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A Primer on Protecting Tax Losses from a Section 382 Ownership Change

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USING -- AND NOT LOSING -- TAX LOSSES:
LIKE FISH, TAX LOSSES DON'T GET BETTER WITH AGE

**A PRIMER ON PROTECTING TAX LOSSES FROM A SECTION 382
OWNERSHIP CHANGE**

by

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I. Executive Summary

- A corporation's ability to use certain tax benefits could be severely limited if the corporation experiences an "ownership change" within the meaning of section 382 of the Internal Revenue Code of 1986, as amended (the "Code"). The tax benefits that could be limited include net operating losses ("NOLs"), net capital losses ("NOLs"), and net unrealized built-in losses and depreciation deductions attributable to those built-in losses, thereby increasing the corporation's corporate tax liability. This primer addresses what triggers an ownership change, the consequences of an ownership change, and how to prevent an ownership change.

II. Purpose of Section 382

- Congress enacted section 382 to prevent taxpayers from "trafficking" in tax losses. Congress was concerned with certain transactions in which taxpayers had acquired target corporations, not for legitimate business purposes, but to use the target corporation's NOLs and NCLs. The resulting rules are extremely broad and complex, and they extend the reach of section 382 to transactions far removed from situations in which taxpayers are attempting to traffic in tax losses.

III. What is an "Ownership Change"?

A. Generally

- A section 382 "ownership change" generally occurs if the percentage of the 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 of stock of the loss corporation owned by such shareholders at any time during the relevant "testing period." I.R.C. § 382(g)(1). A couple of examples may be helpful.

Example 1. An individual that previously did not own stock of the loss corporation acquires 52 percent of the stock via a tender offer. Following the tender offer, the individual is a "5-percent shareholder" whose percentage ownership has increased by more than 50 percentage points, triggering an ownership change.

Example 2. Company is a "loss corporation." Ten unrelated individuals that previously did not own any Company stock each acquire 6% of Company's stock. Following the acquisitions, each individual is a "5-percent shareholder" and each has separately caused a 6 percentage point increase. In the aggregate, they have caused a 60 percentage point increase, triggering an ownership change.

B. What is a "Loss Corporation"?

- A "loss corporation" includes a corporation that:
 - is entitled to use an NOL carryover; or

- has an NOL for the taxable year in which the ownership change occurs; or
- has a “net unrealized built-in loss” (*i.e.*, the aggregate fair market value of the corporation’s assets is less than the corporation’s aggregate adjusted tax basis in those assets); or
- is entitled to use an NCL carryover; or
- has an NCL for the taxable year in which the ownership change occurs, to the extent such NCL is allocable to the period ending on or before the ownership change; or
- has “excess” general business tax credits under section 38, unused minimum tax credits under section 53, or has excess foreign taxes under section 904(c).

I.R.C. §§ 382(k)(1); 383.

- NOLs and net unrealized built-in losses are limited by section 382. Section 383 limits the use of NCLs and “excess” tax credits.

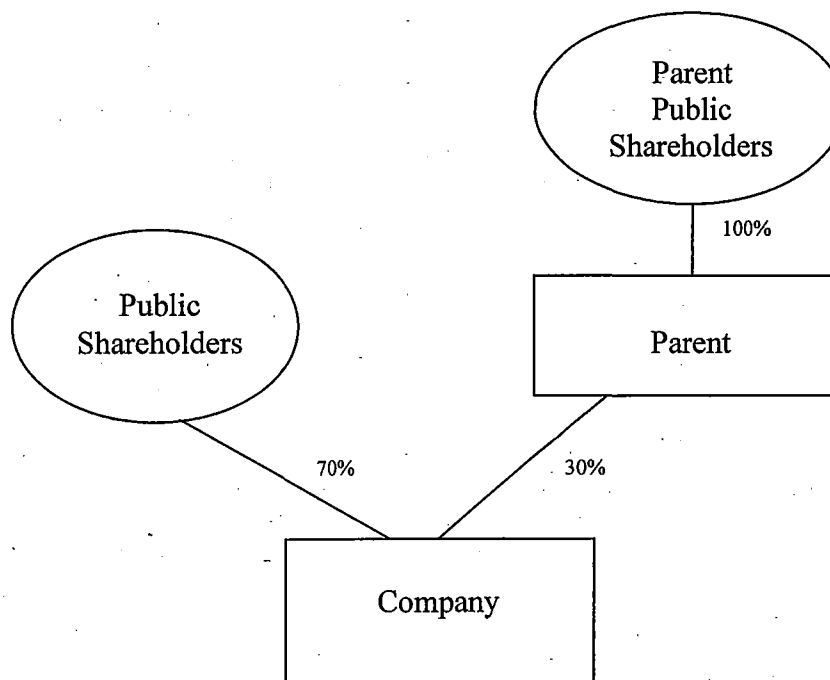
C. What is a “5-Percent Shareholder”?

- A “5-percent shareholder” includes any “person” holding 5% or more of the loss corporation’s stock during the “testing period.” I.R.C. § 382(k)(7). For this purpose, a “person” includes not just natural persons, but also groups of unrelated persons that, directly or indirectly, own an interest in the loss corporation. Treas. Reg. § 1.382-2T(f)(13), (g)(1). An individual will be a “5-percent shareholder” if it has a direct ownership interest in the stock of the loss corporation of 5% or more or if it has an indirect ownership interest in the stock of the loss corporation of 5% or more by virtue of an ownership interest in a “first tier entity” or a “higher tier entity.” Treas. Reg. § 1.382-2(g)(1)(i). For this purpose, a “first tier entity” is any entity that owns 5% or more of the loss corporation’s stock, and a “higher tier entity” is any entity that owns 5% or more of the stock of a first tier entity or any other higher tier entity. Treas. Reg. § 1.382-2T(f)(9), (14).
- The section 382 regulations contain a complicated set of “aggregation” and “segregation” rules to address unrelated shareholders. The aggregation rules generally combine unrelated shareholders that do not individually own 5% or more of the loss corporation’s stock into a “public group” that may be treated as 5-percent shareholder. Treas. Reg. § 1.382-2T(j)(1). The segregation rules generally divide a public group into two public groups in connection with certain transactions. Treas. Reg. § 1.382-2T(j)(2), (3).
- For purposes of determining whether a shareholder is a 5-percent shareholder, the constructive ownership rules in section 318 apply, with certain modifications. Treas. Reg. § 1.382-2T(h). As a result of the constructive ownership rules, an ownership change at a parent level may also trigger an ownership change for a subsidiary.

- An individual that, directly or indirectly, owns 5% or more of the loss corporation at any time during the “testing period” is treated as a 5-percent shareholder even if he or she owns less than 5% of the stock when an ownership change is tested. Treas. Reg. § 1.382-2T(g)(1)(i).
- A “public group” can consist of unrelated shareholders, none of which is a 5-percent shareholder individually, that directly own stock of the loss corporation. This type of public group is referred to as a “direct public group.” A “public group” can also include shareholders of a first tier entity or a higher tier entity that owns 5% or more of the stock in a loss corporation, which is referred to as an “indirect public group.” As a result of the aggregation and segregation rules, a “public group” can be treated as a 5-percent shareholder even if it does not own 5% of the loss corporation’s stock.

Example 3. Company’s stock is publicly traded. Individuals A and B own 7% and 6%, respectively, of Company’s stock. The remaining stock is owned by unrelated shareholders, none of whom directly or indirectly owns 5% or more of the Company’s stock. Individuals A and B are both “5-percent shareholders.” The remaining public shareholders are aggregated into a single, direct “public group” that is treated as a “5-percent shareholder” owning 87% of Company’s stock.

Example 4. Company’s stock is publicly traded. Parent owns 30% of Company’s stock, and the remaining stock is held by unrelated shareholders, none of whom directly or indirectly owns 5% or more of Company’s stock. Parent’s stock is publicly traded and is owned by unrelated shareholders, none of whom directly or indirectly owns 5% or more of Parent’s stock.



The shareholders of Parent are aggregated into one indirect "public group" that is a 5-percent shareholder owning 30% of Company's stock. The public shareholders of Company are aggregated into one direct "public group" that is a 5-percent shareholder owning 70% of Company's stock.

- The section 382 rules treat as an "entity" a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition stock (*i.e.*, the investment decision of each member of the group is based on the investment decision of one or more other members). Treas. Reg. § 1.382-3(a)(1). The owners of an "entity" may be treated as a 5-percent shareholder. Mutual funds, investment funds, and managed accounts that have the same investment advisor generally will not be aggregated together and treated as a 5-percent shareholder under this rule. *E.g.*, Treas. Reg. § 1.382-3(a)(1)(ii), Ex. 3; P.L.R. 200747016 (Aug. 20, 2007).

D. What are the "Testing Period" and the "Testing Dates"?

- Testing Period. The "testing period" is generally the 3-year period ending on the "testing date." I.R.C. § 382(i)(1). If the NOL and NCL carryforwards have not been in existence for the entire 3-year period, then the "testing period" will begin on the first day of the first taxable year in which the NOL or NCL carryforwards arose. I.R.C. § 382(i)(3). However, if the loss corporation has a net unrealized built-in loss on the testing date, the 3-year testing period will only be shortened to begin on the first day of the taxable year in which the net unrealized built-in loss first accrued, if that date is earlier than the date on which any NOLs or NCLs arose. Treas. Reg. § 1.382-2T(d)(3)(ii).

Example 5. As of January 1, 2007, Company had no NOL or NCL carryforwards and did not have a net unrealized built-in loss. During 2007, the value of Company's assets decreased such that it had a net unrealized built-in loss. As of January 1, 2008, Company had no NOL or NCL carryforwards, but it continued to have a net unrealized built-in loss. As of January 1, 2009, Company had NOL carryforwards from its 2008 tax year and continued to have a net unrealized built-in loss. On July 1, 2010, an individual acquires 5% of Company's stock. July 1, 2010 is the testing date, and Company continued to have a net unrealized built-in loss on the testing date. The "testing period" for purposes of section 382 is two and one-half years and will begin on January 1, 2007, the first day of the taxable year in which Company's net unrealized built-in loss first accrued.

- Testing Date. The loss corporation must determine whether it has experienced an ownership change on each "testing date." This is achieved by accounting for all transactions that occur as of the close of the testing date and treating each transaction that occurred on that date as occurring simultaneously. A "testing date" is any date on which (1) the loss corporation experiences an "owner shift" or (2) there is an

issuance or transfer of an option that is treated as exercised for section 382 purposes. Treas. Reg. § 1.382-2(a)(4).

- An “owner shift” is any change in the ownership of the stock of the loss corporation that affects the percentage of stock of such corporation owned by any person who is or becomes a 5-percent shareholder before or after such change. Treas. Reg. § 1.382-2T(e)(1). For example, the acquisition of additional stock by an existing 5-percent shareholder would constitute an “owner shift.”
 - Any “equity structure shift” that affects the percentage of the loss corporation’s stock owned by a 5-percent shareholder also constitutes an owner shift. Treas. Reg. § 1.382-2T(e)(i)(E). An “equity structure shift” includes most tax-deferred reorganizations (except for “F” and divisive “D” and “G” reorganizations). I.R.C. § 382(g)(3); Treas. Reg. § 1.382-2T(e)(2). For example, a merger of the loss corporation with a target or an acquiror would be an “equity structure shift.”
- As described in Section III.F below, certain options with respect to a loss corporation’s stock are treated as exercised upon issuance or transfer. The date on which certain issuances and transfers (including certain indirect transfers) of one of those options occurs is treated as a “testing date.” Treas. Reg. § 1.382-2(a)(4)(i).
- Transfers of stock or an option with respect to stock of the loss corporation that occur upon death, by gift or transfer to a trust, or between spouses or former spouses incident to a divorce do not trigger a “testing date.” I.R.C. § 382(l)(3)(B); Treas. Reg. § 1.382-2(a)(4)(ii).
- Under the “public trading rule,” transfers of loss corporation stock between persons who are not 5-percent shareholders of the loss corporation (and between members of separate “public groups”) are not owner shifts and are not taken into account. Treas. Reg. § 1.382-2T(e)(1)(ii).

E. Transactions that Create Percentage Point Increases

1. Measuring Percentage Point Increases

- Percentage point increases are measured based on a 5-percent shareholder’s ownership of stock on the testing date compared to the 5-percent shareholder’s lowest percentage ownership *at any time* during the testing period. I.R.C. § 382(g)(1)(B). This rule can create surprising results because it compares the 5-percent shareholder’s ownership on the testing date to its lowest ownership during the testing period, not its ownership at the beginning of the testing period.

Example 6. At the beginning of the testing period, Shareholder A owns 7% of Company’s stock. A year later, Shareholder A sells all of its stock in Company. Six months later, Shareholder A acquires 6% of Company’s stock, which it

continues to own on the testing date. Although Shareholder A owns 1 percentage point less stock than it did at the beginning of the testing period, its lowest percentage ownership of the loss corporation during the testing period was zero. Thus, Shareholder A is treated as creating a 6 percentage point increase. See also Section III.E.2 directly below.

2. Acquisitions and Dispositions.

- The quintessential transaction that creates percentage point increases is the acquisition of stock by a person that causes the person to become a 5-percent shareholder or causes a 5-percent shareholder to increase its percentage ownership.
- Less intuitively, the disposition of stock by a person owning 5% or more of the loss corporation can also create percentage point increases. In one of the more bizarre rules in the section 382 regime, if stock of the loss corporation is owned by one or more "public groups," the disposition of stock by an individual or an entity that directly owns 5% or more of the loss corporation to the public shareholders is treated as though all of the stock disposed of by that individual or entity is "segregated" and treated as acquired by a new "public group" that previously owned 0% of the loss corporation's stock. Treas. Reg. § 1.382-2T(j)(3)(i). That new public group is treated as a 5-percent shareholder even if the public group is treated as acquiring less than 5% of the loss corporation's stock.

Example 7. Shareholder A owns 7% of Company's stock. Shareholder A disposes of 4% of Company's stock on the public market. The disposition of stock by Shareholder A is treated as creating a new "public group" that owns 4% of the loss corporation's stock. The new "public group" is a 5-percent shareholder that caused a 4 percentage point increase.

- The rule for dispositions described in the previous bullet point applies only to persons that own 5% of the loss corporation's stock at the time of the disposition. A shareholder that owns less than 5% of the loss corporation's stock, even though the shareholder may be treated as a 5-percent shareholder for section 382 purposes, will not create a new public group if the shareholder disposes of stock.

Example 8. Following the transaction described in Example 7, Shareholder A subsequently disposes of its remaining 3% of Company's stock. That disposition does not create a new public group. Rather, the shares will be attributed to Company's existing public groups. Note that the Internal Revenue Service (the "IRS") may challenge this result if the dispositions are close in time or part of a single plan.

3. Redemption-Type Transactions

- An acquisition of stock by a loss corporation for property (such as in a self tender) causes percentage point increases. Each direct public group that exists immediately before the transaction will be "segregated" at that time into 2 separate public groups,

one of which contains the stock that is acquired in the transaction and one of which contains the stock that is not acquired. As a result, the ownership percentage of the public group treated as owning the stock that is not acquired will increase. Treas. Reg. § 1.382-2T(j)(2)(iii)(C).

Example 9. Company is a loss corporation and 100% of its stock is owned by one direct public group. Company completes a self tender in which it acquires 20% of its outstanding stock. The segregation rules cause the public group to be segregated into 2 public groups before the transaction, one consisting of the shareholders that do not tender ("Continuing Public Group") and one consisting of the shareholders that do tender. Continuing Public Group is treated as owning 80% of Company's stock prior to the self tender and is treated as owning 100% of the stock immediately following the self tender. The self tender causes Continuing Public Group to be treated as creating a 20 percentage point increase.

4. Tax-Deferred Mergers

- Similarly, most acquisitive tax-deferred reorganizations (*i.e.*, "A," "C," certain "D," and certain "G" reorganizations) involving a loss corporation require the segregation of the public groups that exist before the reorganization from those that are treated as owning stock of the loss corporation after the reorganization. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(1)(i).

Example 10. All of Company's stock is owned by one direct public group. Acquiror's stock is also owned 100% by a direct public group. Acquiror and Company merge in an "A" reorganization. Following the merger, Acquiror's shareholders own 60% of the merged entity and Company's former shareholders own 40%. Acquiror's public group is segregated and treated as acquiring 60% of the merged entity (which is the successor loss corporation to Company). This 60 percentage point increase causes a section 382 ownership change.

5. Stock Offerings

- Any stock offering or other transactions to which section 1032 applies will be subject to the "segregation" rule that generally treats the shareholders that purchase the newly issued stock as a new public group. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(1)(ii). This rule is relaxed in the cases of certain stock offerings "solely for cash" and "small issuances."

Example 11. All of Company's 100,000 shares of stock are owned by one direct public group. Company issues 50,000 shares for a combination of cash and property. No new shareholder owns 5% or more of Company's stock following the offering. The public group that existed before the offering is segregated from the shareholders that acquire stock in the offering, and those shareholders are treated as a new public group ("Offering Public Group"). Offering Public Group is treated as owning 33.3% of Company's stock following the offering.

(50,000/150,000). As a result, the offering is treated as causing a 33.3 percentage point increase.

- “Solely for Cash” Exception. The general segregation rule for stock offerings does not apply to a portion of the stock issued in a stock offering “solely for cash.” Treas. Reg. § 1.382-3(j)(3). Under this special rule, the general segregation rule does not apply to stock issued in the offering in an amount equal to (as a percentage of the stock issued) one-half of the aggregated percentage ownership interest of direct public groups immediately before the issuance. A few examples may help.

Example 12. All of Company’s 100,000 shares of stock are owned by one direct public group (“Original Public Group”). Company issues 40,000 shares in a public offering solely for cash. No new shareholder owns 5% or more of Company’s stock following the offering. The general segregation rule does not apply to 50% of the stock issued in the transaction (*i.e.*, the amount equal to one-half of the aggregate percentage ownership interest of direct public groups immediately before the issuance (100%)). Thus, 20,000 of the shares issued in the offering are treated as owned by a new public group (“Offering Public Group”), and the remaining 20,000 are treated as acquired by Company’s original public group. Offering Public Group, thus, has caused a 14.3 percentage point increase (20,000/140,000). There is no percentage point increase attributable to the other 20,000 shares because before the transaction Original Public Group owned 100% of Company’s stock (100,000/100,000) and after the transaction Original Public Group’s ownership is only 85.7% (120,000/140,000).

Example 13. Company has 100,000 shares of stock outstanding, which are owned as follows: Shareholder A owns 8,000 shares, Shareholder B owns 7,000 shares, Shareholder C owns 5,000 shares, and a direct public group owns the remaining 80,000 shares. Company issues 40,000 shares in a public offering solely for cash. No new shareholder owns 5% or more of Company’s stock following the offering. The general segregation rule does not apply to 40% of the stock issued in the transaction (*i.e.*, the amount equal to one-half of the aggregate percentage ownership interest of direct public groups immediately before the issue (80%)). Thus, 24,000 shares issued in the offering are treated as owned by a new public group (“Offering Public Group”), and the remaining 16,000 shares are treated as acquired by Company’s original public group. Offering Public Group, thus, has caused a 17.1 percentage point increase (24,000/140,000).

- “Solely for Cash.” An offering will not be treated as “solely for cash” if the acquiror, as a condition of acquiring shares for cash, is required to purchase other stock for consideration other than cash or the stock is acquired upon the exercise of an option that was not issued solely for cash or was not distributed with respect to stock. Treas. Reg. § 1.382-3(j)(3)(ii)(A). In addition, any other issuance of stock will be combined with the putative “solely for cash” offering if a principal purpose of issuing the stock in separate issuances, rather than in a single issuance, is to minimize or avoid an “owner shift.” Treas. Reg. §§ 1.382-3(j)(3)(ii)(B), -3(j)(8)(ii).

- Limitations. The amount exempted under this special rule cannot exceed the amount of stock acquired in the issuance by any 5-percent shareholder (other than a public group). Treas. Reg. § 1.382-3(j)(4). Unless the Company has actual knowledge to the contrary, any increase in the amount of stock owned by a 5-percent shareholder on the day of the issuance is considered to be attributable to an acquisition of stock in the issuance. The “solely for cash” exception does not apply to stock issued as part of an equity structure shift. Treas. Reg. § 1.382-3(j)(6).
- “Small Issuance” Exception. One or more “small issuances” of stock by a loss corporation may be exempted from the general segregation rule for stock offerings. Treas. Reg. § 1.382-3(j)(2). A loss corporation is allowed a “small issuance limitation” each year. At the loss corporation’s option, the “small issuance limitation” is applied:
 - on a corporation-wide basis, in which case the small issuance limitation is 10% of the total value of the loss corporation’s stock at the beginning of the year (excluding any “plain vanilla” preferred stock); or
 - on a class-by-class basis, in which case the small issuance limitation is 10% of the number of shares of the class outstanding at the beginning of the year.

A “small issuance” is an issuance of stock (other than as part of an equity structure shift, unless issued as part of a tax-deferred “E” recapitalization) in an amount not exceeding the small issuance limitation. If an issuance of stock is a “small issuance,” then the general segregation rule will not apply except to the extent that the total amount of stock issued in that issuance and all other small issuances previously made in the same taxable year exceeds the small issuance limitation.

Example 14. Company has 100,000 shares outstanding on January 1, 2010. The Company’s “small issuance limitation” is 10,000 shares. On February 1, 2010, Company issues 7,000 shares. On May 1, 2010, Company issues 8,000 shares. The February issuance is a “small issuance” and the amount issued does not exceed Company’s 10,000 share small issuance limitation. The May issuance is a “small issuance.” However, the 8,000 shares issued, when combined with the 7,000 shares issued in the February issuance, exceed the 10,000 share small issuance limitation. Accordingly, only 3,000 of the 8,000 shares issued in May qualify for the small issuance exception. The remaining 5,000 shares are treated as acquired by a new public group.

- Aggregation of Issuances. Two or more issuances will be combined for purposes of this exception if (1) they occur at approximately the same time pursuant to the same plan or arrangement or (2) they were split for a principal purpose of avoiding an owner shift. Treas. Reg. § 1.382-3(j)(8).
- Application of the “Solely for Cash” and “Small Issuance” Exceptions to Shareholders of the Loss Corporation. The “solely for cash” and “small

issuance” exceptions also apply to stock issued by certain entities that directly and indirectly own stock of the loss corporation. Treas. Reg. § 1.382-3(j)(11).

6. Fluctuations in Value

- Changes in proportionate ownership solely attributable to fluctuations in the fair market value of different classes of stock will *not* be taken into account in determining whether an ownership change has occurred. I.R.C. § 382(l)(3)(C). However, it is unclear whether this rule merely prevents fluctuations in value from causing a “testing date” or whether the rule also prevents fluctuations in value from causing percentage point increases when determining whether an ownership change has occurred. A loss corporation may apply the “fluctuations in value” rule either by revaluing all of its shares on each testing date (a “full value methodology”) or by establishing the value of a share relative to the value of all other stock in the corporation on the date of acquisition of such share, as adjusted for redemptions, issuances, etc. (a “hold constant principle”). I.R.S. Notice 2010-50, 2010-27 I.R.B. 12. The method chosen must be applied consistently.

F. What Constitutes “Stock”?

- “Stock” for purposes of the section 382 rules generally includes any stock of the corporation, except “plain vanilla” preferred stock. I.R.C. § 382(k)(6)(A).
 - “Plain Vanilla” Preferred Stock. For preferred stock to be excluded from the definition of “stock,” the preferred stock must (1) not be entitled to vote (other than following a dividend arrearage), (2) be limited and preferred as to dividends and not participate in corporate growth to any significant extent, (3) have redemption and liquidation rights that do not exceed the issue price of the stock (except for a “reasonable” redemption or liquidation preference), and (4) not be convertible into another class of stock. I.R.C. §§ 382(k)(6)(A), 1504(a)(4); Treas. Reg. § 1.382-2(a)(3).
 - Options. Certain options that were issued with an abusive purpose are deemed exercised, and the shares underlying those options are treated as outstanding stock. Generally, an option will be treated as exercised on the date it was issued or transferred if “a principal purpose” of issuing, transferring, or structuring the option (alone or in combination with other arrangements) was to avoid or ameliorate the impact of an ownership change of the loss corporation and certain other requirements are satisfied. Treas. Reg. § 1.382-4(d). An “option” includes any contingent purchase, warrant, convertible debt, put, stock subject to risk of forfeiture, contract to acquire stock or similar interest. Treas. Reg. § 1.382-4(d)(9). Compensatory options provided to employees, directors, and independent contractors that are not transferrable and do not have a readily ascertainable fair market value generally will not be treated as exercised for purposes of this rule. Treas. Reg. § 1.382-4(d)(7)(iii).

- In the case of options issued by the loss corporation that are deemed exercised, the shares that are deemed issued are treated under the segregation rules as acquired by a new public group. Treas. Reg. § 1.382-2T(j)(2)(iii)(D).
- “Stock” Not Treated as “Stock.” An interest in a loss corporation that would otherwise be treated as “stock” will not be treated as stock if, among other factors, (1) the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a portion of the total value of the outstanding stock of the corporation, (2) treating the interest as not constituting stock would result in an ownership change, and (3) the corporation has significant losses. Treas. Reg. § 1.382-2T(f)(18)(ii). For example, voting preferred stock or common stock with an unreasonably low growth participation and voting preferred stock that is otherwise “plain vanilla” preferred stock may not be treated as “stock” for purposes of section 382. H.R. Rep. No. 99-841, at II-173 (1986) [hereinafter, “1986 Conference Report”].
- “Not Stock” Interests Treated as “Stock.” Interests in a loss corporation that otherwise would not be treated as stock will be treated as stock if (1) the interests offer a potential significant participation in growth of the corporation, (2) treating the interests as constituting stock would result in an ownership change, and (3) the loss corporation has significant losses. Treas. Reg. § 1.382-2T(f)(18)(iii).

IV. Consequences of an “Ownership Change”

- Section 382 Limitation. If a loss corporation experiences an “ownership change,” its ability to use pre-change NOLs, NCLs, net recognized built-in losses and depreciation deductions attributable to those losses, and other tax benefits will be subject to the “section 382 limitation.” The “section 382 limitation” is generally the value of the loss corporation multiplied by the “long-term tax-exempt rate” for the month in which the ownership change occurs. I.R.C. § 382(b)(1). For ownership changes occurring in October 2010, the “long-term tax-exempt rate” was 3.98%. Rev. Rul. 2010-24, 2010-40 I.R.B. 400.

Example 15. Company experiences an ownership change on October 10, 2010. Immediately before the ownership change, the value of Company’s outstanding stock is \$100 million. The “section 382 limitation” for each following year is \$3.98 million.

- Value of the Loss Corporation. The value of the loss corporation is the fair market value of the corporation’s stock (including the value of any “plain vanilla” preferred stock) immediately before the ownership change. I.R.C. § 382(e)(1). In the case of a publicly traded entity, the value of the loss corporation will generally be measured by the corporation’s market capitalization. T.A.M. 200513027 (Dec. 22, 2004). There is some support for the concept that the value of the stock of a corporation may not

always be equal to the price at which stock is sold in arm's-length transactions. *1986 Conference Report*, at II-187; T.A.M. 9332004 (Apr. 30, 1993) (allowing a loss corporation to show that its value was different than its market capitalization). The IRS, however, appears to believe that using market capitalization is the best approach for determining the value of the loss corporation's stock, and the market capitalization value can be adjusted only if there are "exceptional circumstances." T.A.M. 200513027 (Dec. 22, 2004).

- Section 382 Limitation Reduced to Zero. A loss corporation's section 382 limitation will be reduced to zero if the loss corporation does not continue the "business enterprise of the old loss corporation" at all times during the two-year period beginning on the date of the ownership change. I.R.C. § 382(c)(1). This is the same standard as the "continuity of business enterprise" requirement that applies in the context of tax-deferred reorganizations. *1986 Conference Report*, at II-189. Under that standard, the loss corporation is generally required to either (1) continue the historic business of the loss corporation or (2) use a significant portion of the loss corporation's assets in a business following the ownership change. Treas. Reg. § 1.368-1(d)(1).
- Redemption Transactions. If a redemption or other corporate contraction occurs in connection with the ownership change, the value of the loss corporation is determined after taking into account such redemption or other corporate contraction. I.R.C. § 382(e)(2).
- Substantial Non-Business Assets. Generally, the fair market value of a loss corporation for purposes of the section 382 limitation will be reduced if 1/3 or more of the loss corporation's assets are held for investment. I.R.C. § 382(l)(4).
- Capital Contributions within Two-Years. Any value of the corporation attributable to a capital contribution received by the loss corporation as part of a plan "a principal purpose" of which was to avoid or increase the section 382 limitation will be disregarded in determining the value of the loss corporation. I.R.C. § 382(l)(1)(A). For this purpose, any capital contribution made during the two-year period ending on the ownership change date will be presumed to be part of a plan to avoid or increase the section 382 limitation. I.R.C. § 382(l)(1)(B).
- Unused Tax Benefits. Tax benefits that would have been used in the taxable year but exceeded the section 382 limitation can be carried forward to the next year and can be used in that year, subject to that year's section 382 limitation. However, the carryover period for the tax benefit (generally 20 years for NOLs and 5 years for NCLs) is not extended. I.R.C. §§ 172(b)(1)(A)(1)(ii); 1212(a)(1)(B). Thus, especially in the case of NCLs, the tax benefit may expire before the section 382 limitation allows the loss corporation to utilize the benefit.

- Unused Section 382 Limitation. If the section 382 limitation for the year exceeds the taxable income that is offset with pre-change losses, the unused portion of the section 382 limitation is carried forward and increases the section 382 limitation in the next year. I.R.C. § 382(b)(2).
- Utilization of Tax Benefits Subject to the Section 382 Limitation. The section 382 limitation applies to all of the loss corporation's tax benefits (e.g., NOLs, NCLs, recognized built-in losses, depreciation deductions attributable to built-in losses). The section 382 limitation of a new loss corporation is absorbed by the loss corporation's pre-change losses in the following order: (1) recognized built-in losses for any "recognition period" taxable year (see Section V below) that are capital losses, (2) other NCLs, and (3) NOLs, including recognized built-in losses for any recognition period taxable year that are ordinary losses. Treas. Reg. § 1.383-1(d)(2). This ordering rule will generally result in NCLs, which have a shorter carryforward period, being utilized before NOLs, which have a longer carryforward period.
- Mid-Year Ownership Changes. When a loss corporation experiences an ownership change during a taxable year, it must allocate its taxable income or loss between the pre-change period and the post-change period. When allocating taxable income during the change year, the section 382 limitation does not apply to the portion of the taxable income for the year that is allocable to the period on or before the change date. I.R.C. § 382(b)(3)(A).
 - Ratable Allocation. Generally, net operating loss or taxable income and net capital loss or modified capital gain income for the change year will be allocated between the pre-change period and the post-change period by ratably allocating an equal portion to each day in the year. Treas. Reg. § 1.382-6(a).
 - Closing-of-the-Books Election. A loss corporation may irrevocably elect on its tax return for the year of the change to allocate its net operating loss or taxable income and its net capital loss or modified capital gain net income for the change year between the pre-change period and the post-change period as if the loss corporation's books were closed on the change date. Treas. Reg. § 1.382-6(b).
 - When allocating income using the closing-of-the-books election, the amount of income allocated to either the pre-change period or the post-change period cannot exceed the taxable income or loss for the year that includes the change date. *E.g.*, P.L.R. 9734030 (May 22, 1997); P.L.R. 9427033 (Apr. 13, 1994); P.L.R. 9226026 (Mar. 26, 1992); 57 FR 54535 (Apr. 13, 1994) (preamble to proposed Treas. Reg. § 1.382-6).
 - A loss corporation that expects to recognize cancellation of indebtedness ("COD") income in connection with an ownership change may want to ensure that the COD income is recognized on or before the change date and may want to make the closing-of-the-books

election. If the COD income is recognized on the change date, the COD income should be allocated to the pre-change period, which will allow the loss corporation to use its pre-change NOLs to offset the COD income. *E.g.*, P.L.R. 9427033 (Apr. 13, 1994). See also Section V below for the treatment of COD income for loss corporations with a net unrealized built-in gain.

V. Net-Unrealized Built-In Gain or Loss

- Generally. A loss corporation's section 382 limitation may be increased by its recognized built-in gain if the loss corporation had a "net unrealized built-in gain" as of the ownership change that exceeded the threshold requirement. I.R.C. § 382(h)(1)(A). Conversely, the loss corporation's recognized built-in losses will be subject to the section 382 limitation if it had a "net unrealized built-in loss" as of the ownership change that exceeded the threshold requirement. I.R.C. § 382(h)(1)(B). On the other hand, if a loss corporation does not have a net unrealized built-in gain as of the ownership change, recognized built-in gains will not increase the section 382 limitation. Similarly, if a loss corporation does not have a net unrealized built-in loss as of the ownership change, recognized built-in losses will not be subject to the section 382 limitation.
- Calculation. I.R.S. Notice 2003-65, 2003-2 C.B. 747, establishes two safe harbors for calculating whether a loss corporation has a net-unrealized built-in gain or loss. The two safe harbors are the "section 1374" approach and the "section 338" approach. Under both the "section 1374" and "section 338" approaches, the net unrealized built-in gain or loss is the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change.
 - Threshold. If a loss corporation's net unrealized built-in gain or loss does not exceed the threshold, the unrealized built-in loss gain or loss will be zero. The threshold is the lesser of (1) 15% of the aggregate adjusted bases of the loss corporation's assets as of the ownership change or (2) \$10 million. I.R.C. § 382(h)(3)(B)(i). For this purpose, cash and certain marketable securities are not taken into account. I.R.C. § 382(h)(3)(B)(ii).
- Recognition Period. Recognized built-in gains and losses affect the section 382 limitation only to the extent they are recognized during the "recognition period." The recognition period is the 5-year period beginning on the date of the ownership change. I.R.C. § 382(h)(7).
- Recognized Built-In Loss. A loss corporation will have a "recognized built-in loss" to the extent it recognizes a loss on a disposition of an asset during the recognition period except to the extent the loss corporation establishes that (1) the asset was not held by the loss corporation immediately before the date of the ownership change or (2) such loss exceeds the excess of the adjusted basis of such asset on the date of the

ownership change over the fair market value of the asset on such date (*i.e.*, the amount of the loss that was “built-in” on the ownership change date). I.R.C. § 382(h)(2)(B). If the loss corporation has a net unrealized built-in loss as of the ownership change, built-in losses recognized during the recognition period are subject to the section 382 limitation. I.R.C. § 382(h)(1)(B)(i).

- Depreciation Deductions. If the loss corporation has a net unrealized built-in loss as of the ownership change, then depreciation, amortization, and depletion deductions (collectively, “amortization deductions”) are treated as recognized built-in losses and are subject to the section 382 limitation. I.R.S. Notice 2003-65, §§ III(B)(2)(a)(ii), IV(B)(3). The “section 1374” and “section 338” approaches differ in how they determine what portion of the amortization deductions are treated as recognized built-in losses.
 - Section 1374 Approach. Under the section 1374 approach, amortization deductions are treated as recognized built-in losses unless the corporation establishes that the amount is not attributable to the excess of an asset’s adjusted basis over its fair market value on the date of the ownership change. I.R.S. Notice 2003-65, § III(B)(2)(a)(ii). A loss corporation may use any reasonable method to establish that the amortization deduction amount is not attributable to an asset’s built-in loss on the date of the ownership change. One acceptable method is to compare the amount of the amortization deduction actually allowed to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its fair market value on the date of the ownership change. Only the amount by which the amount of the actual amortization deduction exceeds the amount of the hypothetical amortization deduction is recognized built-in loss.
 - Section 338 Approach. With respect to an asset that has a built-in loss on the date of the ownership change, the section 338 approach treats as recognized built-in loss the excess of the loss corporation’s actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable to the loss corporation with respect to such asset had an election under section 338 been made with respect to the hypothetical purchase. I.R.S. Notice 2003-65, § IV(B)(3).
- Recognized Built-In Gain. A loss corporation will have a “recognized built-in gain” if it recognizes gain on the disposition of any asset during the recognition period to the extent it establishes (1) the asset was held by the loss corporation on the date of the ownership change and (2) the gain does not exceed the excess of the fair market value of the asset on the date of the ownership change over the adjusted basis of such asset on such date. I.R.C. § 382(h)(2)(A). If the loss corporation has a net unrealized built-in gain as of the ownership change, the section 382 limitation for a loss corporation will be increased to the extent of any built-in gains recognized during the recognition period. I.R.C. § 382(h)(1)(A)(i).

- COD Income. Certain COD income may be treated as recognized built-in gain, which can increase the section 382 limitation for the year. I.R.S. Notice 2003-65, §§ III(B)(2)(b), IV(D). Note that the loss corporation must have a net unrealized built-in gain that exceeds the threshold to benefit from the special rule for COD income. Further, the loss corporation will only be able to treat its COD income as recognized built-in gain to the extent of its net unrealized built-in gain. Because of these limitations, a loss corporation may want to trigger the recognition of COD income prior to an ownership change, possibly in connection with a “closing-of-the-books” election. See Section IV above. The section 1374 and section 338 approaches differ in their treatment of COD income.
 - Section 1374 Approach. The section 1374 approach generally treats as recognized built-in gains any COD income that is included in gross income during the first 12 months of the recognition period if the income arises from a debt owed by the loss corporation as of the date of the ownership change. I.R.S. Notice 2003-65, § III(B)(2)(b).
 - Section 338 Approach. Under the section 338 approach, COD income that is included in gross income and that is attributable to any pre-change debt of the loss corporation is treated as recognized built-in gain in an amount not exceeding the excess, if any, of the adjusted issue price of the discharged debt over the fair market value of the discharged debt on the date of the ownership change. I.R.S. Notice 2003-65, § IV(D).

VI. How to Determine Whether an “Ownership Change” Has Occurred?

- The complexity of the section 382 attribution, aggregation, and segregation rules makes it very difficult to determine whether a loss corporation has experienced an ownership change. That difficulty is compounded because a loss corporation needs to determine what transactions have occurred not only with respect to its stock but also with respect to the stock of certain entities that directly and indirectly own its stock. Fortunately, the section 382 rules provide certain “operating” rules that allow a loss corporation to make certain assumptions regarding its stock ownership and establish procedures for determining the ownership of its stock.
- Reliance on Securities Filings. If a loss corporation’s stock is registered under the Securities Exchange Act of 1934, then the loss corporation may rely on the existence and/or absence of filings of Schedules 13D and 13G (or any similar schedules) as of any date to identify the corporation’s shareholders who have a direct ownership interest of 5% or more on such date. Treas. Reg. § 1.382-2T(k)(1)(i). The loss corporation may also rely on the Schedules 13D and 13G of entities that directly and indirectly own any interest in the loss corporation when identifying 5-percent shareholders.

- Schedules 13D and 13G often do not describe all of the information necessary to determine whether a person is treated as a 5-percent shareholder, especially when an investment advisor files a Schedule 13G on behalf of its mutual funds and related accounts. *E.g.*, P.L.R. 200747016 (Aug. 20, 2007) (refusing to allow a loss corporation to treat shares owned by certain mutual fund groups as held by the loss corporation's public group(s) when the Schedule 13Gs filed by investment advisors failed to clearly indicate that no member of the mutual fund group owned 5% or more of loss corporation's stock). In a series of private letter rulings, the IRS has indicated that an investment advisor and its related mutual funds and accounts will not be treated as an "entity" that is a 5-percent shareholder so long as neither the advisor nor its funds affirms the existence of a securities law "group" in the Schedules 13D and 13G. *E.g.*, P.L.R. 200902007 (Oct. 7, 2008); P.L.R. 200818020 (Jan. 29, 2008); P.L.R. 200806008 (Nov. 7, 2007); P.L.R. 200713015 (Dec. 20, 2006). When the securities filings did not clearly indicate that no one fund owns 5% or more of the loss corporation's stock, the IRS has allowed taxpayers to rely on information provided by the investment advisor in e-mails and through telephone conversations. *E.g.*, P.L.R. 200747016 (Aug. 20, 2007).
- Sworn Statements. A loss corporation may rely on a statement under penalties of perjury from an entity that directly or indirectly owns less than 50% of the loss corporation's stock with respect to information regarding transfers of stock in such entity by its significant shareholders. Treas. Reg. § 1.382-2T(k)(1)(ii).
- Duty to Inquire. A loss corporation is required to determine the stock ownership on each testing date of (i) any individual who has a direct ownership interest of 5% or more in the loss corporation, (ii) any first tier entity, (iii) any higher tier entity that has an indirect ownership interest in the loss corporation of 5% or more and (iv) any "5 percent owner" who indirectly owns 5% or more of the stock of the loss corporation in its capacity as a "5 percent owner" in any one first tier entity or higher tier entity. Treas. Reg. § 1.382-2T(k)(3). For this purpose, a "5 percent owner" is any individual that, at any time during the testing period, owned a 5% or more direct ownership interest in a first tier entity or a higher tier entity. Treas. Reg. § 1.382-2T(f)(10). See Section III.C. for a discussion of who is a 5-percent shareholder.
- Exception for Actual Knowledge. The section 382 rules provide certain administrative rules of convenience in identifying 5-percent shareholders and determining whether an ownership change has occurred. However, a loss corporation may not rely on some of those rules if it has "actual knowledge" to the contrary. A loss corporation is required to take this actual knowledge into account if it has the knowledge on a testing date or acquires such knowledge before the date that the income tax return for the applicable year is filed. Treas. Reg. § 1.382-2T(k)(2).

VII. Preventing an "Ownership Change"

- Publicly traded loss corporations with significant NOLs, NCLs, and net unrealized built-in losses cannot prevent an "ownership change" unless they take affirmative

steps to deter or void transactions that could create new percentage point increases. A corporation generally has two potential deterrent measures: (1) adopting a section 382 “poison pill” (sometimes called a “shareholder rights plan”), or (2) adopting a section 382 ownership limit in the corporation’s articles of incorporation.

- A corporation considering adopting either of these deterrent measures will want to consult with its counsel to ensure that its board of directors appropriately satisfies its fiduciary duties when adopting a deterrent or recommending that the shareholders adopt a deterrent. In deciding which deterrent to adopt, a corporation must consider, among other issues, (1) how quickly it can implement the deterrent, (2) how effective the deterrent will be in preventing an ownership change, (3) whether the deterrent will be enforceable, and (4) how investors will react to the adoption of the deterrent. These issues are discussed below.

A. Adopt a Section 382 “Poison Pill”

- Summary of a Section 382 “Poison Pill.” Many public companies with significant NOLs and NCLs have recently adopted poison pill plans that are intended to discourage an ownership change. In 2009, over 40 public companies adopted section 382 poison pills, including Citigroup Inc. and Ford Motor Company. A section 382 poison pill is similar to an anti-takeover “poison pill,” except that an anti-takeover poison pill will typically have a higher ownership threshold (10% to 20%) than a section 382 poison pill (4.9%). Under a section 382 poison pill, each shareholder would receive a right entitling it to acquire a preferred stock interest that is economically equivalent to a share of common stock. If a shareholder engages in a transaction that creates a prohibited percentage point increase, the other shareholders would be able to exercise their rights and acquire the preferred stock interest at a significant discount (e.g., 50%) compared to the value of the corporation’s outstanding common stock. As a result, the shareholder engaging in the prohibited transaction would be diluted.
 - Rights become exercisable only if the board of directors affirmatively determines that a triggering event has occurred. In addition, the board of directors can grant a shareholder a waiver from the poison pill. Thus, the board of directors has significant control over the process.
- Ease of Implementation. A section 382 poison pill can be adopted by the board of directors without a shareholder vote. A board of directors adopting a poison pill will be well-advised to engage a financial advisor to set the terms of the poison pill, especially the “exercise price” of the rights. In addition, the corporation will need to engage a rights agent to administer the rights. Hiring a financial advisor and rights agent can slow the process of adopting a “poison pill” and involves additional expense.
- Protection from an Ownership Change. A section 382 poison pill merely discourages shareholders from engaging in transactions that could cause percentage point increases. A section 382 poison pill would not prevent or void a transaction that

produces a percentage point increase. Rather, a section 382 poison pill would make it economically unattractive for a shareholder to engage in a transaction that would cause a percentage point change, because the shareholder could be diluted as a result of engaging in the prohibited transaction. However, a section 382 poison pill does not apply to all transactions that can create percentage point increases. Section 382 poison pills do not prevent existing holders of 5% or more of the loss corporation's stock from disposing of stock in manner that would cause percentage point increases.

- Enforceability. A properly adopted Section 382 poison pill should generally be enforceable to the same extent as a traditional anti-takeover poison pill.
 - The Delaware Supreme Court recently upheld a board of director's decision to adopt a section 382 poison pill and its subsequent refusal to redeem the rights upon a deliberate triggering of the section 382 poison pill by a stockholder. *Versata Enterprises, Inc. v. Selectica, Inc.*, No. 193, 2010 (Del. Oct. 4, 2010).

B. Adopt a Section 382 Ownership Limit

- Summary of a Section 382 Ownership Limit. A loss corporation can also amend its articles of incorporation to include an ownership limit that would prevent any person from (1) acquiring more than 4.9% of the corporation's stock or (2) engaging in certain transactions that could create percentage point increases. It is common for corporations that are emerging from bankruptcy to have their shareholders adopt a section 382 ownership limit. The IRS has issued private letter rulings holding that certain ownership limits that void prohibited share transfers will be respected for section 382 purposes. *E.g.*, P.L.R. 200837027 (Mar. 14, 2008) (ruling that so long as the limit is enforceable under state law and is enforced according to its terms, any purported acquiror of shares in violation of the limit will not be treated as owning the shares for section 382 purposes); P.L.R. 9405011 (Nov. 3, 1993) (same), P.L.R. 9351011 (Sept. 23, 1992) (same).
- Ease of Implementation. A shareholder vote would be required to adopt a section 382 ownership limit. Accordingly, a loss corporation would either have to wait to adopt a section 382 ownership until its regularly scheduled annual meeting or it would have to incur the expense of holding a special shareholder meeting to approve the section 382 ownership limit. The board of directors would have the discretion to waive the section 382 ownership limit.
- Protection from an Ownership Change. A section 382 ownership limit likely would provide the most protection from an ownership change. First, a section 382 ownership limit would be tailored specifically to the section 382 rules and should generally "catch" transactions that cause percentage point increases. Second, a section 382 ownership limit would void transactions that could potentially cause a percentage point increase, and, as discussed above, the IRS has ruled privately that certain ownership limits that void transactions would be respected for tax purposes. A section 382 ownership limit would not merely discourage a transaction that would cause a percentage ownership change, like a section 382 poison pill, but would

actually prevent an attempted transaction from occurring for section 382 purposes. Third, unlike section 382 poison pill, a section 382 ownership limit can prevent an existing 5-percent shareholder from disposing of stock in a manner that would create a new public group treated as a 5-percent shareholder.

- As a practical matter, to obtain a sufficient number of votes to approve the section 382 ownership limit, a loss corporation may have to agree to waive the “no disposition” rule for some or all of the existing 5-percent shareholders. A loss corporation, however, may be able to have the existing 5-percent shareholders agree, as a condition of receiving such a waiver, to dispose of their stock in a way that creates the least percentage point increase. For example, as discussed in Section III.E.5, a disposition of stock only creates a new public group if the individual or entity owns 5% or more the loss corporation’s stock as of the disposition date. A loss corporation may be able to take advantage of this rule by having the 5-percent shareholder agree that it will dispose of stock until it owns 4.9% of the outstanding shares and then will wait some period of time before disposing of additional stock. A staggered disposition by a 5-percent shareholder may allow the loss corporation to minimize the percentage point increases caused by a 5-percent shareholder disposing of its stock.
- Enforceability. A loss corporation should consult with corporate counsel regarding the enforceability of a newly adopted section 382 ownership limit. In some states, such as a Maryland, a newly adopted section 382 ownership limit may be enforceable against all shareholders. In other states, such as Virginia, the newly adopted section 382 ownership limit may be enforceable only against shareholders who voted for the adoption of the section 382 ownership limit or who become shareholders after the adoption of the section 382 ownership limit.
- Example. For an example of a section 382 ownership limit adopted by a corporation, see the 2010 Proxy Statement for Deerfield Capital Corp. filed on Oct. 13, 2009, available at <http://www.sec.gov/Archives/edgar/data/1313918/000104746909009155/a2195046zdef14a.htm>.

C. Investor Reaction to a Section 382 Deterrent

- Either of the deterrents described above would limit or discourage certain transactions with respect to the loss corporation’s stock and may be viewed by investors as tools to entrench management.
- Anti-takeover poison pills have historically been viewed negatively by the market and corporate watchdog groups. For example, RiskMetrics, a leading voice on how institutional shareholders vote, recommends in its proxy guidelines that shareholders vote against, or withhold voting for, incumbent directors if the corporation has adopted a poison pill with a term of more than 12 months or has adopted or renewed a poison pill without a shareholder vote. RiskMetrics Group, *2010 U.S. Proxy Voting*

Guidelines Summary (Jan. 8, 2010), at 10-11, available at http://www.riskmetrics.com/policy/2010/policy_information [hereinafter, *RiskMetrics Guidelines*].

- A commitment or policy that puts a newly adopted pill to a binding shareholder vote “may potentially offset an adverse recommendation.” *RiskMetrics Guidelines*, at 11. Accordingly, a corporation considering adopting a section 382 poison pill plan may want to consider initially providing that the plan will have only a 12-month term (prior to a shareholder vote approving the plan) or may want to adopt a long-term plan, commit to putting the plan to a shareholder vote within 12 months and seek an advanced review from RiskMetrics of its adoption of the section 382 poison pill.
- As far as whether it recommends shareholders approve a section 382 ownership limit or poison pill, RiskMetrics adopts a “case-by-case” review. *RiskMetrics Guidelines*, at 25, 26. For section 382 ownership limits and poison pills, RiskMetrics Group lists the following factors that will be considered in whether it will recommend voting for the adoption of the section 382 ownership limit or for ratification of the decision of the board of directors to adopt the poison pill:
 - the ownership threshold (*i.e.*, 4.9%);
 - the value of the NOLs;
 - shareholder protection mechanisms (sunset provisions or commitment to cause expiration of the protective amendment upon exhaustion or expiration of the NOL);
 - the loss corporation’s existing governance structure, including board independence, existing takeover defenses, track record of responsiveness to shareholders, and any other problematic governance concerns; and
 - any other factors that may be applicable.

RiskMetrics Guidelines, at 25, 26.

VIII. Bankruptcy

- A bankruptcy often will trigger an ownership change because creditors will exchange debt for stock of the corporation as part of the plan of reorganization. Special, and more lenient, rules apply under section 382 to a loss corporation in bankruptcy. A bankrupt loss corporation may be able to make one of two elections.
 - “(1)(5)” Election. The “(1)(5)” election gives a loss corporation a “free pass” on an ownership change triggered by a bankruptcy. A loss corporation that is under the jurisdiction of a court in a title 11 or similar bankruptcy proceeding will not be treated as experiencing an ownership change so long as shareholders and “qualified” creditors of the loss corporation (determined

immediately before the ownership change) own (after such ownership change and as a result of being shareholders or creditors of the loss corporation) stock of the loss corporation (or of a corporation controlling the loss corporation) that constitutes 50% of voting power and value. I.R.C. § 382(l)(5).

- To be a “qualified” creditor with respect to a debt, (1) the creditor must have held the debt for at least 18 months before the date the loss corporation filed the title 11 or similar case, or (2) the debt must have arisen in the ordinary course of loss corporation’s trade or business and the creditor must have held the beneficial interest in such debt at all times. I.R.C. § 382(l)(5)(E).
- Under the “(l)(5)” election, the NOL carryforwards will be computed as though no interest was paid on any debt that is converted to stock for approximately three years prior to the ownership change. I.R.C. § 382(l)(5)(B).
- If a loss corporation making an “(l)(5)” election experiences a second ownership change within 2 years of the bankruptcy ownership change, the bankruptcy ownership change will be treated as an “ownership change” that limits the loss corporation’s ability to use its tax benefits and the section 382 limitation for the second ownership change will be zero. I.R.C. § 382(l)(5)(D).
- “(l)(6)” Election. The “(l)(6)” election allows a loss corporation to have a higher section 382 limitation as a result of an ownership change triggered by a bankruptcy. If the loss corporation does not make the “(l)(5)” election, then the value of the loss corporation for purposes of the section 382 limitation will include any increase in value attributable any surrender or cancellation of creditors’ claims in the bankruptcy. I.R.C. § 382(l)(6).

IX. Reporting and Recordkeeping Requirements

- A loss corporation must include a statement in its federal income tax return for each taxable year that is a loss corporation in which an owner shift, an equity structure shift or on which certain transfers of an option have occurred. Treas. Reg. § 1.382-11(a). The statement must include (1) the date(s) of any owner shifts, equity structure shifts, or applicable transfers of an option, (2) the dates on which any ownership change(s) occurred, and (3) the amount of any tax attributes that caused the corporation to be a loss corporation. Treas. Reg. § 1.382-11(a). The statement may also include certain elections related to section 382, including the election to allocate income for a year in which an ownership change occurs using the “closing-of-the-books” method. Treas. Reg. § 1.382-11(a).
- A loss corporation must keep records as are necessary to determine (1) the identity of any its 5-percent shareholders, (2) the percentage of its stock owned by each such 5-percent shareholder, and (3) whether the section 382 limitation is applicable. Treas.

Reg. § 1.382-2T(a)(2)(iii).

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