

White Paper
Impact of Public Trading on I.R.C. §382

IRS Section 382 – limitation on Net Operating Losses

Issue: Internal Revenue Code (IRC) §382’s limitation on the utilization of net operating losses (NOLs) inadvertently applies to ownership changes triggered by normal market trading activity (notably exacerbated by the current financial crisis’ pressure on stock prices). Such uncontrollable limitations can create a permanent loss of a valuable corporate asset (NOLs) and present an undue and unpredictable cash flow burden on affected companies, which would likely cause a reduction in investment and employment by those companies.

Recommendation: Currently, the only defense a company has to avoid this unfair and unintended consequence is to limit the public’s trading of its stock (e.g., a “382 poison pill”). One proposal that has been suggested is to modify the test for an “ownership change” under IRC §382 to require a change of “more than 80 percentage points” (rather than 50 percentage points) over any three year testing period that includes 2008 and 2009, to reflect recent market volatility and to create economic stimulus. This modification of IRC §382 would enable companies that experience difficulty in refinancing debt to raise new capital in the equity markets without triggering ownership changes that limit the use of net operating loss (“NOL”) carryovers under IRC §382. This change to IRC §382 would also give additional protection to companies, who through no fault of their own, have experienced extreme volatility in the value and trading of their corporate stock. The proposed change would take account of the extraordinary volatility in the U.S. stock market by temporarily raising the ownership threshold used to determine when an IRC §382 limitation is triggered. This proposal would not be a “reduction” in taxes or reduce tax revenues that were anticipated by the Treasury Department and would continue to allow IRC §382 apply to its original purpose and would encourage the flow of capital and create immediate economic stimulus.

Background: Congress enacted IRC §382 to prevent taxpayers from “trafficking” NOLs, i.e., acquiring or selling corporations primarily for their NOLs. IRC §382 limits the ability of corporations to utilize “pre-change” NOLs (and certain built-in losses) after an “ownership change.” An ownership change generally occurs if one or more of the corporation’s 5% shareholders *increase* their ownership, in the aggregate, by more than 50 percentage points over a rolling three year period.

If an ownership change occurs, the utilization and/or timing of the utilization of net operating losses (NOLs) can be significantly limited. The annual limitation is an amount equal to the IRS’ long-term tax-exempt rate multiplied by the “market capitalization” (subject to certain adjustments) of the loss corporation. Market capitalization is determined by the stock price at the time of the ownership change multiplied by the number of shares outstanding. This “§382 Limit” can cause a company with NOLs to

pay significant cash taxes immediately after the ownership change and may even result in the permanent loss of NOLs.

Unintended Consequences: The §382 regulations are written so broadly that they can result in unintended consequences to companies that have never bought or sold NOLs. The §382 regulations define ownership changes in a way that encompasses normal market trading. Additionally, since one of the factors that determine a company's NOL limitation is its market capitalization, a low market capitalization will yield a low NOL limit to be used to offset future taxable income. Clearly the overall market volatility in 2008 has impacted most companies' market capitalization.

The unintended consequences are best explained via the following example --

For years XYZ Corp is 90% owned by the public and 10% by two mutual funds owning 5% each.

During 2007, XYZ Corp acquires assets (and therefore there is no acquisition of any NOLs) of a competitor in exchange for 25% stock in XYZ Corp. At the end of 2007, XYZ Corp has accumulated a 25% percentage towards an ownership change under Section 382.

During 2008, the two existing mutual fund owners each increase their ownership by 3% each (for a total of 6%) and three new mutual funds acquire 7% of the public's stock each (for a total of 21%). The trading could very well have been driven by the significant drop in XYZ Corp's stock price during the recent financial crisis. This trading activity does not in any way involve the trafficking of NOLs, nor is there a practical manner in which XYZ Corp could avoid such activity.

At the end of 2008, XYZ Corp is owned 63% by the public (25% related to the asset purchase & 38% general public) and 37% by mutual funds. Based on the current Section 382 tax provisions, XYZ Corp went through 50% ownership change during 2008 (25% in 2007 & 27% in 2008), which is the trigger for NOL limitations.

If the ownership change occurred during the financial crisis, XYZ Corp's NOL will likely be materially limited causing XYZ Corp to pay significant taxes and/or permanently lose some or all of its NOLs. If the ownership change occurred before the recent financial crisis, the NOL limitation may not have as material of an impact. Alternatively, if the "normal" trading activity of the mutual funds and the general public were not considered under Section 382 or if the ownership change threshold were 80% instead of 50%, an ownership change would not have occurred at all.

In this example, XYZ Corp was not involved in any acquisition or sale involving NOLs (i.e., potential trafficking of NOLs); it was merely impacted by normal market trading activity and a macroeconomic down turn in the economy.

IRC Section 382
Sample Calculation of Annual NOL Limitation

The following calculations exemplify how a company's share price at the time of an ownership change can impact the calculation of its annual NOL limitation.

<u>Sample Calculation*</u>	<u>On Day of Ownership Change</u>	
	<u>\$2 Share Price</u>	<u>\$20 Share Price</u>
Average Price per Share of Loss Corporation	\$ 2.00	\$ 20.00
x Shares Outstanding	150,000,000	150,000,000
= Market Capitalization	<u>\$ 300,000,000</u>	<u>\$ 3,000,000,000</u>
x Federal Long-Term Tax Exempt Rate (12/08)	5.40%	5.40%
Estimated Annual Loss Limitation	\$ 16,200,000	\$ 162,000,000

* Please note that this is a simplified version of the calculation and therefore does not take into consideration adjustments which could change the outcome for a particular loss corporation.