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THE VALUE OF NET OPERATING LOSSES[1]

When a corporation incurs a net operating loss (NOL), it can use the NOL to obtain refunds of taxes paid during the previous two years. Any NOLs remaining after the two year carry-back period can be carried forward for 20 years to offset future taxable income (which includes net capital gains).[2]

When a corporation with accumulated NOLs—*a loss corporation*—sells its assets for cash *(i.e., taxable asset acquisition)*, it can use the NOLs to offset taxable income arising from the sale. Similarly, if a loss corporation distributes assets to its shareholders, the corporation can also use the NOLs to offset taxable income arising from the distribution of appreciated assets. However, any NOLs remaining after a distribution, which is part of a *complete* liquidation of a loss corporation, disappear.[3]

When the shareholders of a loss corporation sell their shares for cash *(i.e., taxable stock acquisition)* or engage in a *tax-deferred reorganization*, the loss corporation's NOLs survive. However, the value of its NOLs to the acquirer is affected by Section 382 of the Internal Revenue Code (IRC). In an effort to discourage the buying and selling of loss corporations solely for the purpose of taking advantage of their NOLs (i.e., trafficking in NOLs), Congress limited the use of a loss corporation's NOLs in Section 382. Section 382 does not change the loss corporation's total amount of NOLs or their expiration period; it creates *limitations* on their use.

[1] This technical note discusses net operating losses accumulated by parent C-corporations and is not applicable to NOLs of subsidiaries or S-corporations.

[2] In 2001 and 2002, the carry-back period was five years. Corporations can elect to forgo the carry-back period.

[3] Other tax attributes, such as net capital losses and "earnings and profits," also disappear if a taxable asset acquisition is followed by a complete liquidation. These consequences to tax attributes are also applicable to a taxable stock acquisition with a 338 election because the corporation is deemed to have sold its assets and completely liquidated. They are not applicable to a taxable stock acquisition with a 338(h)(10) election.

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Section 382: The Basics

Owner shift and ownership change

In determining whether Section 382 applies to a transaction, there must be both an *owner shift* and an *ownership change*. While these definitions encompass typical stock acquisitions and tax-deferred reorganizations, Section 382 applies to a much broader set of transactions as described below.

The first step in establishing whether Section 382 applies is to determine if an *owner shift* has occurred:

- *Definition of an owner shift*
  - A change in ownership that affects the ownership percentage of a shareholder who owns at least 5% (i.e., 5% shareholder) of the loss corporation's shares.
  - The acquisition involves a 5% shareholder if the shareholder owns at least 5% before or after the transaction.
  - Shareholders, who are not 5% shareholders at the time of the transaction, are aggregated and treated as one 5% shareholder.
  - This definition prevents normal trading by shareholders, who own less than 5%, from being an owner shift.

- *Examples of an owner shift*[4]
  - A sale of shares by an existing 5% shareholder
  - A purchase of shares by an existing 5% shareholder
  - A purchase of 5% of a loss corporation's shares creating a 5% shareholder
  - A redemption of the loss corporation's shares affecting the ownership percentage of a 5% shareholder (i.e., a non pro-rata redemption)
  - A recapitalization affecting the ownership percentage of a 5% shareholder
  - A stock issuance affecting the ownership percentage of a 5% shareholder
  - An equity structure shift (i.e., tax-deferred reorganization)
  - A transaction under Section 351 (i.e., formation of a new corporation) that affects the ownership percentage of a 5% shareholder

[4] While examples of an owner shift often refer to changes in ownership of a target, the loss corporation with an owner shift could also be an acquirer.

- *Definition of shares used to calculate an owner shift*
  - Includes common stock and some preferred stock (e.g., voting or convertible preferred stock).
  - Does *not* include employee stock options unless the primary purpose of the options is to reduce the impact of the owner shift.
  - Does *not* include shares bought and sold by underwriters on the same day as part of a public offering.

If an owner shift has occurred, the second step is to determine if an *ownership change* has occurred.

- *Definition of an ownership change*
  - The ownership of the 5% shareholders has increased by more than 50 percentage points from the *lowest* point over the prior *three* years.
  - Shareholders, who are not 5% shareholders at the time of the transaction, are aggregated and treated as one 5% shareholder.

- *Examples of an ownership change*

Examples	**Now**	**Lowest**	**Difference**
The acquirer buys 51% of the target's shares and the acquirer did not hold the target's shares prior to the purchase.	51%	0%	51%
The founders, who own 100% of the target, sell ¾ of their holdings through an initial public offering and none of the new shareholders own > 5%.	75%	0%	75%
Through a tax-deferred reorganization, the acquirer's shareholders own 60% of post-merger entity and the acquirer did not hold the target's shares prior to the purchase.	60%	0%	60%