the dividends and proceeds from the sale of a loss corporation's stock (the "economic owner") and the investment advisor, who holds the power to vote and/or dispose of such stock (the "reporting owner")
 - Right to dividends
 - Right to proceeds upon the sale of stock
- PLR 9533024, PLR 9725039, PLR 200806008, and PLR 200902007, 201902022
- If not a separate 5% shareholder, the stock is treated as held by the public group
- Similar rule for "family of funds" filing as a 5% shareholder where no fund owns 5% or more

Investment Advisors (cont'd)

PLR 200747016 provides guidance on how to interpret information on Schedules 13D and 13G filed with the SEC

- SEC filers who do not provide additional information and taxpayer has no actual knowledge
- SEC filers who provide additional information
- SEC filers who do not provide additional information, but taxpayer has actual knowledge

PLR 20110006

- Actual Knowledge
- Not obligated to pursue for all shareholders

5th Event: Investment Advisor Purchase

On or about February 1, 2015, an investment advisor buys approximately 200 common shares in the public market

- On or about February 1, 2015, an investment advisor purchases 200 shares of common stock from the public for total consideration of approximately \$200 (or \$1.00 per share).
- According to the Schedule 13, the filer was an investment advisor and the unrelated clients of the investment advisor have the economic ownership of the stock. As a result, the shares will remain in the public group.

Investment Advisor files Schedule 13

5% S/Hs	# of Common Shares	# of A Pfd Shares	Not a Testing Date	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0		\$1.00	n/a	\$1,000	61.7%	61.7%	0%
Investor A	200	0		\$1.00	n/a	\$200	12.3%	0%	12.3%
Public Group 1	420	0		\$1.00	n/a	\$420	26.0%	0%	26.0%
TOTALS	1,620	0				\$1,620	100%	61.7%	38.3%

Cash Issuance Exception

Exempts a percentage of stock issued (in a solely-for-cash-issuance) from the regular segregation rules equal to one-half of aggregate percentage of stock owned by direct public groups immediately before the issuance. Note that a loss corporation with a low percentage of its equity treated as held by public groups will not benefit significantly from this exception.

Effect: The portion of stock exempted is treated as acquired by the existing public groups

The exception as calculated above cannot exceed: total stock issued minus newly issued stock owned by 5% shareholders immediately following the issuance

- Absent actual knowledge, any increase in the amount of the loss corporation's stock owned by a 5% shareholder on the day of the issuance is considered to be attributable to an acquisition of stock in the issuance
- Exempt share calculation is based on the total issuance (may include shares issued to 5% shareholders)
 - 1.382-3(j)(13)(ex 2)(iii)

7th Event: Secondary Offering

On or about March 1, 2015 the Company issued approximately 200 common shares in public offering

- ▶ On or about March 1, 2015 the Company issued 200 shares of common stock in a public offering valued at approximately \$200 (or \$1.00 per share)
- ▶ None of the 5% shareholders purchases the new shares
- ▶ The cash issuance exception under Reg. Section 1.382-3(j)(3) was applied to this event and 26 of the 200 shares was allocated to the existing public group based on its percentage interest in the Company immediately prior to the acquisition ($26\% \times \frac{1}{2} \times 200 \text{ shares} = 26 \text{ shares}$). The remaining 174 common shares were allocated to a new public group, “Public Group 2.”
- ▶ Based on a value of \$1.00 per common share the cumulative owner shift as of March 1, 2015 was 45.0%.

Cash Issuance Exception Illustrated

Cash Issuance Application to Issuance of 200 Shares				
<i>Allocation to Existing Public Groups</i>				
Public Group 1	200 shares	x 26%	x 50%	26
<i>Allocation to New Public Group</i>				
Public Group 2	200 shares	- 26 shares	=	174
TOTAL SHARES				200

Secondary Offering

5% S/Hs	# of Common Shares	# of A Pfd Shares	Testing Date #6: Offering	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0		\$1.00	n/a	\$1,000	55.0%	55.0%	0%
Investor A	200	0		\$1.00	n/a	\$200	11.0%	0%	11.0%
Public Group 1	420	0	26	\$1.00	n/a	\$446	24.5%	0%	24.5%
Public Group 2	0	0	174	\$1.00	n/a	\$174	9.5%	0%	9.5%
TOTALS	1,620	0	200			\$1,820	100%	55.0%	45.0%

Reg. § 1.382-3

- “Secondary transfer” exception to segregation rules for sales by 5-percent shareholders to public
- “Small redemption” exception to segregation rules (similar to current small issuance exception)
 - PLR 201451015 (December 19, 2014)
- Small holder first tier and higher tier entity exception from segregation rules
- Modifies segregation rules applicable to transactions involving tiered entities

Secondary Transfer Exception

Reg. § 1.382-3(j)(13): an exception to § 1.382-2T(j)(3)(i)

- Transfer of LossCo stock by Individuals or First-Tier Entities that directly own 5% or more in LossCo to public does not create a new public group
 - Existing public groups deemed to acquire proportionate shares instead of a new segregated public group acquiring the shares
- Each public group of the entity existing at the time of the transfer is treated as acquiring its proportionate share of the transferred ownership interest

Event 6: Founder Share Sales

On or about March 1, 2016, Founder sold 200 shares of common stock in the Company on the open market

- ▶ On or about March 1, 2016, Founder reported a sale of 200 shares of common stock in the Company on Schedule 13D filed with the S.E.C.
- ▶ Under the segregation rules and Reg. Section 1.382-2T(j)(3)(i), each direct public group that exists immediately after a disposition by a direct 5 percent shareholder shall be segregated so that the ownership interests of each public group that existed immediately before the transaction are separate from the public group that acquires stock of the loss corporation. New Treasury Regulation 1.382-3(j)(13), allocates those shares pro-rata to the existing public groups.
- ▶ Accordingly, the percentage shift in ownership percentage as a result of this sale is 56% as of March 1, 2016. **This exceeds the 50% threshold and, consequently, an ownership change has occurred.**
- ▶ Of note, had the shares been sold after April 1, 2016, the ownership shift would have been 45% because Investor A's share acquisition would have been over 3 years old and outside the testing period.

Event 6: Founder Sales Shares

5% S/Hs	# of Common Shares	# of A Pfd Shares	Testing Date #6: Sale	Value: Common	Value: A Pfd	Total Value	Testing Date %	Testing Period Low %	Shift in Owner %
Founder	1,000	0	(200)	\$1.00	n/a	\$800	44%	44%	0%
Investor A	200	0		\$1.00	n/a	\$200	11.0%	0%	11.0%
Public Group 1	446	0	146	\$1.00	n/a	\$592	32.5%	0%	32.5%
Public Group 2	174	0	54	\$1.00	n/a	\$228	12.5%	0%	12.5%
TOTALS	1,820	0	0			\$1,820	100%	38.4%	56%

Section 382 Limitation

- ▶ Fair Market Value of old loss corporation multiplied by a published IRS rate (long-term tax-exempt rate) subject to certain adjustments
 - Final regulations issued on April 25, 2016 modified the calculation of the long-term tax-exempt rate. These rules effectively lower the rate for any ownership changes occurring in November 2016 and thereafter.
 - The rate for September 2019 is 1.89%.
- ▶ Section 383 limits other attributes (e.g. credit carryforwards)

Section 382 Limitation Value

Does not include any new investment being made on the change date

Value of pure preferred, options and warrants are included in the value of the loss corporation to calculate the 382 limitation

- Even though not tracked for equity shifts

Market capitalization of a public company may be the starting point

- Does a control premium matter? See TAM 200513027

Adjustments to Value

The value can be reduced if the loss corporation is holding “substantial nonbusiness assets” (1/3 of total asset value) immediately after the ownership change

Annual limitation may become zero if continuity of business enterprise is violated within 2 years of change

- A loss group is treated as a single entity for this test
 - need at least one member loss group member to continue business

Corporate Contractions

Corporate contractions

- Substantial dividends paid by LossCo following the ownership change
- Debt incurred at the acquiring parent company level could also result in a corporate contraction
 - PLR 200406027 (October 10, 2003)
 - Legislative History example
 - Leveraged Acquisitions?
 - How will debt be repaid? Target or parent funds? Is parent a holding company? Newly formed?

Capital Contributions and Section 382(l)(1)

May be required to back out value of **capital contributions** made within 2 years of ownership change if they are pursuant to a plan

No regulations

Legislative history allows disregarding of:

- Contributions on formation
- Contributions before loss corporation status exists
- Contributions to meet basic operations (e.g. meet payroll or other operating expenses)
- H.R. Rep. No. 426, 99th Cong., 2d Sess., II-189 (1985)

For example, in PLR 200730003 capital contributions made so that a life insurance company could maintain minimum capitalization requirements were not excluded from value by the Section 382(l)(1) anti-stuffing rule.

- See also TAM 9332004, PLR 9508035, PLR 9541019, PLR 9630038, PLR 9706014, PLR 9835027

Capital Contributions and Section 382(l)(1) (cont'd)

Notice 2008-78

Taxpayers may rely on the rules in the Notice for purposes of determining whether a capital contribution is part of a plan with respect to an ownership change that occurs in any taxable year ending on or after September 26, 2008

Turns off the *presumption in the statute*

To meet the safe harbor and have the capital contribution not be considered part of a plan if—

(a) ***The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party, no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution,*** 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.

(b) The contribution is made by a related party but no more than 10% of the total value of the loss corporation's stock is issued in connection with the 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.

(c) 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 § 1.355-7(d)(8) or (9), respectively.

(d) 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 carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

Calculation of the Section 382 Limitation

Section 382 Limitation Example:

– Value immediately before change	\$1,820
– <u>Capital Contributions pursuant to a plan</u>	<u>(\$200)</u>
– Adjusted value	\$1,620
– <u>Published rate (L.T. tax exempt)</u>	<u>5.00%</u>
– Annual NOL Limitation	\$81
– Annual limitation accrues, <i>even if unused</i>	

Successive Ownership Changes

If two or more successive ownership changes, then each Section 382 limitation is applied independently (Reg. Section 1.382-5(d))

- *Later ownership changes may result in a lower, but not a higher, Section 382 limitation*
- Application of rule may result in layers of NOLs where each layer is subject to different limitations
- A single low limitation can trap prior NOLs, and subsequent limitations can not create a higher limitation for previously limited NOLs
- Successive changes on unused limitations
- May require a permanent write-down of NOLs for financial statement purposes
- **Planning Tip:** Condition to close and cooperation from target on determining past ownership changes

Close the Books Election

- If the ownership change occurs mid year and the tax year does not end, the current year NOL (if any) is apportioned between the pre change and post change period
 - Ratable allocation in equal portion to each day in the year
 - Alternative: Close the books method
 - allocate as if books closed with some adjustments
 - Election with return in change year
- Without Election - Default method is pro rata allocation over entire year
- Not available for 163(j) excess interest

Determination of Built-in Gains and Losses

- ▶ Section 382(h) requires any loss corporation with an ownership change to determine whether it has a Net Unrealized Built-in Gain (“NUBIG”) or Net Unrealized Built-In Loss (“NUBIL”)
- ▶ If a corporation has a NUBIL, then built-losses recognized during the *five-year recognition* period are treated as pre-change losses and subject to the Section 382 annual limitation
- ▶ If a corporation has a NUBIG, then built-in gains recognized during the *five-year recognition* period will increase the Section 382 limitation
- ▶ A stand-alone loss corporation can have a NUBIG or NUBIL, but not both
- ▶ Threshold amount (if doesn't meet, NUBIG or NUBIL is 0):
 - \$10 million or
 - If less than \$10 million, 15% of the value of the assets

RBIGs & RBILs

A loss corporation with a NUBIG must establish that any gain recognized within the recognition period is a recognized built-in gain (“RBIG”) from a disposition during the 5 year recognition period

A loss corporation with a NUBIL must establish that any loss recognized is not a recognized built-in loss (“RBIL”) from a disposition during the 5 year recognition period

RBIG/RBIL are limited to the amount of NUBIG/NUBIL

Legislative History

- ▶ The legislative history to the Tax Reform Act of 1986 indicates that the purpose behind section 382 is the “neutrality principle,” i.e., that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation. H.R. Rep. No 99-841, at II-185 (1986).
- ▶ To further the neutrality principle, the rules in section 382(h) are intended to treat built-in gains and losses that are recognized after the ownership change the same as if they had been recognized before the ownership change.

Depreciation, Amortization and Depletion as RBIG and RBIL

Items of income and items of deduction are treated as RBIG or RBIL if the item is “properly taken into account during the recognition period” and is “attributable to periods before the change date”

Income items get treated as RBIG

- Accrual method taxpayer would have included the item in income
 - doesn’t include pre-paid per Treas. Reg. Section 1.382-7(a)
- Timber rulings
- Deduction items treated as RBIL:
 - Depreciation, amortization & depletion
 - CCA 200926027: requires carryforward of RBIL and not carryback
 - CCA 201132022: RBIL is “disallowed” for any post change year that it is recognized and treated as pre-change loss for 382

Under prior law, AMT taxpayers need to take into account NUBIL rules in determining ACE basis

Notice 2003-65

- Notice 2003-65 provides safe harbor settlement guidelines regarding the determination of NUBIG/NUBIL and the identification of RBIG/RBIL
- Two approaches for determining when items of income, gain, deduction, and loss are treated as RBIG and RBIL:
 - “1374 approach” or
 - “338 approach”
- Similar results under both approaches for dispositions
- Different results with respect to items of income and deductions
 - 1374 approach more narrow approach with few items as RBIG and RBIL
 - 338 approach increases Section 382 limitation for recognized built-in gains from “deemed” amortization of certain assets
- COD and bad debt deductions – 12 month rule for RBIG and RBIL
- Notice is effective until temporary or final regulations are issued

Guidance Issued With Respect to New TCJA -100% Expensing of Certain Tangible Property – Calculations Under Notice 2003-65

- ▶ The TCJA provides that new and used qualified property acquired and placed in service after 9/27/17 may be eligible for immediate expensing.
 - Qualified property generally includes tangible property (i.e. intangible assets and goodwill are excluded)
 - Bonus depreciation automatically applies to qualified assets unless elect out
- ▶ Notice 2018-30 – Requires that the calculations under Notice 2003-65 with respect to the Section 338 approach in calculating RBIG must use the prior law cost-recovery system and not the 100-percent expensing approach as stated in new Section 168(k).
 - As a result, loss corporations must maintain detailed records supporting the RBIG calculation, and not just refer to what the taxpayer would have done in an actual Section 338 transaction.
 - Creates additional record keeping

Proposed Treas. Reg. Section 1.382-7

- ▶ On September 9, 2019 the Treasury and IRS issued Proposed Regulations regarding items of income and deduction that are treated as built-in gains and losses under section 382 (the “Proposed Regulations”).
- ▶ The proposed regulations are **prospective** and would apply to determinations of NUBIG or NUBIL and of RBIG or RBIL for section 382 ownership changes occurring after the date the Proposed Regulations are adopted as final regulations.
- ▶ The Proposed Regulations **reject** the 338 approach from Notice 2003-65 and would adopt a modified version of the 1374 approach from that notice.

Comparing Proposed Treas. Reg. Section 1.382-7 to Notice 2003-65

- ▶ When computing the amount of RBIG/RBIL related to existing assets, the proposed regulation makes clear that taxpayers must equalize the adjusted basis to the FMV on the change date and recover the amount over the same period and rate as the actual remaining adjusted basis of the existing assets. (Prop. Treas. Reg. Section 1.382-7(d)(3)(iii)).
 - The 1374 approach of Notice 2003-65 provides that taxpayers may use any “reasonable method” to establish that the amortization deduction amount is not attributable to an asset’s built in loss on the change date.

Comparing Proposed Treas. Reg. Section 1.382-7 to Notice 2003-65 (Cont'd)

7 year property purchased on 8/15/2017 for \$10,000,000

On 12/31/2019 property has FMV of \$1M and A/B is \$4,373,000 - NUBIL is \$3,373,000

Depreciation Reported on Return

2017	\$1,429,000		
2018	\$2,449,000		
2019	\$1,749,000	<u>RBIL AB (\$1M)</u>	<u>Annual RBIL</u>
2020	\$1,249,000	\$285,616	<\$963,384>
2021	\$893,000	\$204,208	<\$688,792>
2022	\$892,000	\$203,979	<\$688,021>
2023	\$893,000	\$204,208	<\$688,792>
2024	\$446,000	\$101,989	<\$344,011>

*Revised basis is recovered over remaining life

Built-in Gains and CFCs

- The gain recognized on a disposition of an asset is not recognized built-in gain if it is:
 - dividend income (including amounts treated as dividends under Section 1248) or
 - Inclusions of income with respect to stock (excluding gain recognized on the disposition of stock) under Sections 951(a) and 951A(a).
 - Prop. Reg. Treas. Section 1.382-7(d)(2)(ii).
- US corporate taxpayers now include GILTI on their US corporate tax returns, which may include gain related to built-in gain assets in the CFC that were related to a trade or business. ***Dispositions of built-in gain assets held in a CFC, however, will not give rise to RBIG if the US taxpayer was a LossCo with a NUBIG.***

Notice 2003-65: “338 Approach” Example

Hypothetical Section 338 Purchase of the Company under IRS Notice 2003-65:

- Company Value	\$1,820
- <u>Company Liabilities</u>	<u>\$600</u>
- Hypothetical ADSP	\$2,420
- <u>Est. Tax Basis in Assets</u>	<u>\$2,000</u>
- NUBIG	\$420

NUBIG/FMV of Assets (exclude cash & A/R) = 17% (exceeds 15% or \$10M)

Notice 2003-65: “338 Approach” Example (cont’d)

- ▶ NUBIG (from prior slide) \$420
 - RBIG attributable to Depreciable Asset 1 \$30
 - RBIG attributable to Goodwill \$390
- ▶ Hypothetical Amortization on Depreciable Asset 1
 - -(assumes 10 years remaining on the asset and actual depreciation of \$2 per year allowed)
 - -RBIG attributable to Asset 1 \$30
 - -Amortization Period /10 years
 - -Hypothetical amortization \$1 per year
 - (only count the incremental increase in amortization)
- ▶ Hypothetical Amortization on Goodwill
 - RBIG attributable to Goodwill \$390
 - Amortization period /15 years
 - Hypothetical amortization \$26 per year

Notice 2003-65: “338 Approach” Example (cont’d)

Adjustments to Section 382 Limitation in 5 Year Recognition Period						
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Hypothetical Asset Deprecation	1	1				
Gain on Disposition of Asset 1	-	28	-	-	-	-
Hypothetical Goodwill Amortization	26	26	26	26	26	-
Total Recognized Built-In Gain	27	55	26	26	26	0
PLUS: Annual NOL Limitation	81	81	81	81	81	81
EQUALS: Adjusted Limitation	108	136	107	107	107	81

Appendix

Impact of TCJA - New NOL Rules

- ▶ Net operating losses (NOLs) arising in tax years ***ending after*** 12/31/2017
 - Indefinite carryforward and no carrybacks
 - Old rules apply to NOLs from before 12/31/2017
 - Carryback of NOLs for property and casualty insurance companies and farming losses can still be carried back two years and offset 100% of the income
 - Mixed use companies?
- ▶ NOLs for taxable years ***beginning after*** 12/31/2017
 - Deduction is limited to 80% of taxable income for which the NOL is carried to
- ▶ No changes to capital loss carryforward and carryback rules
 - Carryback 3 years and carryforward 5 years
 - Only capital gains can offset capital losses
 - Permanent difference if carried back?

NOL Ordering

- ▶ Section 172(a) – NOL deduction for the taxable year an amount equal to the lesser of:
 - The aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, or
 - 80 percent of taxable income computed without regard to the deduction allowable under this section
- ▶ Example
 - Calendar year LossCo has \$90 million in NOLs generated through 12/31/17 and incurs a \$50 million NOL in the tax year ending 12/31/18
 - LossCo earns \$100 million of taxable income in 2019
 - Result?
 - The entire \$90M of NOLs generated through 12/31/17 would be available to offset 2019 taxable income
 - Can LossCo offset the remaining \$10M with the 2018 NOL? If so, how much?
 - Is the 80-percent limitation calculated with or without regard to any pre 2018 NOLs?
- ▶ Notice 2018-67
- ▶ JCT Blue book
- ▶ Draft Technical Correction bill

Impact of TCJA -The New Net Interest Limitation

- ▶ Replaces current “earnings stripping” rule under Section 163(j) which limited interest deductions paid by corporations to related tax-exempt persons
- ▶ Limits the deduction for “net business interest expense” to 30% of “adjusted taxable income”
- ▶ Adjusted taxable income is taxable income computed without regard to (similar to EBITDA):
 - In the case of tax years beginning prior to Jan. 1, 2022, any deduction allowable for depreciation, amortization or depletion (similar to EBIT)
- ▶ Disallowed interest may be carried forward indefinitely (subject to Section 382 limitation). Timing and calculation issues arise under this provision, and it is not yet clear how the interaction of Section 382 and 163(j) will work.
- ▶ No close the books election available
 - ▶ Prop. Reg. Section 1.382-2(a)(7)
 - ▶ A trap for the unwary.
- ▶ Prop. Reg. Section 1.382-7 clarifies that Section 382 disallowed business interest carryforwards are not treated as RBIL.

Refundable AMT Credits

- Corporate AMT was repealed under TCJA
- AMT Refundable Credit Amount equal to 50% (in years 2018 - 2020) and 100% in 2021 of the excess of the credit over the credit allowed in such year
- Despite earlier IRS conclusion, OMB has now asserted that the refundable portion of the credit is not subject to sequestration
- Are AMT credits previously limited from ownership changes still subject to Section 383 now that they are refundable?
- See CCA 201126029

Issues the IRS is looking at

- ▶ The application of §382 to foreign corporations
 - Was the application limited to ECI related activities?
 - Post-TCJA
 - Should a foreign corporation with NUBIL be subject to §382?
 - Should a foreign corporation have a single §382 limit or multiple §382 limits depending on its activities (i.e., one for ECI related activities, one for Subpart F related activities, and one for GILTI related activities)?
- ▶ Section 382(h)(4)
 - What is the scope of §382(h)(4)?
 - Is §382(h)(4) solely a carryforward mechanism or does it subject the unused RBIL to §172 absorption limits (i.e., the post-TCJA 80% limitation)?

What is a Rights Plan?

- Each stockholder of the company will be given a contingent “right” (similar to an option) to acquire shares of common stock at a purchase price determined by your [investment banker/other party]
- The rights do not become exercisable until an acquirer acquires at least 4.99% of the common stock
 - “triggering event”
- When a triggering event does occur, the rights, other than the rights that are held by the acquirer, become exercisable by the stockholders
- Because the acquirer is singled out and denied the right to exercise rights, the acquirer would suffer a significant degree of dilution because of the shares of the other stockholders are issued shares of common stock at half the market value of the common stock

Rights Plan Tax Impact

- Revenue Ruling 90-11, 1990-1 C.B. 10, 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.

Business Effect of a Rights Plan

- A potential acquirer who has prior knowledge of the existence and the effects of the NOL Rights Plan, would likely not make an acquisition above the 4.99% threshold since it is not in their economic interest as a stockholder because of dilutive impact
- Encourages a potential acquirer to negotiate with management and the Board directly
- The protection is limited
 - The mere act of triggering the NOL Rights Plan by a stockholder could impair the Company's NOLs
 - NOL Rights Plan is really only a deterrent, not a fail safe to prevent an "ownership change" or to protect the Company's NOLs
 - Compare to a charter restriction
- Method of adopting/Procedures
 - Board approval
 - Shareholder vote
 - Register rights as securities
 - Form 8-K notification

Reporting Loss Corporation Ownership Changes

- ▶ Include a statement in federal return for each year an owner shift occurs
- ▶ Some details to include:
 - Dates of owner shifts
 - Dates of ownership changes
 - Amount of attributes
- ▶ Common parent of a group that has a loss subgroup must file an information statement for the loss subgroup
 - Can be included in the parent's statement (doesn't need to be separate)

Example: Section 382 Statement

Statement Pursuant to Reg. § 1.382-11(a)

By the Company, Inc.

EIN 12-3456789

For the tax year ended December 31, XXXX

1. Owner shifts, equity structure shifts, or other transactions described in paragraph (a)(2)(i) of Reg. § 1.382-2T occurred on the following dates during the taxable year:
 - XXXXX
2. An ownership change occurred on XXXXX
3. Following is a list of attributes described in paragraph (a)(1)(i) of Reg. § 1.382-2 that caused the corporation to be a loss corporation:
 - Net operating loss carryforward of \$XXX
 - AMT credit carryforward of \$XXX
 - Foreign tax credit carryforward of \$XXX
4. (If necessary) The closing-of-the-books election under Reg. § 1.382-6(b) is hereby made with respect to the ownership change occurring on XXX

Questions & Answers

Annette M. Ahlers

Of Counsel, Tax Practice Group

213.928.9825

ahlersa@pepperlaw.com

- ▶ Has more than 25 years' experience providing large and mid-size corporate clients advice in corporate tax matters
- ▶ Previously worked for the National Tax Group of Ernst & Young, LLP, where she was a national tax partner and director of M&A tax services for the mid-Atlantic area
- ▶ Started career as attorney-adviser in the Office of Chief Counsel (Corporate) of the Internal Revenue Service (1990 to 1994)



Todd B. Reinstein

Partner, Tax

202.220.1520

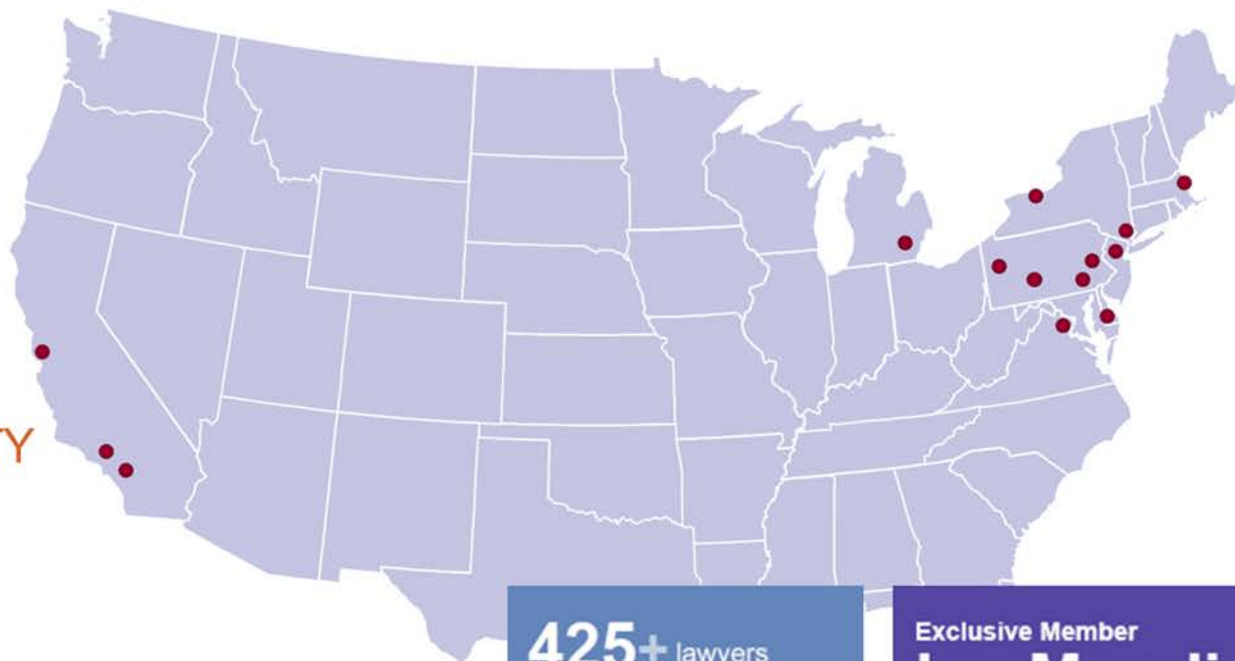
reinsteint@pepperlaw.com

- ▶ focuses his practice on advising clients on U.S. federal corporate income tax law
- ▶ has significant experience with corporate loss limitation studies (Section 382) and the tax aspects of bankruptcy and workouts
- ▶ has submitted successful private letter ruling requests to the Corporate Branch of the IRS National Office
- ▶ co-author of Bloomberg BNA Tax Management Portfolio, No. 764-4th, Dividends — Cash and Property



Locations

BERWYN
BOSTON
DETROIT
HARRISBURG
LOS ANGELES
NEW YORK
ORANGE COUNTY
PHILADELPHIA
PITTSBURGH
PRINCETON
ROCHESTER
SILICON VALLEY
WASHINGTON
WILMINGTON



425+ lawyers

14 offices in U.S.

125+ years of
serving clients

Exclusive Member

LexMundi

firm for
Pennsylvania

For more information, visit

www.pepperlaw.com

Todd Reinstein
202.220.1520
reinstet@pepperlaw.com