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Tax Update

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IRS Issues Guidance Regarding the Limitation on the Utilization of Net Operating Losses under Section 382

The Internal Revenue Service (IRS) recently issued rulings and a new Notice on IRC Section 382's application in Private Letter Rulings (PLR) 200901001 (Jan. 2, 2009), 200901003 (Jan. 2, 2009), 200902007 (Jan. 9, 2009), and Notice 2009-14, 2009-7 I.R.B. 1 (Jan. 30, 2009).[1] The first two rulings address IRC Section 382(l)(3)(C) and the difficult tax issue that arises from changes in relative ownership attributable solely to the fluctuation in value between different classes of a loss corporation's stock. The third ruling confirms that the owner of a company's stock for IRC Section 382 purposes is the "economic owner" that possesses the right to dividends on the stock and proceeds from the sale of the stock. Notice 2009-14 provides guidance on the application of IRC Section 382 to debt, preferred stock and warrants that are acquired by the U.S. Treasury under the Emergency Economic Stabilization Act of 2008.

IRC Section 382 in General

IRC Section 382 can limit a loss corporation's ability to utilize its historic net operating losses against current taxable income if the corporation undergoes an "ownership change." A corporation has undergone an ownership change under IRC Section 382(g)(1) when the percentage of the corporation owned by one or more "5-percent shareholders" has increased by more than 50 percentage points over the lowest percentage ownership of such 5-percent shareholders during the testing period, usually a three-year period. Increases in the ownership of 5-percent shareholders are determined based on the relative fair market value of the loss corporation's stock owned by the 5-percent shareholders in comparison to the total fair market value of the loss corporation's outstanding stock. Thus, when applying the IRC Section 382 rules a loss

notable

- **Joan C. Arnold** has been elected to be a director of the Council for the Tax Section of the American Bar Association, beginning in August 2009.

quotable

- On February 3, **Todd Reinstein** was quoted in *Tax Analysts* on Notice 2009-14 regarding the Section 382 implications of investments made by the U.S. government under the TARP plan.

published

- **Steven Bortnick**'s article titled "IRS Replaces Intermediary Transaction Tax Shelter Notice," and an article titled "New York Making a Play to Tax Carried Interests" by **Steven Bortnick**, **Lance Jacobs** and **Timothy Leska**, were published in the December 2008 (Vol. 8, No. 12) edition of *Practical US/Domestic Tax Strategies*.
- **Steven Bortnick**'s article titled "Tax in the Middle Kingdom," and an article titled "What to Expect When You're Buying Back Debt" by **Steven Bortnick**, **J. Bradley Boericke** and **Timothy Leska**, were published in the February 2009 edition of *PEI Manager*.

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corporation must be able to value its stock, including the relative value of common stock and certain preferred stock, and must be able to properly identify its 5-percent shareholders.

Fluctuations in Value

IRC Section 382(l)(3)(C) states that "[e]xcept as provided in regulations, any change in proportionate ownership which is attributable *solely* to fluctuations in the relative fair market values of different classes of stock shall not be taken into account." Practitioners have had a difficult time interpreting what is meant by the word "solely" and what the operative rules are. That is, do you ignore all fluctuations or do you adjust the relative values of owners on certain testing dates?

The IRS has not issued regulations on IRC Section 382(l)(3)(C) and value fluctuation, but has provided some insight in rulings, including PLR 200901001 and PLR 200901003. In both rulings the IRS affirms a key principle from earlier rulings.[2] This principle permits a loss corporation to factor out changes in proportionate ownership of its stock that are attributable solely to fluctuation in the values of different classes of stock. The value of a shareholder's stock in the loss corporation should be considered to remain constant since the date that the shareholder acquired the stock, relative to the value of all other stock of the loss corporation that was outstanding on such date. In other words, shares should be valued at the transfer date and then deemed to perform in the future in a proportional manner to other shares. Arguably, under the approach taken by the IRS in the Rulings, a revaluation of issued shares would only be undertaken when such shares are actually transferred.

This provision is increasingly important during economic downturns. Preferred stockholders often obtain a greater overall share in a faltering company as its common stock value declines due to the additional preferences they typically have over the common shareholders. This problem is an acute one in bankruptcy planning. A company could inadvertently trigger an unwanted ownership change just before going into bankruptcy instead of during the bankruptcy, as a result of the relative fluctuations in value between the different classes of stock. This is a particularly harsh result since the loss corporation essentially would lose the benefit of special bankruptcy tax provisions under IRC Section 382 in this situation.

Economic Ownership

A second difficult issue under IRC Section 382 is determining the actual economic owners of a loss corporation's outstanding stock. A corporation may generally rely on public filings, including Schedule 13D and 13G filings, to determine its 5-percent shareholders. However, investment advisors and other entities that are the "reporting owner" of the loss corporation's stock for public reporting purposes may not be the true "economic owner" of the underlying stock for IRC Section 382 purposes.

The IRS addresses this problem in PLR 200902007, which affirms earlier rulings issued by the IRS.[3] In PLR 200902007 the IRS concludes that the "economic owner" is the person who has the right to the dividends and proceeds from the sale of the stock. For example, an investment advisor may have the power to acquire, hold, vote on, or dispose of stock. Even so, the investment advisor is not considered the economic owner of the stock when it does not have the rights to dividends and proceeds.

In PLR 200902007 the IRS also addresses when and in what manner loss corporations can rely upon Schedule 13D and 13G filings with the SEC to identify 5-percent shareholders for purposes of IRC Section 382. In general, the loss corporation can rely on Schedule 13D and 13G filings to establish that a person is an economic owner of 5 percent or more of the corporation's stock. As noted in PLR 200902007, a loss corporation must, however, take into account any actual knowledge that it possesses when evaluating Schedule 13D and 13G filings. In some instances that "actual knowledge" may be sought by the taxpayer by directly contacting the filer to clarify ambiguous information in the filing.

Notice 2009-14

The IRS recently issued Notice 2009-14 as a supplement to Notice 2008-100, 2008-44 I.R.B. 1081 on how to apply IRC Section 382 to stock and other instruments acquired by the U.S. Treasury under the Emergency Economic Stabilization Act of 2008 (EESA). The new notice provides, in part, that stock acquired by Treasury will not be considered to have caused Treasury's ownership in the issuing corporation to have increased for IRC Section 382 purposes. In addition, redemptions of stock held by Treasury will be treated as if the redeemed stock had never

been outstanding. Thus, in the targeted cases, the IRC Section 382 limitation on the utilization of net operating losses will not be applied because of transactions between a corporation and Treasury.

Pepper Perspective

Corporations that intend to use historic net operating losses or that wish to preserve net operating losses beyond bankruptcy should carefully consider IRC Section 382 and recent guidance from the IRS. Proper planning and analysis of the relevant issues can help corporate taxpayers avoid the many traps for the unwary within IRC Section 382.

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Endnotes

1 Unless otherwise stated, all references to "IRC Section" are to the Internal Revenue Code of 1986 (the Code), and all references to "Treas. Reg. Section" are to the Treasury Regulations promulgated thereunder (the Regulations). Also, a private letter ruling may not be cited as precedent under IRC Section 6110(k) by a taxpayer who did not receive the ruling, but may be considered under Treas. Reg. Section 1.6662-4(d)(3)(iii) in determining whether there is substantial authority for purposes of the accuracy-related penalty.

2 *Also See* PLR 200511008 (Dec. 6, 2004); PLR 200520011 (Feb. 18, 2005); PLR 200622011 (Feb. 2, 2006).

3 *See* PLR 200747016 (Nov. 23, 2007). *See also* our previous *Tax Update* article discussing PLR 200747016, "Tax Net Operating Losses, Section 382, and Investment Advisors" (Apr. 4, 2008).

speakers' corner

- On January 29, **Steven D. Bortnick** spoke on "Tax Due Diligence in Acquisitions" at a teleconference sponsored by Lorman Education Services.
- **Ellen McElroy** spoke on "Substantiating Success-Based Fees and Other Transaction Cost Issues" at the Tax Executive Institute's Pittsburgh Chapter luncheon in Pittsburgh, Pa. on February 4.
- On February 4, **Steven D. Bortnick** spoke on "Minimizing Taxes in Commercial Workouts & Debt Modifications" at a Strafford Publications Legal teleconference.
- **Joan C. Arnold**, **Howard S. Goldberg**, and **Todd B. Reinstein** spoke on "Consolidated Return Issues Affecting Use of Favorable Tax Attributes" and "Current Topics in Consolidated Return Area" at the Twenty-First Annual Tax Executive Institute Houston Chapter Tax School on February 4.
- **Steven D. Bortnick** will speak on "Doing Deals: Structuring Private Equity M&A Transactions" to the University of Michigan Private Equity Club in Ann Arbor on February 9.
- On February 19, **Charles L. Potter, Jr.** will present a Pennsylvania business tax update during a CCH online seminar.
- **Leonard Schneidman** will speak on "Sovereign Wealth Funds" at the International Private Equity Fund Formation and Operations Forum in New York City on February 23.
- **Charles L. Potter, Jr.** will present a "Pennsylvania Tax Update" at Penn State Greater Allegheny on February 23, 25 and 26.
- On February 26, **Joan C. Arnold** will present at the International Fiscal Association USA Branch meeting on the report - "The Definition of a Permanent Establishment." The report was prepared for the 2009 global Congress of IFA, to be held on September 2009 in Vancouver.
- **Steven D. Bortnick** will monderate a "Leveraged Buyout" panel at the Fourth Annual Stern Private Equity Conference at New York University's Kimmel Center on March 6.
- **Leonard Schneidman** will present "Doing Business Abroad," a Massachusetts Continuing Legal Education seminar in Boston, Ma. on March 10.

'Whose Property is it Anyway?' – California's Strict Constructionist Escheat Statute

The California Court of Appeal's 6th District recently overturned a superior court's grant of summary judgment in a ruling that may have far-reaching implications on the availability of an immunity defense under unclaimed property law, both in California and elsewhere.[1]

Under Title 10 of the California Civil Procedure Code,[2] "unclaimed property" is essentially all property that is currently (or will become) unclaimed, abandoned, escheated or otherwise transferred to the state. Under Sections 1510-1523, generally all unclaimed property escheats to California if it is unclaimed for three years, including intangible property like stock and dividends.

Every entity holding property that has escheated to California is statutorily obligated to make an annual report of all escheated property in its possession, and to deliver or pay over said property to the state no sooner than seven months after and no later than seven months and fifteen days after the filing of the report.[3] Naturally, the delivery of property to the state by escheat can cause conflicts between the owners and the transferors upon discovery of the transfer. However, Section 1321 provides that transferors of unclaimed property to California under unclaimed property law will generally be immune from any and all claims that may arise with reference to the transfer. Transferors have a statutory obligation to hand over escheated property to the state, and thus, they rely on these immunity provisions to protect them from lawsuits by the missing owners.

In *Vondjidis v. Hewlett Packard*, the Court of Appeal ruled that this immunity provision is only available to transferors that establish that they have complied with the statutory requirements. In holding that that the transferor in the case, Hewlett-Packard, had not met this obligation under the statute, it appears the court may have significantly limited the availability of immunity for future transferors.

The immunity provisions are intended to shift the burden of these competing interests to the states, and are of particular importance for multistate businesses whose policies may only substantially, but not fully, comply with the black letter of certain states' unclaimed property law.

Factual and Procedural Background

At issue in *Vondjidis* is whether the defendant, Hewlett-Packard (HP), was permitted to avail itself of California's immunity protections for the transfer of unclaimed property. HP maintains a corporate policy that regards shareholders as "lost" if multiple stock-related mailings are returned as undeliverable. After a shareholder is regarded as lost for an appropriate amount of time, HP begins the process of transferring the apparent unclaimed stock to the state, including hiring an escheatment vendor to facilitate the transfer, and sending a final mailing to the shareholder's address of record with notice of the imminent escheat.[4]

The plaintiff (Vondjidis) was an employee at HP's Athens office from March 1974 to October 1978.[5] During the course of his employment, Vondjidis purchased HP shares through an employee stock purchase plan. HP policy with regard to stock owned by employees working in foreign offices was to send stock-related mailings and dividend checks to the foreign office at which the employee worked. As part of this policy an employee was responsible for providing HP with a current address once he or she left the employ of HP. For four years after Vondjidis left HP, he was contacted numerous times by other employees from the Athens office regarding his mail they had received. Further, Vondjidis was provided with a change of address

form at least four times, which he never completed, and therefore he received no mailings from HP after 1982, when HP's Athens office was closed.

According to company policy, in 1993, after receiving returned mail regarding Vondjidis' stock for more than a decade, HP utilized an escheatment vendor to transfer Vondjidis' shares to California. Vondjidis eventually learned of the transfer in 2001, and filed suit against HP in superior court for various claims, alleging that HP had known his identity and address, but had failed to provide notice and failed to perform proper due diligence before transferring the shares to California.[6]

HP answered the complaint and affirmatively pleaded the defense that it was immune from suit under California unclaimed property law.[7] HP moved for summary judgment in December 2004, and was granted its motion in August 2006 on the ground that HP was indisputably immune from suit, and the superior court entered judgment in HP's favor.[8] Vondjidis filed an appeal to the California Court of Appeal's 6th District on the ground that HP could only avail itself of the immunity provision if HP could establish that it had complied with the provisions of Title 10 of the California Civil Procedure Code.[9]

Appeal and Reversal of Summary Judgment

On November 25, 2008, the Court of Appeal ruled in favor of Vondjidis, reversing the grant of summary judgment and remanding the case to the superior court.[10] In its decision the Court of Appeal adopted Vondjidis' argument, holding that HP had failed to establish that it had complied with the provisions of Title 10, and thus did not demonstrate that it was entitled to summary judgment.

The court held that the plain language of the immunity statutes restricted the availability of general immunity to transfers "under the provisions" of Title 10,[11] and immunity for stock transfers made "under subdivision (b) of Section 1516."[12] Citing California Supreme Court precedent,[13] the court held that the objective of the unclaimed property act is to protect missing owners by locating them, and stated that this purpose was evident from the plain language of Section 1516(b), requiring that the transferor corporation would have not known the location of the owner at the end of the three-year period in order to have a proper escheat of stock to the state.

speakers' corner (continued)

- **Steven D. Bortnick** will present on "Opportune Investing in Distressed Debt" at a 100-minute teleconference sponsored by Financial Research Associates LLC on March 11.

webinars

- On February 4, **Annette M. Ahlers** and **Steven D. Bortnick** participated in a webinar on "Minimizing Tax in Commercial Loan Workouts and Debt Modifications: Legal Strategies for Reducing Cancellation-of-Debt Income.
- **Steven D. Bortnick** will participate in a webinar discussing "Structuring Parallel Funds" onWednesday, March 11, at 10:30 a.m.

HP asserted that the immunity provisions applied even without perfect compliance with all of the unclaimed property provisions, and that its corporate policies regarding contacting shareholders and escheatment were sufficient for Title 10 under a good-faith compliance standard. HP argued that if these immunities were restricted to cases with strict compliance, it would provide immunity only in cases where it was not needed, as transfers made perfectly would be beyond reproach.[14] HP argued that without the protection of immunity, holders of property will have a disincentive to consider certain property as escheated and to transfer it to the state for productive use. The court rejected HP's argument holding that the state had no proper interest in encouraging delivery of property that was not qualified as unclaimed property.[15]

The court held that HP failed to conclusively show that it did not know Vondjidis' location, because HP had Vondjidis' Athens address at all times within its personnel records, regardless of whether it appeared in HP's shareholder records.[16] Accordingly, the court held that the evidence appeared to show that HP had specifically **not** satisfied the requirements of Title 10, and at least there were issues of material fact to be determined at trial. Thus, the case was remanded back to superior court and the summary judgment order vacated.

Pepper Perspective

The immediate effect of the court's ruling is that the superior court will now hear a case that raises various factual and legal issues regarding the duties of transferors of unclaimed property. Essentially, this superior court case will address significant issues, such as determining the extent of due diligence required of a transferor under Title 10, and what particular efforts may satisfy such a due diligence requirement. In this case, the court appeared to give little consideration to the fact that Vondjidis refused to provide a change of address form, despite repeated efforts by HP to obtain one. This suggests that this court places all responsibility on the transferor, and gives no weight to any actions on the part of the owner that may have caused the transfer to not be perfectly compliant with the unclaimed property law. The court also did not give deference to HP's own internal policies and procedures with respect to turning over escheat property to the state.

From a practical perspective, uncertainty regarding what due diligence actions a transferor must take and what corporate policies and procedures the transferor must have in place creates a huge potential compliance pitfall for all businesses, not only those subject to California unclaimed property law. In all states, holders of property for owners have duties to perform certain tasks, such as properly disposing of an owner's property and paying over money due, like interest and dividends. However, all states also impose statutory duties on businesses to account for unclaimed property, for which they are subject to a number of enforcement actions, such as audits and penalties for failure to comply.[17] The immunity provisions are intended to shift the burden of these competing interests to the states, and are of particular importance for multistate businesses whose policies may only substantially, but not fully, comply with the black letter of certain states' unclaimed property law.

A case such as *Vondjidis* adds increased complexity to the compliance burden, effectively requiring multistate businesses in California to adopt an escheat policy that perfectly follows the unclaimed property procedures, or face potential exposure to audit and penalties from California as well as civil suits by claimants. However, adopting a California-based policy may leave the business open to *Vondjidis*-like challenges in any state where the California-based escheat policy is not perfectly congruent with the procedural hurdles or with other states in which the business operates. As such, it behooves all multistate businesses to review their current escheat policies, gauge their potential exposure, and determine if modification of their escheat policies for one or several states.

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Endnotes

1 *Vondjidis v. Hewlett Packard*, 168 Cal. App. 4th 921 (Cal. Ct. App. 2008).
2 References to "Section" hereinafter will refer to the California Civil Procedure Code, unless otherwise noted.
3 Cal. Civ. Proc. Code §§ 1530 & 1532.
4 *Id*. at 927.
5 168 Cal. App. 4th at 925-27.
6 *Id*. at 927-28.
7 Cal. Civ. Proc. Code §§ 1321 & 1532(d).
8 Order Granting Hewlett-Packard Company's Motion for Summary Judgment, and Entering Judgment in Hewlett-Packard's Favor, *Vondjidis v. Hewlett Packard*, No. 1-03-CV-815388 (Santa Clara Co. Super. Ct. Aug. 28, 2006).
9 *Id*.
10 168 Cal. App. 4th 921 (Cal. Ct. App. 2008).
11 Cal. Civ. Proc. Code § 1321.
12 Cal. Civ. Proc. Code § 1532(d).
13 *Douglas Aircraft Co. v. Cranston*, 58 Cal. 2d 462 (1962).
14 168 Cal. App. 4th at 932.
15 168 Cal. App. 4th at 933.
16 168 Cal. App. 4th at 935.
17 *See, e.g.*, Cal. Code Civ. Proc. §§ 1571-1576; 765 Ill. Comp. Stat. 1025/23-26; N.Y. Aband. Prop. Law §§ 1400-1422; 72 Pa. Stat. Ann. §§ 1301.23-.26; Va. Code Ann. §§ 55-210.24-.26:1.

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