Section 382: Traps for the Unwary
Tax Executives Institute’s 2008 Annual Conference
Boston, MA

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PART I – Has an Ownership Change Occurred?
Section 382 Overview

Purpose of Section 382:

• Originally enacted to prevent “trafficking” in NOLs
• Limits ability of new shareholders to benefit from corporate NOLs earned prior to the time the new shareholders were around
Section 382 Overview

Net Operating Loss Issues:

• Target companies often have significant net operating losses (NOLs) for federal tax purposes
• Purchasers might overvalue the target’s NOLs or sellers might undervalue the NOLs
• The target’s net operating losses are often limited by various tax provisions, including Section 382
• NOLs can generally be carried forward 20 years
Various NOL Limitations

- Section 382 Limitation
- Other Limitations
  - Section 381
  - Section 383
  - Section 384
  - Section 269
  - Consolidated Return Regs (SRLY Rules)
  - CERT Rules
• Limits a “loss corporation”
• That undergoes an “ownership change”
  – An ownership change occurs if, immediately after an owner
    shift or an equity structure shift - The percentage by value
    of stock of the loss corporation owned by one or more
    5-percent shareholders has increased by more than 50
    percentage points over the lowest percentage ownership
    of such shareholders
• During a 3-year “testing period”
• From utilizing “pre-change losses” or other tax attributes
• Against “post-change” income
Why Section 382 Matters

• NOL companies that undergo an ownership change do not have unfettered use of their NOLs as an offset to future taxable income
• Purchase price modeling should account for limits on NOLs
• Equity transactions should be monitored to make sure the limitations are not tripped inadvertently
• Cumulative annual limitations may be greater than the NOL carryforward
  – Might need to write down DTA (see slide 78)
What is a Section 382 Study?
– Determining whether an ownership change has occurred
What is a Section 382 Study?

- Determines when company became a “loss corporation”
- Identifies equity transactions treated as “owner shifts”
- Concludes on when prior ownership changes, if any, occurred
- Calculates limitation from each prior ownership change
- May project when certain equity events drop off the 3-year rolling “testing period”
Testing Dates
## Testing Date Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Equity Event</th>
<th>Type of Equity</th>
<th># of Shares</th>
<th>Info Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/03</td>
<td>Initial Capitalization</td>
<td>Common</td>
<td>1,000</td>
<td>Audited Financials</td>
</tr>
<tr>
<td>3/1/03</td>
<td>Investor</td>
<td>Series A Preferred</td>
<td>100</td>
<td>Private Placement Memorandum</td>
</tr>
<tr>
<td>2/1/04</td>
<td>Public Offering and Preferred Conversion</td>
<td>Common</td>
<td>400</td>
<td>Audited Financials and Form S-1</td>
</tr>
<tr>
<td>12/31/04</td>
<td>Exercise of Stock Options</td>
<td>Common</td>
<td>20</td>
<td>Audited Financials and Option Plan</td>
</tr>
<tr>
<td>2/1/05</td>
<td>Acquisition by Investment Advisor</td>
<td>Common</td>
<td>90</td>
<td>Schedule 13G</td>
</tr>
<tr>
<td>3/1/05</td>
<td>Public Offering</td>
<td>Common</td>
<td>200</td>
<td>Audited Financials and Form S-1</td>
</tr>
<tr>
<td>4/1/05</td>
<td>Sale by Founder</td>
<td>Common</td>
<td>10</td>
<td>Schedule 13D</td>
</tr>
<tr>
<td>6/1/06</td>
<td>Sale by Founder</td>
<td>Common</td>
<td>300</td>
<td>Schedule 13D</td>
</tr>
</tbody>
</table>
What generally counts as “equity” when determining a Section 382 ownership change?

• Common voting stock
• Convertible preferred stock
• Voting preferred stock
• Certain convertible options or instruments issued in an attempt to avoid Section 382
• Certain options issued deep in the money
Equity Under 382

What generally does NOT count as “equity” when determining a Section 382 ownership change?

• Plain vanilla preferred stock
  – Not entitled to vote
  – Not convertible
  – Limited and preferred as to dividends
  – Does not participate in corporate growth
  – Redemption and liquidation rights do not exceed issue price

• Most stock options

• Debt, including most convertible debt
Sources of Information for Equity Issuances

What information is needed to complete a Section 382 Study?

- Federal income tax returns beginning with the first year the company incurred an NOL or had a built-in loss
- Baseline shareholder information from first NOL year, including identity of 5% shareholders (equity rollforward documents)
- Preferred shareholder schedule
- Convertible debt documents (conversion ratios)
- Financial Statements, including footnotes
- Details of all subsequent equity events of 5% shareholders, including 10-Ks, 10-Qs, 13Ds, 13Gs, proxy statements, S-4s, and Form 3s and 4s (for insiders)
- Stock option exercises
- Private placement documents for preferred rounds
Equity Roll-forward:
“Testing Date-by-Testing Date”
Steps to Calculate Owner Shifts

On Each Testing Date:

• Determine stock interests on each testing date
• Assign FMV to equity
• Compute total value on the testing date and determine 5% threshold
• Evaluate owners of 5-percent or more including attribution
• Apply rules for transaction on each testing date and over testing period (include segregation and aggregation rules)
• Determine testing date ownership percentage for each 5-percent shareholder *based on value* and compare that 5-percent shareholder’s lowest ownership percentage *based on value* during the testing period
• Add only the positive owner shifts calculated in #6 on testing date to determine aggregate ownership shift for the testing date
• If cumulative owner shift is greater than 50% percentage points on the testing date, an ownership change has occurred
# Equity Rollforward: Initial Capitalization as of January 1, 2003

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Initial Capital: Common</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>0</td>
<td>0</td>
<td>1,000</td>
<td>$1.00</td>
<td>$0</td>
<td>$1,000</td>
<td>100%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>TOTALS</td>
<td>0</td>
<td>0</td>
<td>1,000</td>
<td></td>
<td></td>
<td>$1,000</td>
<td>100%</td>
<td>100%</td>
<td>0%</td>
</tr>
</tbody>
</table>
Summary of Event

On or about January 1, 2003 the Company issued 1,000 common shares

• On January 1, 2003 the Company issued 1,000 shares of Company common stock to Founder as part of the Company’s initial capitalization. The common stock was valued at $1.00 per share.
Valuation of Each Class of Stock
Value

- Various PLRs – values remain constant (PLR 200411012, PLR 200511008, PLR 200520011, PLR 200622011)
- Each ruling provides that taxpayer may apply this principle
- Look for future IRS guidance (Issue is on the IRS 2009 Guidance Plan)
- Any change in proportionate ownership which is attributable solely to fluctuations in relative FMV of different classes of stock is not taken into account (Section 382(l)(3)(C))
## Equity Rollforward: Issuance of Series A Preferred as of March 1, 2003

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #1: New Pfd</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>$2.00</td>
<td>$1,000</td>
<td>83.3%</td>
<td>83.3%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>0</td>
<td>0</td>
<td>100</td>
<td>$1.00</td>
<td>$2.00</td>
<td>$200</td>
<td>16.7%</td>
<td>0%</td>
<td>16.7%</td>
</tr>
<tr>
<td>TOTALS</td>
<td>1,000</td>
<td>0</td>
<td>100</td>
<td></td>
<td></td>
<td>$1,200</td>
<td>100%</td>
<td>83.3%</td>
<td>16.7%</td>
</tr>
</tbody>
</table>
On or about March 1, 2003 the Company issued 100 shares of Series A preferred stock:

- On March 1, 2003 the Company issued 100 shares of Series A preferred stock to Investor A in exchange for $200 (or $2.00 per share).
- This class of preferred stock is treated as stock for Section 382 purposes because it is convertible into common stock at a 2-to-1 ratio.
- The value of $2.00 per share used for the Series A preferred stock on this testing date is based on the issuance price paid for such stock.
- Based on an issue price of $2.00 per Series A preferred share (and holding the value of the common stock constant from the date of issuance at $1.00 per share) the cumulative owner shift as of March 1, 2003 was 16.7%.
- Investor A is treated as a separate 5% shareholder on the issuance of the 100 shares of Series A preferred stock under the segregation rules of Reg. Section 1.382-2T(j)(2)(iii)(B).
Agenda

5% Shareholders
What is a 5% Shareholder?

- Any individual who owns directly or indirectly an amount of the loss corporation stock that aggregates to a 5% ownership interest by value (trying to get to “arms and legs”)
- Certain public groups created under the Section 382 rules
- Certain groups of people acting in concert such that they are treated as an “entity” under the rules
- A group that consists of all shareholders who own less than 5% of the stock
Transactions Involving 5% Shareholders

For example:

- Initial public offerings (IPO)
- Stock acquisitions
- Stock redemptions – special rules
- Tax-free reorganizations using stock as currency
- Recapitalizations
- Conversions of preferred into common stock
- Major debt issuances, especially if convertible debt or accompanied by warrants
- Conversions of debt into equity
- Issuances or exercises of stock options or warrants
- Sales by 5% shareholders
- Option exercises
What is a 5% Shareholder?

• Review SEC information:
  – “Reliance” on the existence or absence of Schedules 13D & 13G
  – No obligation to inquire or to determine if actual facts are consistent with the ownership
  – “Actual knowledge”
  – Other SEC information:
    • Forms 3 and 4
    • DEF 14A – Proxy Statement
    • 10Qs
    • 10Ks
Public Groups
Public Groups

- Certain public groups created under the Section 382 rules are treated as 5% shareholders.
- Certain groups of people acting in concert such that they are treated as an “entity” under the rules.
- Certain shareholders who own less than 5% of the stock are treated as a public group.
## Equity Rollforward: Public Offering as of February 1, 2004 (Preferred Conversion)

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #2: IPO</th>
<th>Testing Date #2: Pfd</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td></td>
<td></td>
<td>$1.00</td>
<td>$2.00</td>
<td>$1,000</td>
<td>83.3%</td>
<td>83.3%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>0</td>
<td>100</td>
<td>200</td>
<td>(100)</td>
<td>$1.00</td>
<td>$2.00</td>
<td>$200</td>
<td>16.7%</td>
<td>0%</td>
<td>16.7%</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>1,000</strong></td>
<td><strong>100</strong></td>
<td><strong>200</strong></td>
<td><strong>(100)</strong></td>
<td><strong>$1,200</strong></td>
<td><strong>100%</strong></td>
<td><strong>83.3%</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Equity Rollforward: Public Offering as of February 1, 2004 (New Common Shares)

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #2: IPO</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td>IPO</td>
<td>$1.00</td>
<td>n/a</td>
<td>$1,000</td>
<td>62.5%</td>
<td>62.5</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>200</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$200</td>
<td>12.5%</td>
<td>0%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Public Group 1</td>
<td>0</td>
<td>0</td>
<td>400</td>
<td>$1.00</td>
<td>n/a</td>
<td>$400</td>
<td>25.0%</td>
<td>0%</td>
<td>25.0%</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>1,200</strong></td>
<td>0</td>
<td><strong>400</strong></td>
<td><strong>$1,600</strong></td>
<td></td>
<td><strong>100%</strong></td>
<td><strong>62.5%</strong></td>
<td><strong>37.5%</strong></td>
<td></td>
</tr>
</tbody>
</table>
Summary of Event

On or about February 1, 2004, the Company issued approximately 400 common shares in a public offering and converted all Series A preferred stock into common stock.

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

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

- Limitation is equal to 10% of the total value of the corporation’s stock outstanding at the beginning of the year.
  - Can also be done on a class by class basis.
  - If the amount of the issuance exceeds the remaining limitation, none of that issuance qualifies.
  - Must combine entire issuance, including amounts issued to 5% shareholders to determine application or not.

- Effect: stock is treated as acquired by existing public groups.
## Equity Rollforward: Exercise of Stock Options as of December 31, 2004

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #3: Options</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$1,000</td>
<td>61.7%</td>
<td>61.7%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>200</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$200</td>
<td>12.3%</td>
<td>0%</td>
<td>12.3%</td>
</tr>
<tr>
<td>Public Group 1</td>
<td>400</td>
<td>0</td>
<td>20</td>
<td>$1.00</td>
<td>n/a</td>
<td>$420</td>
<td>26.0%</td>
<td>0%</td>
<td>26.0%</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td>1,600</td>
<td>0</td>
<td>20</td>
<td></td>
<td></td>
<td>$1,620</td>
<td>100%</td>
<td>61.7%</td>
<td>38.3%</td>
</tr>
</tbody>
</table>
## Small Issuance Limitation (based on value)

**Calculation of Limitation:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Shares</th>
<th>Value ($/Share)</th>
<th>Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock at 1/1/04</td>
<td>1,000</td>
<td>$1.00</td>
<td>$1,000</td>
</tr>
<tr>
<td>Preferred Stock at 1/1/04</td>
<td>100</td>
<td>$2.00</td>
<td>$200</td>
</tr>
<tr>
<td>Total Value at 1/1/04</td>
<td></td>
<td></td>
<td>$1,200</td>
</tr>
</tbody>
</table>

**Small Issuance Limit %**

| Limitation | $120 |

### Limitation Used:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Option Exercises</td>
<td>($20)</td>
</tr>
</tbody>
</table>

**REMAINING LIMITATION**

<table>
<thead>
<tr>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100</td>
</tr>
</tbody>
</table>
During the tax year ended December 31, 2004, the Company issued 20 shares of common stock pursuant to its employee stock option plan.

- During the tax year ended December 31, 2004, the Company issued 20 shares of common stock to employees upon the exercise of options. None of these employees was a 5-percent shareholder as defined in Section 382(k)(7).
- The Company’s issuance of 20 shares of common stock upon the exercise of options is considered a small issuance under Section 382. The total issuance valued at $20 does not exceed the small issuance limitation of $120 (based on the value of the Company’s common and preferred stock at January 1, 2004 of $1,200 times 10%). The segregation rules of Treas. Reg. Section 1.382-2T(j)(iii)(B) do not apply to the option exercise because it does not exceed the small issuance limitation. Pursuant to Treas. Reg. Section 1.382-3(j)(5), each of Company’s existing direct public groups should be treated as having acquired a proportionate number of the shares issued. Since Company had only one public group on the relevant date, all of the shares were allocated to that public group.
- The cumulative owner shift as of December 31, 2004 was 38.3%.
Investment Advisors
• **Investment advisors** may not count
  
  – PLRs distinguish between a person who has the right to the dividends and proceeds from the sale of a loss corporation’s stock (the “economic owner”) and the investment advisor, who holds the power to vote and/or dispose of such stock (the “reporting owner”)
    
    • Right to dividends
    • Right to proceeds upon the sale of stock
  
  – PLR 9533024, PLR 9725039, and PLR 200806008
• PLR 200747016 provides some guidance on how to interpret information on Schedules 13D and 13G
  – SEC filers who do not provide additional information and taxpayer has no actual knowledge
  – SEC filers who provide additional information
  – SEC filers who do not provide additional information, but taxpayers has actual knowledge
<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Filing of 13G</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$1,000</td>
<td>61.7%</td>
<td>61.7%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>200</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$200</td>
<td>12.3%</td>
<td>0%</td>
<td>12.3%</td>
</tr>
<tr>
<td>Public Group 1</td>
<td>420</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$420</td>
<td>26.0%</td>
<td>0%</td>
<td>26.0%</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>1,620</strong></td>
<td><strong>0</strong></td>
<td><strong>0</strong></td>
<td><strong>$1,620</strong></td>
<td></td>
<td><strong>100%</strong></td>
<td><strong>61.7%</strong></td>
<td><strong>38.3%</strong></td>
<td></td>
</tr>
</tbody>
</table>
On or about February 1, 2005, and investment advisor acquired 90 shares of the Company’s common stock as reported on Schedule 13G filed with the Securities and Exchange Commission.

- Investor B acquired 90 shares of the Company on February 1, 2005, as reported on Schedule 13G filled with the SEC on February 15, 2005. As provided in the Schedule 13G filing, Investor B is deemed to be an investment advisor under Rule 13d-1 under the Securities Exchange Act of 1934. In addition, no single client of Investor B is deemed a 5% shareholder in the Company through its relationship with Investor B.
Agenda

Cash Issuance Exception
Cash Issuance Exception

• Exempts a percentage of stock issued (in a solely-for-cash-issuance) from the regular segregation rules equal to one-half of aggregate percentage of stock owned by direct public groups immediately before the issuance

• Effect: The portion of stock exempted is treated as acquired by the existing public groups
## Equity Rollforward: Public Offering as of March 1, 2005

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #4: Offering</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$1,000</td>
<td>55.0%</td>
<td>55.0%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>200</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$200</td>
<td>11.0%</td>
<td>0%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Public Group 1</td>
<td>420</td>
<td>0</td>
<td>26</td>
<td>$1.00</td>
<td>n/a</td>
<td>$446</td>
<td>24.5%</td>
<td>0%</td>
<td>24.5%</td>
</tr>
<tr>
<td>Public Group 2</td>
<td>0</td>
<td>0</td>
<td>174</td>
<td>$1.00</td>
<td>n/a</td>
<td>$174</td>
<td>9.5%</td>
<td>0%</td>
<td>9.5%</td>
</tr>
<tr>
<td>TOTALS</td>
<td>1,620</td>
<td>0</td>
<td>200</td>
<td></td>
<td></td>
<td>$1,820</td>
<td>100%</td>
<td>55.0%</td>
<td>45.0%</td>
</tr>
</tbody>
</table>
### Cash Issuance Application to Issuance of 200 Shares

<table>
<thead>
<tr>
<th>Allocation to Existing Public Groups</th>
<th>200 shares</th>
<th>x 26%</th>
<th>x 50%</th>
<th>26</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Group 1</td>
<td>200 shares</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Allocation to New Public Group</th>
<th>200 shares</th>
<th>- 26 shares</th>
<th>=</th>
<th>174</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Group 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| TOTAL SHARES                        |            |              |      | 200 |

Illustration: Cash Issuance Exception
Summary of Event

On or about March 1, 2005, the Company issued approximately 200 common shares in public offering

- On or about March 1, 2005, the Company issued 200 shares of common stock as consideration in a public offering valued at approximately $200 (or $1.00 per share).
- The cash issuance exception under Reg. Section 1.382-3(j)(3) was applied to this event and 26 of the 200 shares was allocated to the existing public group based on its percentage interest in the Company immediately prior to the acquisition (26% x 1/2 x 200 shares = 26 shares). The remaining 174 common shares were allocated to a new public group, “Public Group 2.”
- Based on a value of $1.00 per common share the cumulative owner shift as of March 1, 2005 was 45.0%.
Testing Period

• 3 Year period ending on the testing date
  – First day of the tax year from which a 382 attribute is carried forward or NUBIL exists
• Exception – clock restarts after an ownership change
# Equity Rollforward: Sale by 5% Shareholder as of April 1, 2005

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #5: Sale</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000</td>
<td>0</td>
<td>(10)</td>
<td>$1.00</td>
<td>n/a</td>
<td>$990</td>
<td>54.4%</td>
<td>54.4%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>200</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$200</td>
<td>11.0</td>
<td>0%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Public Group 1</td>
<td>446</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$446</td>
<td>24.5%</td>
<td>0%</td>
<td>24.5%</td>
</tr>
<tr>
<td>Public Group 2</td>
<td>174</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$174</td>
<td>9.5%</td>
<td>0%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Public Group 3</td>
<td>0</td>
<td>0</td>
<td>10</td>
<td>$1.00</td>
<td>n/a</td>
<td>$10</td>
<td>0.6%</td>
<td>0%</td>
<td>0.6%</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>1,820</strong></td>
<td><strong>0</strong></td>
<td><strong>0</strong></td>
<td><strong>$1,820</strong></td>
<td></td>
<td><strong>100%</strong></td>
<td><strong>54.4%</strong></td>
<td><strong>45.6%</strong></td>
<td></td>
</tr>
</tbody>
</table>
Summary of Event

Founder sold 10 shares of common stock in the Company on the open market as of April 1, 2005

- On or about April 1, 2005, Founder reported a sale of 10 shares of common stock in the Company on Schedule 13D with the S.E.C.
- Under the segregation rules and Reg. Section 1.382-2T(j)(3)(i), each direct public group that exists immediately after a disposition by a direct 5 percent shareholder shall be segregated so that the ownership interests of each public group that existed immediately before the transaction are separate from the public group that acquires stock of the loss corporation. As a result, a new public group, Public Group 3, was created to represent the sale of shares by Founder.
- Accordingly, the percentage shift in ownership percentage as a result of this sale is 45.6% as of April 1, 2005.
# Equity Rollforward: Sale by 5% Shareholder as of June 1, 2006

<table>
<thead>
<tr>
<th>5% S/Hs</th>
<th># of Common Shares</th>
<th># of A Pfd Shares</th>
<th>Testing Date #6: Sale</th>
<th>Value: Common</th>
<th>Value: A Pfd</th>
<th>Total Value</th>
<th>Testing Date %</th>
<th>Testing Period Low %</th>
<th>Shift in Owner %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>990</td>
<td>0</td>
<td>(300)</td>
<td>$1.00</td>
<td>n/a</td>
<td>$690</td>
<td>37.9%</td>
<td>37.9%</td>
<td>0%</td>
</tr>
<tr>
<td>Investor A</td>
<td>200</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$200</td>
<td>11.0</td>
<td>11.0%</td>
<td>0% *</td>
</tr>
<tr>
<td>Public Group 1</td>
<td>446</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$446</td>
<td>24.5%</td>
<td>0%</td>
<td>24.5%</td>
</tr>
<tr>
<td>Public Group 2</td>
<td>174</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$174</td>
<td>9.5%</td>
<td>0%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Public Group 3</td>
<td>10</td>
<td>0</td>
<td></td>
<td>$1.00</td>
<td>n/a</td>
<td>$10</td>
<td>0.6%</td>
<td>0%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Public Group 4</td>
<td>0</td>
<td>0</td>
<td>300</td>
<td>$1.00</td>
<td>n/a</td>
<td>$300</td>
<td>16.5%</td>
<td>0%</td>
<td>16.5%</td>
</tr>
</tbody>
</table>

**TOTALS** | **1,820**          | **0**             | **0**                   |               |              | **$1,820** | **100%**       | **48.9%**           | **51.1%**        |

*Note that Investor A’s original investment in the Company is now outside the 3-year testing period.*
Summary of Event

Founder sold 300 shares of common stock in the Company on the open market as of June 1, 2006

- On or about June 1, 2006, Founder reported a sale of 300 shares of common stock in the Company on Schedule 13D with the S.E.C.
- Under the segregation rules and Reg. Section 1.382-2T(j)(3)(i), each direct public group that exists immediately after a disposition by a direct 5 percent shareholder shall be segregated so that the ownership interests of each public group that existed immediately before the transaction are separate from the public group that acquires stock of the loss corporation. As a result, a new public group, Public Group 4, was created to represent the sale of shares by Founder.
- Accordingly, the percentage shift in ownership percentage as a result of this sale is 51.1% as of June 1, 2006. This exceeds the 50% threshold and, consequently, an ownership change has occurred.
PART II – After the Ownership Change and Other Issues
Section 382 Limitation

Why Section 382 limitation matters:

• NOL companies that undergo an ownership change do not have unfettered use of their NOLs as an offset to future taxable income

• Cumulative annual limitations may be greater than the NOL carryforward
Impact of an Ownership Change
Calculation of the Section 382 Limitation

Section 382 Limitation Example:

- Value on change date $1,820
- Change date investment ($0)
- Value immediately before change $1,820
- Capital Contributions (2 yrs) ($200)
- Adjusted value $1,620
- Published rate (L.T. tax exempt) 5.00%
- Annual NOL Limitation $81
- Annual limitation accrues, even if unused
Section 382 Limitation

Section 382 Annual Limitation:

• Fair Market Value of old loss corporation times a published IRS rate (long term tax exempt rate)

• Value does not include any new investment being made on the change date
Valuation of the Loss Corporation
Adjustments to Value

- Redemption or other corporate contraction occurs in connection with an ownership change, the value is determined after taking it into account
- Holding “substantial nonbusiness assets” (1/3 of total asset value) immediately after the ownership change
- May be required to back out value of *capital contributions* made within 2 years of ownership change
- Annual limitation may become zero if continuity of business enterprise is violated within 2 years of change
Capital Contributions and Section 382(l)(1)

- No regulations
- Legislative history allows disregarding of:
  - Contributions on formation
  - Contributions before loss corporation status exists
  - Contributions to meet basic operations (e.g. meet payroll or other operating expenses) (H.R. Rep. No. 426, 99th Cong., 2d Sess., II-189 (1985))
  - For example, in PLR 200730003 capital contributions made so that a life insurance company could maintain minimum capitalization requirements were not excluded from value by the Section 382(l)(1) anti-stuffing rule. (See also TAM 9332004, PLR 9508035, PLR 9541019, PLR 9630038, PLR 9706014, PLR 9835027)
Notice 2008-78 (September 26, 2008)

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

- Establishes four safe harbors
  - The contribution is made by a less than 20% un-related shareholder and the ownership change occurs more than six months after the contribution.
  - The contribution is made by a related party but no more than 10% of the total value of the loss corporation’s stock is issued in connection with the contribution, or the contribution is made by a person other than a related party and the ownership change occurs more than one year after the contribution.
  - The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan.
  - The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or it is received before the first year from which there is a carryforward of tax attributes.
Successive Ownership Changes – Impact on Section 382 Limitation
Successive Ownership Changes

• If two or more successive ownership changes, then each Section 382 limitation is applied independently (Reg. Section 1.382-5(d))
  – Later ownership changes may result in a lower, but not a higher, Section 382 limitation
  – Application of rule may result in layers of NOLs where each layer is subject to different limitations
  – A single low limitation can trap prior NOLs, and subsequent limitations can not create a higher limitation for previously limited NOLs
Previously Acquired NOLs

Self-generated versus acquired NOLs and successive ownership changes:

• Targets, especially large consolidated groups, may have NOL “pools” from various acquired entities
• Special rules apply when successive ownership changes – must apply most restrictive limitation to the pool of NOLs that are around on any change date
• Purchasers should trace Target’s NOLs to determine the source of the NOLs
NUBIG, NUBILs, and Notice 2003-65
NUBIGs & NUBILs

• Requires any loss corporation with an ownership change to determine whether it has a NUBIG or NUBIL

• If a corporation has a NUBIL, then built-losses recognized during the five-year recognition period are treated as pre-change losses and subject to the Section 382 annual limitation

• If a corporation has a NUBIG, then built-in gains recognized during the five-year recognition period will increase the Section 382 limitation

• A loss corporation can have a NUBIG or NUBIL, but not both
• Items of income and items of deduction are treated as RBIG or RBIL if the item is “properly taken into account during the recognition period” and is “attributable to periods for the change date”
  – Deduction items:
    • Depreciation, amortization & depletion
    • COD and bad debt deductions – 12 month rule
Built-in gain planning:

- Determine whether loss company has a net unrecognized built-in gain (NUBIG) or loss (NUBIL) on the change date
- Notice 2003-65: identify items that eliminate NUBIL or adjust NUBIL into a NUBIG (e.g., C.O.D.I)
- All prior ownership changes, even in closed years, should be reviewed to determined if Section 382 limit may be increased
Notice 2003-65

- IRS Notice 2003-65 – provides safe harbor settlement guidelines regarding the determination of NUBIG/NUBIL and the identification of RBIG and RBIL
- Notice is effective until temporary or final regulations are issued
- Increase Section 382 limitation for recognized built-in gains and “deemed” amortization of certain assets
  - Section 1374 approach
  - Section 338 approach
Calculation of NUBIG/NUBIL on hypothetical sale of all corporation’s assets at FMV to purchaser who assumes all of its liabilities:

+ FMV of assets
- Adjusted tax basis of assets
- Any deductible liabilities that would have been included on hypothetical sale
-/+ Section 481 adjustments
+ Built in deductions
= NUBIG or (NUBIL)
Hypothetical Section 338 Purchase of the Company under IRS Notice 2003-65:

- Company Value $1,820
- Company Liabilities $600
- Hypothetical ADSP $2,420
- Est. Tax Basis in Assets $2,270
- Net Unrealized Built-in Gain (NUBIG) $150
Hypothetical Section 338 Purchase of the Company under IRS Notice 2003-65 (continued):

• NUBIG (from prior slide) $150
  – NUBIG attributable to Asset 1 $30
  – NUBIG attributable to Goodwill $120

• Hypothetical Amortization on Goodwill
  – NUBIG attributable to Goodwill $120
  – Amortization period / 15 years
  – Hypothetical amortization $8 per year
### Adjustments to Section 382 Limitation in 5 Year Recognition Period

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disposition of Asset 1</td>
<td>-</td>
<td>30</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hypothetical Amortization (5 years)</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>-</td>
</tr>
<tr>
<td>Total Recognized Built-In Gain</td>
<td>8</td>
<td>38</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>PLUS: Annual NOL Limitation</td>
<td>81</td>
<td>81</td>
<td>81</td>
<td>81</td>
<td>81</td>
<td>81</td>
</tr>
<tr>
<td>EQUALS: Adjusted Limitation</td>
<td>89</td>
<td>119</td>
<td>89</td>
<td>89</td>
<td>89</td>
<td>81</td>
</tr>
</tbody>
</table>
Filing an Information Statement
Reporting Loss Corporation Ownership Changes

• Include a statement in federal return for each year an owner shift occurs

• Some details to include:
  – Dates of owner shifts
  – Dates of ownership changes
  – Amount of attributes
Statement Pursuant to Reg. § 1.382-11(a)
By the Company, Inc.
EIN 12-3456789
For the tax year ended December 31, 2006

1. Owner shifts, equity structure shifts, or other transactions described in paragraph (a)(2)(i) of Reg. § 1.382-2T occurred on the following dates during the taxable year:
   • June 1, 2006

2. An ownership change occurred on June 1, 2006

3. Following is a list of attributes described in paragraph (a)(1)(i) of Reg. § 1.382-2 that caused the corporation to be a loss corporation:
   • Net operating loss carryforward of $500

4. The closing-of-the-books election under Reg. § 1.382-6(b) is hereby made with respect to the ownership change occurring on June 1, 2006
Agenda

Reporting Section 382 Issues on Financial Statements
NOLProjectionExample

NOL Projection Example

NOL Carryover (16 years old, 20 year carryforward) = $6,000,000

382 Limitation (after NUBIG) in 2008 = $380,000

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected Income/Loss</th>
<th>Annual NOL Limitation</th>
<th>Utilized NOL</th>
<th>Unrestricted NOL Carryforward</th>
<th>Remaining Restricted NOL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(1,000,000)</td>
<td>380,000</td>
<td>-</td>
<td>(380,000)</td>
<td>5,620,000</td>
</tr>
<tr>
<td>2</td>
<td>(700,000)</td>
<td>380,000</td>
<td>-</td>
<td>(760,000)</td>
<td>5,240,000</td>
</tr>
<tr>
<td>3</td>
<td>500,000</td>
<td>380,000</td>
<td>500,000</td>
<td>(640,000)</td>
<td>4,860,000</td>
</tr>
<tr>
<td>4</td>
<td>200,000</td>
<td>380,000</td>
<td>200,000</td>
<td>(820,000)</td>
<td>4,480,000*</td>
</tr>
</tbody>
</table>

* NOL Expires unused; Need to adjust Deferred Tax Asset
Sample Info, Form 10K, Financial Statements,* Footnote regarding “Income Taxes”:

• Deferred tax assets and valuation allowance
  – Loss carryforwards 20 m.
  – Valuation allowance (2.5 m.)

• Explanation
  – We have provided a valuation allowance related to the benefits of certain net operating losses that we believe are unlikely to be realized. The valuation allowance decreased by $1.9 million in fiscal 2007. The decrease was due to utilization of $1.0 million and expired losses of $0.9 million.

*These examples were taken from actual filing with the S.E.C. Pepper Hamilton LLP cannot provide advice as to the adequacy of a statement for financial reporting purposes, but we include for illustrative purposes only.
Sample Info, Form 10-Q:

- As more fully described in Note 7 (Income Taxes) to the consolidated financial statements in the 2006 Form 10-K, all of our U.S. deferred tax assets had full valuation allowances at December 31, 2006 and this continues to be the case at June 30, 2007. We will maintain this valuation allowance until an appropriate level of profitability is sustained or we are able to develop tax planning strategies that enable us to conclude that it is more likely than not that our U.S. deferred tax assets are realizable.

*These examples were taken from actual filing with the S.E.C. Pepper Hamilton LLP cannot provide advice as to the adequacy of a statement for financial reporting purposes, but we include for illustrative purposes only.
Sample Info, Form 10K:

- The Company experienced an ownership change as a result of the Transaction, causing a limitation on the annual use of the net operating loss carryforwards.
- Utilization of the Company’s net operating loss may be subject to a substantial annual limitation due to the ownership change limitations set forth in Internal Revenue Code Section 382 and similar state provisions.

*These examples were taken from actual filing with the S.E.C. Pepper Hamilton LLP cannot provide advice as to the adequacy of a statement for financial reporting purposes, but we include for illustrative purposes only.
Sample Info, Form 10K:

- Our effective tax rate decreased to 25% in 2006 from 35% in 2005, primarily due to a $300 million increase in the deferred tax valuation allowance in 2005, which was reversed in 2006, related to net operating losses.

*These examples were taken from actual filing with the S.E.C. Pepper Hamilton LLP cannot provide advice as to the adequacy of a statement for financial reporting purposes, but we include for illustrative purposes only.
Sample Info, Form 10K:

- Section 382 of the Internal Revenue Code limits the Company’s ability to utilize the tax deductions associated with its depreciable assets as of the end of the 2005 year to offset the taxable income in future years, due to the existence of a Net Unrealized Built-In Loss (“NUBIL”) at the time of the change in control. Such a limitation will be effective for a five-year period subsequent to the change in control.

*These examples were taken from actual filing with the S.E.C. Pepper Hamilton LLP cannot provide advice as to the adequacy of a statement for financial reporting purposes, but we include for illustrative purposes only.
Agenda

Special Rules for Bankruptcy Situations
Section 382 in Bankruptcy

Special Rules

- 382(l)(5) - generally provides for no limitation on use of NOLs if certain requirements are met
- 382(l)(6) – generally provides for increased limitation if certain requirements are met
  - (l)(6) is applicable if requirements for (l)(5) are not met or if Debtor elects out of (l)(5)
Section 382 in Bankruptcy

382(l)(5)

- In title 11 immediately before the change
- Continuity of interest (tests pre-change shareholders and “qualified creditors”)
Section 382 in Bankruptcy

382(l)(5) Effects and Consequences

• The use of pre-change losses is not subject to limitation under Section 382
• If another ownership change occurs within 2 years, the Section 382 limitation with respect to the second ownership change will be 0
382(1)(6)

• Certain tax-free reorganizations; or
• Title 11 case; and
• 382(1)(5) doesn’t apply
• Must continue the business for 2 years following the change date or the 382 limitation is 0
Section 382 in Bankruptcy

382(l)(6) Effects

- 382 limit applies
- Limitation is based on enhanced value following surrender or cancellation of creditor’s claims
Section 382 in Bankruptcy

Choosing between (l)(5) and (l)(6)

• Compare amount of NOLs
• Compare amount of COD income
• Comfort the transaction will qualify under (l)(5)
• Future plans
  – Ownership change
  – Continuing the business
  – May want to modify bylaws/charter to prevent sales for 2 years
Questions

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