



Business Combinations



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Instructor

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Before we get to the tax.....

- Tax can be a tool by which we facilitate business
- Understand what the business plan is
- What is being brought to the deal
 - Cash
 - Assets
 - Intangibles
- What are the exit strategies
 - Discuss up front
 - Buy/Sell
 - Public Offering
 - Private Equity
 - Family Legacy

Match the Tax to the Plan

- Entity Selection
- Operating Agreements
 - Work with Counsel to get them right
 - Family businesses
 - Review them before signing
- Follow the agreements

Sections 351

Incorporating a Business and Transfers to Controlled Corporations

What is Section 351?

- In general, §351 provides no gain or loss is recognized when property is transferred in exchange for stock of a controlled corporation
- Why is this important?
 - Appreciated property can be exchanged for stock of a controlled corporation without any current gain recognition
- §351 applies to incorporations of new businesses but is frequently used as a vehicle to acquire and combine multiple businesses in both strategic and PE transactions
- §351 is a valuable tool for accomplishing tax-free and partially tax-free deals where either §368 is not available or the buyer is looking for a partial step up in basis

Section 351 – General Requirements

- No gain or loss is recognized upon the transfer of property to a corporation if
 - Property is transferred for common or preferred stock (other than NQPS) in the corporation
 - The transferors obtain or retain Sec. 368(c) control of the corporation immediately after the exchange
 - The transaction has a business purpose
- Gain is recognized to the extent of boot received
 - Basis of property acquired by the corporation is increased by the gain recognized

Transfers to Controlled Corporations

- Investment Companies
- Transfers of Property
- Receipt of Boot/Non-Qualified Preferred Stock
- Liabilities
- Control Requirement
- Integration of multiple transferors

Investment Companies – Basic Principles

- §351(e)(1) – Provides an exception to the general rule under §351
- Transfers of property to an “Investment Company” do not qualify for non-recognition treatment
 - If the transfer results in a diversification of the transferors’ interest and
 - If the transferee is:
 - Regulated Investment Company (“RIC”)
 - Real Estate Investment Trust (“REIT”)
 - A corporation with more than 80% of its value made up of assets held for investment, readily marketable stocks or securities, or interests in RICs and REITs

What is Property?

- The Code does not define property for purposes of §351
- Courts have broadly interpreted the term “property” stating in one case that it encompasses whatever may be transferred (*U.S. v. Stafford*, 727 F.2d 1043, 1052 (11 cir. 1984)).
 - Money
 - Stock of a corporation
 - Interest in a partnership
 - Patents and other intangible assets
 - Transferor obligations (See *Peracchi*)
 - Other property
 - Inventory
 - Receivables (consider method of accounting issues)

Intangible Property

Intangible Rights and Know-How: Clients often want to transfer “sweat equity” and idea or business know-how in exchange for equity

Rev. Rul 64-56 poses four questions to determine if a transfer of know-how qualifies as property under §351:

1. Did the inherent nature of the consideration transferred cause the consideration to be “property?”
2. Was the property afforded legal protection?
3. If services were provided, were these services ancillary and subsidiary to the transfer?
4. Were all substantial rights in the property transferred?

Property vs. Services

- §351(d)(1) – For purposes of this section, stock issued for services shall not be considered as issued in return for property
- Reg. §1.351-1(a)(1)(i) – Stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property

Built-in Loss Property

- §362(a) – A transferee corporation generally assumes the transferor's basis in property transferred in an exchange to which §351 applies
- However, if the aggregate adjusted basis exceeds the FMV of the property transferred, §362(e)(2) limits the transferee's basis to the FMV of the property immediately after the transfer
- §362(e)(2)(C) – Election to apply limitation to transferor's stock basis
 - The transferor and transferee may elect to apply the reduction in basis to the transferor's basis in the transferee corporation stock
 - Irrevocable election

Receipt of Boot

Receipt of Boot – *Rev. Rul. 68-55*

- When several assets are transferred to a corporation each asset must be considered transferred separately in exchange for a portion of each category of consideration received
- The fair market value of each category of consideration received must be separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets (i.e. generally no cherry picking)
- Compare to an independent sale of some property and transfer of other property
 - What facts may be necessary for such a transaction?

Receipt of Boot: Example

- XYZ transfers property A (FMV and AB \$50) and property B (FMV \$50 and AB \$0) to Corp X in a qualifying 351 transaction
- XYZ receives \$50 in stock and \$50 of cash
- Allocation of consideration as follows:
 - Property A \$25 in cash and \$25 in stock
 - Property B \$25 in cash and \$25 in stock
- What is the gain or los realized in the transaction?
- What is the gain or loss recognized in the transaction?

Liabilities

- Assumption of transferor's liabilities is **not** boot
 - §357(a); Reg. §1.357-1(a)
- Exceptions
 - All assumed liabilities are boot if either -
 - Principal purpose – avoidance of federal income tax, or
 - No business purpose
 - §357(b)((1); Reg. §1.357-1(c)
- Excess of debt transferred over basis of property transferred is gain
 - §357(c)((1); Reg. §1.357-2(a)
 - Certain exclusions apply

Liabilities

Avoiding §357(c) – Debt in excess of basis

- Transferor contributed personal note to offset debt in excess of property transferred
 - 9th Circuit held that the note represented a “new and substantial increase” in transferor’s investment
 - Peracchi v. Comm, 143 F.3d 487 (CA-9, 1998)
 - However, other courts have held to the contrary
 - Lessinger, 85 TC 824

Liabilities

Transferor’s Basis

- §358 - Stock and boot received by transferor
 - Equal to basis of property transferred
 - Less money or amount of assumed liability
 - Less FMV other property received
 - Plus gain recognized
 - Basis in any boot received is FMV

Control Requirement

- In general, a transfer qualifies as tax-free under §351(a) only if transferors are in **control** immediately after
- “Control” is defined in §368(c) as 80% of the voting power **and** 80% of the shares of each class of nonvoting stock

Control Requirement

- The **constructive ownership** rules defined by §318 do not apply, except with regard to affiliated groups (*Rev. Rul. 56-613*)
 - Stock owned by others may not be attributed to one who transfers property to a corporation for the purpose of determining whether there is nonrecognition of gain or loss

Property vs. Services

Determination of control:

- Stock received only for services is *not* counted in determining if transferors are in control of the corporation immediately after the transfer
- Stock received for services *is* counted in determining control if the service provider also transfers property
 - Property transferred must be more than a nominal amount (generally 10% of the total value in exchange for property - see *Rev. Proc. 77-37*)

Control Requirement

- Multiple transferors are regarded as a single group of transferors if the transfers are part of an integrated plan
 - If simultaneous transfers are not possible, a written agreement should be executed by the transferors
 - Key component to using section 351 in business acquisitions and combinations

Control Requirement

- **Control “immediately after”** has not been clearly defined by the IRS or by the courts.
 - When transfers are not made simultaneously, control “immediately after” is generally determined by applying the step transaction doctrine in order to determine if the separate transfers should be respected as a single transfer.

Control Requirement

Accommodation transfers

- Existing shareholders are excluded from the transferor group if –
 - The value of the transferred property is relatively small compared to the value of the previously existing ownership and
 - 10% of value of current interest
 - The primary purpose of the transfer is to gain §351 treatment

§351 Acquisition Structures

Multiple party transfer – §351 Roll-up

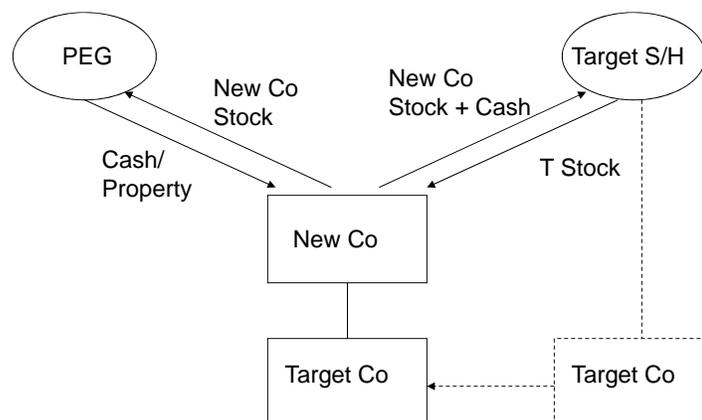
- Reg. §1.351-1(a)(1) – immediately after does not require simultaneous transfers
- Rights of parties previously defined and execution of the agreement in orderly procedure

Advantages

- §368 requires continuity of interest, boot is limited
- Partnership can be a party to §351 acquisition
- The NewCo can adopt more favorable accounting methods



§351 Acquisitions – Basic Structure



Taxable and Tax-free Mergers and Acquisitions

Objectives

Gain a general understanding of:

- Section 338 and taxable asset acquisitions
- The IRC §368 alphabet & statutory framework
- Common terminology & important concepts
- Planning considerations

§338 – Overview and Historical Background

Stock sale vs. Asset sale

- Purely business standpoint – often preferable to buy stock
- Federal income tax purposes – often preferable to buy assets
 - Basis step-up

§338

- Treats stock purchase as an asset purchase
- Allows a corporate purchaser the convenience of a stock purchase with tax benefits (step-up) of an asset purchase

§338 Election – Overview

- Sale of Target (T) stock
 - Gain recognized by T on deemed sale of assets from Old T to New T
 - Adjusted Deemed Sales Price (Seller) - Reg. § 1.338-4
 - ADSP allocated among acquisition date assets under Reg. § 1.338-6 & -7
 - Deemed liquidation of Old T following the asset sale
 - New T has stepped-up basis in assets.
 - Adjusted Grossed-Up Basis (Buyer) - Reg. § 1.338-5
- Deemed steps are treated as actually occurring for Federal Tax purposes.
- IRC §338 intends to create the same tax results as any other asset sale.
 - Use of an installment note or contingent purchase price requires special consideration & planning

Qualified Stock Purchase – Basic Principles

- In order to qualify for an IRC § 338 election, a “qualified stock purchase” (QSP) must occur.
 - Generally, acquisition must occur within a 12 month period.
- Definition: Any transaction or series of transactions in which target stock meeting the 80% vote and value affiliation requirements of IRC §1504(a)(2) is acquired by purchase during the “12-month acquisition period”
 - Ownership requirement to file as a part of a consolidated income tax return

Qualified Stock Purchase – Basic Principles

- Eligible Purchasers
 - Limited to Corporations (or entities treated as corporations) including S Corporations
- “Purchase”
 - Essentially limited to unrelated purchaser and seller, where seller recognizes all of the gain or loss on the sale
 - Purchase can include not only acquisition of stock, but also redemptions of stock from unrelated target owners within the 12 month period (redemptions serve to reduce the denominator of total outstanding stock for determining the 80% vote/value test)
 - Reverse Cash Merger (See Rev Rul 90-95)

Qualified Stock Purchase – Basic Principles

- Purchase - Specifically Excluded Transactions:
 - Acquisition where basis of target stock, in the hands of the acquiring corporation is determined in any way by reference to the basis of stock in the hands of the seller
 - Acquisition where basis is determined under IRC §1014, relating to property acquired from a decedent
 - Acquisition that qualifies under IRC §351, 354, 355, or 356, or any other transaction where seller does not recognize all gain
 - Acquisition of stock from a related party (e.g. IRC §304)

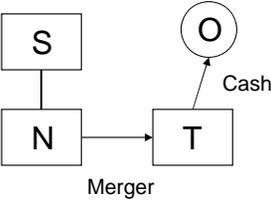
Qualified Stock Purchase – Detailed Analysis

Multi-Step Transaction

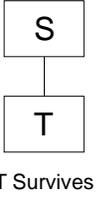
- Subsequent liquidation of T does not cause failure of the QSP (Rev. Rul. 90-95)
- Elimination of corporate acquirer immediately after the purchase may cause failure of the QSP – Why?
- Special rules cover interaction with tax-free reorganization provisions (Rev. Rul. 2001-46 & 2008-25)

Qualified Stock Purchase – Reverse Cash Merger

Reverse Subsidiary Merger – Rev. Rul. 90-95



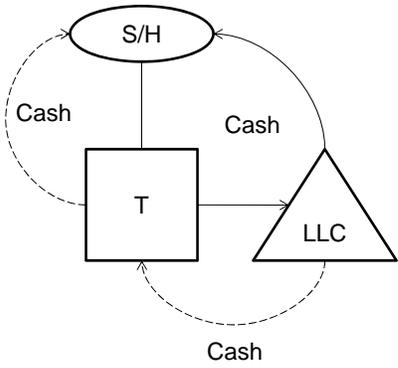
The diagram shows a parent company 'S' (square) with a subsidiary 'N' (square). 'N' is merging with a target company 'T' (square). An arrow points from 'N' to 'T' with the label 'Merger'. Above 'T' is a circle 'O' with an arrow pointing to it labeled 'Cash'.



The diagram shows the result: 'S' (square) is now the parent of 'T' (square). Below 'T' is the text 'T Survives'.

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Alternative to 338(h)(10) – Forward Cash Merger



The diagram shows a shareholder 'S/H' (oval) owning a target company 'T' (square). 'T' is merging with an LLC (triangle). An arrow points from 'T' to 'LLC' with the label 'Cash'. A dashed arrow points from 'LLC' back to 'S/H' with the label 'Cash'. Another dashed arrow points from 'S/H' to 'T' with the label 'Cash'.

Revenue Ruling 69-6

- T is merged with and into LLC in exchange for cash
- Target is deemed to transfer assets to P in exchange for consideration
- Target is then deemed to liquidate & distribute consideration to shareholders
- Effective where you do not have (or want) a corporate acquirer

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§338(h)(10) Election – Overview

- §338(h)(10) Election
 - Joint Election made by Target (T) and Purchaser (P)
- Must be a Qualified Stock Purchase (QSP)
 - 80% of Target Voting Power
 - 80% of Target Value
 - Transactions occur within 12-month period
- Eligible Targets
 - S Corporation
 - Subsidiary of a Consolidated Return (Not the Parent)
 - Member of Affiliated Group not Filing a Consolidated Return

§338(h)(10) Election – Making the Election

- Election made jointly by Purchasing Corporation and Sellers of Target
- Form 8023 must be filed no later than the 15th day of the 9th month following the acquisition
 - Both Purchaser and Seller must sign the election
 - If either party an S corp, must be approved by all shareholders
 - Non-selling parties must also consent to election
- Election is irrevocable
- If §338(h)(10) election is not valid, §338 election is also not valid.

Adjusted Deemed Sales Price (Reg. §1.338-4)

- ADSP = Grossed-up amount realized on sale, plus liabilities of target less selling costs

Adjusted Grossed-Up Basis (Reg. 1.338-5)

- AGUB: the amount for which T is deemed to have purchased all of its assets.
- AGUB is the sum of:
 - The grossed-up basis in the P's recently purchased T stock
 - P's basis in non-recently purchased T stock, and
 - Liabilities of new T (including T's tax liability)
 - acquisitions costs

Asset Sale Reporting – Section 1060

- All sales of assets used in a trade or business must be reported on Form 8594 in the year the sale occurs
 - If a §338(h)(10) transaction, use Form 8883
 - Must be filed by seller and purchaser
- Consideration allocated using the **residual method** from Reg. §§1.338-6 and 1.338-7
 - Consideration includes assumed liabilities (not the same as ADSP).
- If the purchase price allocation is agreed upon in the sales agreement, both parties are bound by the allocation.
- Tax & GAAP allocations are often different particularly in accounting for the assumption of liabilities and deferred revenue.

Allocation Classes

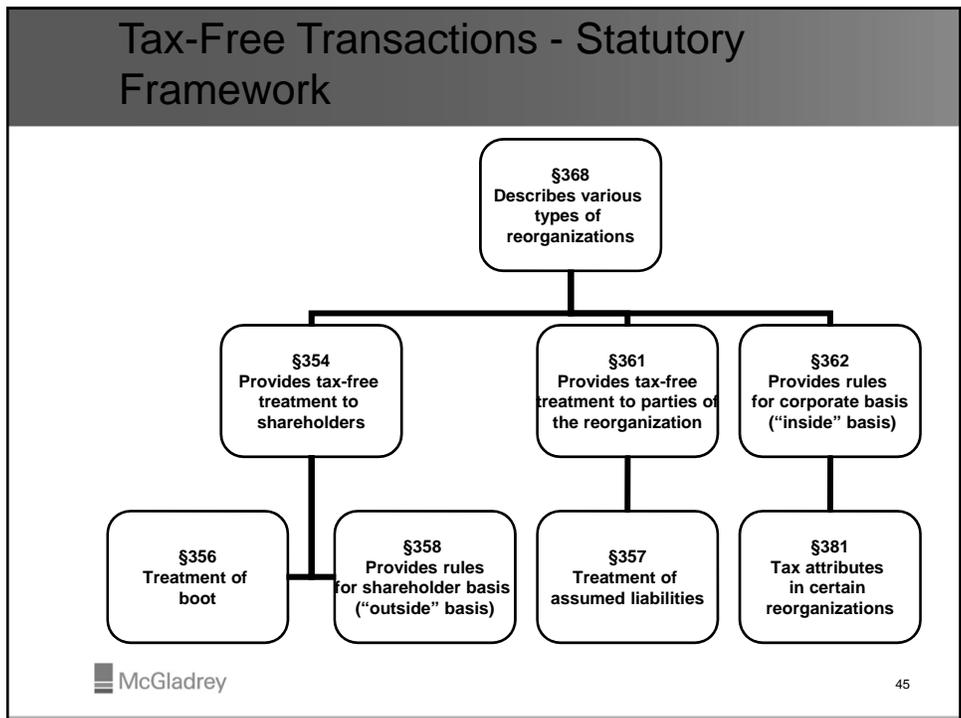
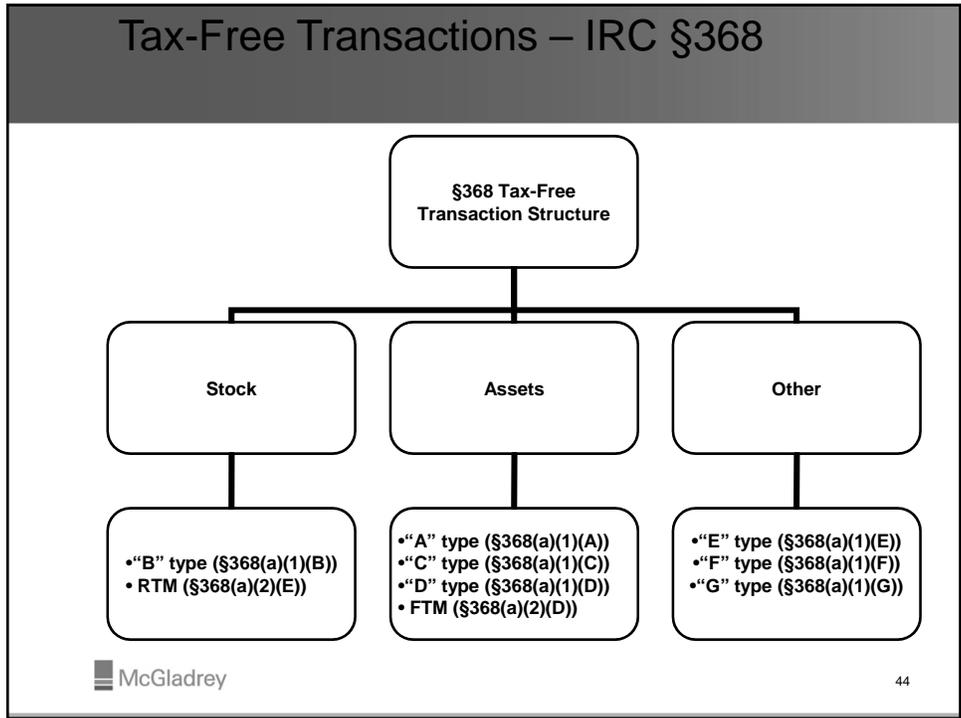
- Class I – Cash & general deposit accounts
 - Allocation must equal FMV of these assets
- Class II – Actively traded personal property as defined in 1092(d)(1)
 - Publicly traded stocks, government securities, CDs, foreign currency
- Class III – Accounts receivable
 - Includes mortgages and credit card receivables if in regular course of business

Allocation Classes

- Class IV – Inventory
- Class V – Anything not defined in any other class
 - Fixed assets
- Class VI – Section 197 assets except goodwill and going concern value
 - Trademarks, non-competes, other identifiable intangibles
- Class VII – Goodwill and going concern value

Section 368: Tax-free Mergers and Acquisitions





General Requirements of IRC §368

1. Party to a Reorganization
2. Plan of Reorganization
3. Business purpose
4. Continuity of proprietary interest (COI) – Reg. §1.368-1(e)
5. Continuity of business enterprise (COBE)
6. Other Judicial Doctrine

Continuity of Interest (COI)

- The shareholders must receive significant qualifying consideration, i.e. stock or securities, in the acquiring corporation to retain a continuing interest in the venture under “modified corporate form”
 - *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2nd Cir. 1932)
- Total qualifying consideration is compared total merger consideration to determine whether COI is met
- Judicial doctrine adopted by Reg. §1.368-1(b).

Planning Note: The Regs. provide rules regarding fixed and contingent consideration and other situations which are beyond the scope of this session, but all must be addressed with evaluating whether a transaction is a qualified reorganization.

Continuity of Interest (Cont.)

- Pre and Post-Reorganization Continuity must be evaluated (detailed regulations exist)
- The amount of continuity needed depends on the type of reorganization
 - Based on case law, the consideration mix will include at least 38% stock for an “A” merger
 - Reg. §1.368-1(e)(2)(v), Ex. 1 states that a 40% continuing interest is sufficient to meet COI
 - Other types of reorganizations will require a much higher stock component (“B” & “C” requires solely voting stock)
- Not required for “E” and “F” reorganizations pursuant to Reg. §1.368-1(b)

Continuity of Business Enterprise (COBE)

- The continuity of business enterprise (COBE) is achieved if the acquiring corporation continues the target corporation’s historic business or uses a “significant” portion of its historic business assets – Reg. §1.368-1(d)
- For example: If there are 3 historic lines of business of equal value, the preservation of one is sufficient to maintain COBE
- Not required for “E” and “F” reorganizations pursuant to Reg. §1.368-1(b)

Business Purpose and Other Judicial Doctrine

- Business Purpose: Reorganization must have a non-tax business purpose
- Economic Substance: The facts & circumstances must demonstrate that a transaction has objective non-tax considerations.
 - Codified under § 7701(o) which provides a two-prong (Subjective & Objective) Test.
 - Strict Liability Penalty imposed under §§ 6662(b)(6).
- Sham Transaction: Only motivation underlying a transaction is that of tax avoidance.

Other Judicial Doctrine (Cont.)

- Step Transaction: Collapsing a series of separate meaningless transactions into one transaction to determine true substance, and thus, true tax consequences (another economic substance analysis)
 - 3 Part Test: Binding Commitment, End Result, & Mutually Interdependent.
- Substance Over Form: Looks past a transaction's documentation and other elements to determine the substance of the transaction.

Planning Note: The judicial doctrine above should not be ignored, nor minimized when evaluating a transaction. Non-tax professionals often minimize their importance, but these may be the areas most likely attacked under IRS scrutiny.

Sections 382

Limitations on Net Operating Losses and Credits

Outline: Section 382

- Section 382 and Section 383 in general
- Section 382 specifics
 - Loss corporation
 - Ownership change
 - Testing dates
 - Ownership shift
 - Stock and non stock
 - Testing period
- Impact of a change in ownership

Outline: Section 382

- Detailed look at Section 382
 - Change date
 - Constructive ownership
 - Entity attribution
 - 5% shareholders
 - Segregation rules
 - Stock ownership presumptions
 - Loss corporation's duty to inquire

Section 382 – General rules

- Ownership change under Sec. 382 occurs if:
 - Testing date occurs (ownership shift or equity shift)
 - Cumulative increase of >50% in ownership of 5% shareholder(s) over the lowest % ownership during the testing period
- Upon an ownership change:
 - Loss corporation's utilization of NOLs, built in losses, and certain credits (Sec. 383) are subject to an annual limitation

Section 382 – The “Loss Corporation”

- Corporation entitled to use an NOL in a year or incurring an NOL in the year a testing date occurs
- Also applies to corporations with a net unrealized built in loss and corporations with certain credit carryovers (Sec. 383)
 - Timing of NUBIL is important as the corporation need not have an NOL to be subject to Sec. 382
- Successor rules can result in survivor of a merger becoming a loss corporation

Section 382 – Testing date

- Ownership is tested at the end of the testing date
- Any change in stock ownership, if
- The change affects % of stock held by a 5% shareholder
 - No de minimus exception
 - Exchanges between non 5% shareholders are generally disregarded
- Measurement between lowest % and % at the end of the testing date

Section 382 – Owner Shift

Examples:

- Purchases
- Redemptions
- Sec. 351 transactions
- Issuances
- Debt to equity conversions
- Equity structure shifts
- Worthless stock deduction

Section 382 – Owner Shift

Equity structure shift:

- Any Sec. 368 reorganization other than an “F”, divisive “D” or “G”
 - Redemptions or other transactions that occur in conjunction with an “F” may cause an owner shift or equity structure shift
 - Small issuance exception (discussed later) does not apply

Section 382 – Stock

Only changes in stock generate testing dates

- All stock other than as defined within Sec. 1504(a)(4)
 - Nonvoting, nonparticipating, nonconvertible
 - Limited and preferred as to dividends
 - Not entitled to an unreasonable redemption or liquidation premium
 - Even where stock becomes voting due to dividend arrearages
- Each share of stock with the same terms is assumed to have the same value

Section 382 – Treatment of options

Option:

- Warrant, option, put, option to acquire an option
- Convertible debt
- Stock subject to substantial risk of forfeiture (restricted)
- Contract to acquire stock
- Similar interests
- Generally not convertible stock

* Note that warrants issued deeply in the money could represent stock under general tax principles

Section 382 – Treatment of options

- In general an option is not treated as exercised unless the principle purpose of the issuance is to avoid or ameliorate the impact of an ownership change
- Prior regulations were basically the opposite
- As a result we are *generally* able to ignore options and warrants
- Restricted stock should generally not be considered until the restriction lapses

Section 382 – Testing period & Change Date

Determining the testing period

- 3 year period ending on a testing date
- Shorter periods in the following situations:
 - If an ownership change occurred within the 3 year period, the testing period begins the day after the change date
 - The first date of the tax year that an NOL or NUBIL exists

Change Date

- Testing date that results in an ownership change

Section 382 – Constructive Ownership

- Attribution under Sec. 318(a)(1) does not apply
 - However, all stock held by the Sec. 318(a)(1) relationship are treated as one shareholder
 - Spouse, parents, children, grandchildren
- Attribution under Sec. 318(a)(2)
 - Proportionate ownership
 - No 50% requirement for corporate ownership
 - Corporation not attributed stock from shareholders
- Actual ownership of stock is disregarded if attributed to a shareholder or higher tier entity

Section 382 – 5% Shareholder Rules

5% shareholder

- Shareholder owning stock of the corporation representing 5% of the value at any time during the testing period
 - Direct or indirect
- Non 5% shareholders are aggregated into a single 5% shareholder (subject to segregation discussed later)
- Determined after applying constructive ownership rules

Section 382 – Stock ownership Presumptions

Publicly traded stock

- May rely on presence and absence of 13D & G filings to determine stock ownership
 - Same applies for higher tier entities
- Actual knowledge that filer is not the economic owner may allow taxpayer to disregard the filing
 - Investment advisor who does not have the right to dividends and proceeds upon sale

Section 382 – 5% Shareholder Rules

Example 1:

- A files an initial 13D showing ownership of 7%
- Loss corporation may assume that A had 0% prior to the filing or may inquire as to previous ownership during the testing period

Example 2:

- A files a final 13D showing ownership of 3%
- Previous 13D showed ownership of 8%
- Loss corporation may assume that 3% is owned throughout the remaining testing periods that include the testing date

Section 382 – Segregation Rules

- Certain transactions result in segregation
- Segregation of public groups of the loss corporation
- Applied only to Direct Public Groups
- Creates new public groups separate from the original and subsequently created public groups
- Following an ownership change public groups are aggregated back into a single group

Query: How likely is it that you only have a single public group?

Section 382 – Segregation Examples

Apply the segregation rules:

- LossCo issues 300 shares to the public in an IPO
- Following the transaction LossCo has 1,000 shares outstanding
- PG1 owned 500 of the 700 shares outstanding prior to the IPO
- The remaining 200 shares are owned by individual X
- What is ownership following the IPO?

Section 382 – Segregation Rules

Segregation rules apply to direct 5% shareholders as well as the LossCo

Example:

- Individual X owns 15% of LossCo and sells 7% on the public market – no one person acquires 5%
 - PGX is created and will be treated as acquiring 7%
 - Would your answer change if X only sold 2% of LossCo on the public market?

Section 382 – Segregation Rules

- Why does it matter?
 - On Date 1 John Doe owns 10% of LossCo, PG1 & PG2 each own 45%
 - John Doe sells 4% on Date 2
 - Joe Black acquires 12% on date 3
- Test the ownership % with and without creating a new public group

Section 382 – Segregation Rules

Redemptions:

- Public group is split into two groups immediately before the redemption
- Following redemption the newly created public group is eliminated
- Example: PG1 owns 100% of LossCo and LossCo redeems 30% of the stock – PG2 is created and is treated as owning 30% before and PG1 owns 70%
 - The redemption causes a 30% increase in PG1's ownership

Section 382 – Segregation Exceptions

- Two significant exceptions simplify and ease application of the segregation rules
 - Small issuance exception
 - Cash Issuance exception
- Amount of stock exempted from the segregation rules is allocated proportionately to the existing public groups
 - Actual knowledge can rebut proportionality

Section 382 – Segregation Exceptions

Small issuance exception:

- Applies to Sec. 1032 transactions & recapitalizations (not equity structure shifts)
- 10% of the value of the company or 10% of a class
 - Based upon the beginning of the year value or outstanding shares
- An issuance can be partially eligible for the small issuance and partially subject to segregation
 - LossCo issues 4 separate 3% issuances
 - On the 4th issuance only 1% qualifies for the SIE and a new PG is created for the remaining 2%

Section 382 – Segregation Exceptions

Cash issuance exception:

- Solely for cash (not option exercises or debt conversions)
- May apply to portion of a small issuance that exceeds the 10% limit

Segregation does not apply to:

- Half of the % interest of direct public groups immediately prior to the issuance

Section 382 – Segregation Exceptions

Example: Cash issuance exception

- LossCo is owned by PG1 80%, Individual A 20%,
- LossCo issues 5M shares to the public solely in exchange for cash
 - 80% x 50% or 40% of the 5M is eligible, so 2M of the shares are allocated to PG1 and the remaining 3M are allocated to a new PG

Section 382 – Segregation Exceptions

Limits on exceptions:

- Amount of stock exempted from segregation cannot exceed the amount the amount of stock issued less the amount issued to a 5% shareholder (other than a public group)
 - Cannot exempt more than the amount that is issued to non 5% shareholders

Section 382 – Presumptions & Duty to Inquire

- Public companies – 13D & G (existence & absence)
 - May disregard with actual knowledge
- May rely on first and higher tier entities to determine changes in ownership of the entity
- LossCo has a duty to inquire in determining ownership held by:
 - Individual shareholders >5%
 - First tier and higher tier entities
 - Indirect >5% owner through an entity
 - No duty to inquire whether an individual with less than 5% directly owns in total more than 5% through ownership of less than 5% through entities



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Section 382 – Calculating the Limitation

- Single limitation applies to both §382 and §383
- Limitation is tax-effected under §383
- Example
 - LossCo has an annual limitation of \$200
 - LossCo has \$5,000 in NOL and \$1,000 in credits subject to §383
 - LossCo generates \$500 in post-acquisition income
 - Describe the utilization



Section 382 – Identification

- Any taxpayer utilizing NOLs in the current year should be a target
- Companies taking a benefit for NOLs on their financial statements are also targets
- Banks (including S corporations) in need of additional capital
- Companies that have raised significant capital in the past – particularly those companies with multiple classes of stock
- Companies that have undergone a change but are not sure what the actual NOL limitation is
- Companies need not have NOLs

Section 382 – What is a Study

- A section 382 study is generally a two-phased analysis
- Phase I: determine whether a change (or how many) has occurred during the analysis period
 - Determine the appropriate methodology (FVM or HCP)
 - Identify testing dates, 5% shareholders and segregation
- Phase II: determine the annual limitation
 - Determine whether a NUBIG or NUBIL
 - Application of Notice 2003-65 to determine increase to annual limitation (if a NUBIG)