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Net Operating Loss Utilization Assistance

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Introduction

We are facing a difficult and unprecedented economic environment. Many corporations, both new and well established, are generating net operating loss, or “NOL,” carryforwards for the first time or are experiencing a significant increase in their existing NOL carryforwards.¹ Although these NOL carryforwards are often viewed as valuable tax assets, a number of complex anti-loss trafficking tax rules must be considered to determine if and when these tax assets can be utilized. The most important of these rules is Section 382 of the Internal Revenue Code, or “Section 382” of the “Code.”

Any corporation reporting an NOL carryforward should obtain a Section 382 Study for the reasons set forth below, the most important of which is to comply with tax return and financial statement requirements. The Morgan Lewis Tax Practice regularly evaluates NOL carryforward issues and can efficiently produce comprehensive, high-quality Section 382 Studies for our clients.

NOL Utilization under Section 382

Any corporation that has an NOL carryforward, a capital loss carryforward, or certain tax credit carryforwards must consider Section 382. Furthermore, a corporation with a “built-in loss,” or an aggregate asset tax basis in excess of fair market value, must consider Section 382 if the built-in loss is greater than a relatively low threshold. This rule may be particularly relevant for corporations that have experienced large writedowns in their assets for financial accounting purposes.

Section 382 imposes a limitation on the amount of income that a corporation may offset with NOLs and certain other tax attributes upon an “ownership change.” In general, an “ownership change” is an aggregate increase of more than 50% of the ownership of a corporation (by value) over a prescribed period by the corporation’s “5% shareholders” from the lowest percentage of ownership of these shareholders in that period. In general, the prescribed ownership change testing period is the lesser of three years or the period between a prior ownership change and the given testing date.

The term “5% shareholder,” for the purpose of Section 382, is a term of art and involves the operation of elaborate shareholder attribution, aggregation, and segregation rules. If an ownership change occurs, the resulting Section 382 limitation, for each year after the

1. To the extent a corporation has losses for tax purposes that exceed its current taxable income, those losses become “net operating losses,” which can then be applied against the corporation’s taxable income for its prior two taxable years (or up to five years in certain instances), potentially resulting in a tax refund, or carried forward for use in the corporation’s following 20 taxable years.

ownership change, will generally be equal to the value of all the stock of the corporation (at the time of the ownership change) multiplied by a published IRS discount rate in effect at the time of the ownership change. The Section 382 limitation is subject to a number of special adjustment rules, the most important of which allows a Section 382 limitation to be increased by any built-in gain recognized within five years of an ownership change that occurred at a time when the corporation was subject to a corresponding unrealized built-in gain.

The value of a corporation at the time of a Section 382 ownership change is the key to determining how much of an impact the resulting Section 382 limitation will have on the corporation's tax attribute utilization. In the case of corporations that are being sold for a relatively high value as compared to their NOL carryforwards, and that have experienced no prior Section 382 ownership changes, the resulting Section 382 limitation may result in little, if any, deferral of NOL utilization by the acquired corporation. However, in the case of a corporation that is sold for a low value relative to the size of its NOLs, the resulting Section 382 limitation may make the NOLs of the corporation worthless from the buyer's perspective, since the NOL carryforward period will expire before the corporation's NOLs can be utilized under the Section 382 limitation.

When Does a Corporation Need to Commission a Section 382 Study?

Corporations are required by the tax laws to determine the applicability of Section 382 as they generate NOLs and other relevant tax attributes and file related informational statements with their tax returns. However, often corporations wait to commission a "Section 382 Study" until they become profitable and wish to utilize these NOLs and other tax attributes. In such an instance, corporations must generally record a full valuation allowance in their financial statements against their deferred tax assets for the NOLs or tax attributes that are potentially subject to limitation until a Section 382 Study is completed.

Corporations that defer commissioning a Section 382 Study and are being marketed for sale are often forced to produce a Section 382 Study by a buyer as a condition to the sale. A Section 382 Study is necessary to satisfy a buyer's tax diligence requests regarding NOL utilization or the selling corporation's claims as to the value of its tax attributes. If a corporation waits to commission a Section 382 Study until it is forced to do so by a buyer or becomes profitable the Section 382 Study will likely be more costly as well as less precise due to the passage of time that occurs between the relevant stock transfers and issuances and the time at which the Section 382 Study is completed. Furthermore, having a Section 382 Study in place before a stock transaction allows a corporation to be proactive in its Section 382 tax planning and structure the transaction so as to maximize its future NOL utilization.

Morgan Lewis NOL Utilization Analysis

Morgan Lewis tax attorneys have an in-depth understanding of all tax attribute utilization limitations including the Section 382 rules. We produce full scale Section 382 Studies (and other tax attribute analyses) for a full range of private and public corporations. Morgan Lewis studies are generally priced on a fixed-fee basis and more competitively

than large accounting firms, and can be completed on a much more accelerated timeline. This is particularly important in the case of transaction related studies. The spreadsheets used in our studies can generally be updated by clients for future capital structure changes and stock transfers after the issue date with minimal involvement from Morgan Lewis lawyers, extending the benefit of our studies beyond the initial issue date.

In producing Section 382 Studies, we conduct thorough due diligence into the historical capital structure and corporate transaction history of our clients and their valuation records and data in order to apply all the various components of Section 382. These components include, among other rules, the aggregation and segregation rules, the constructive ownership and attribution rules, the anti-stuffing rules (as modified by recent IRS guidance), the continuity of business rules, and the net unrealized built-in gain and loss rules. Our studies can also address the application of other important tax attribute limitation standards such as special state and local tax limitations, federal consolidated return limitations, Section 269 of the Code, and the corporate alternative minimum tax. Our tax attorneys work closely with each client, its auditors, and its financial advisors to address the client's individual situation and ascertain the most advantageous outcome available.

For more information on Section 382 Studies or other Morgan Lewis tax services, please contact the following Morgan Lewis attorney.

Philadelphia

Paul A. Gordon

215.963.5568

pgordon@morganlewis.com

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Morgan Lewis is an international law firm with more than 1,400 lawyers in 22 offices located in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis, please visit www.morganlewis.com.

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