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# Recent Tax Legislation Expands Opportunities to Utilize Net Operating Losses for Tax Refund

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As a result of the economic downturn, many businesses generated net operating losses ("NOLs") for federal income tax purposes for their 2008 and 2009 taxable years. The Worker, Homeownership, and Business Assistance Act ("WHBAA"), enacted in November 2009, expanded the ability of taxpayers to carry back these NOLs to offset income from prior tax years. Many taxpayers will be able to take advantage of this legislation to obtain tax refunds.

Even with the expanded carry back provisions, however, a taxpayer may not have sufficient income in prior years to fully utilize its NOLs. In other cases, a taxpayer may choose to waive its ability to carry back NOLs because it determines that the NOLs will be of greater value to it in the future. In either case, a taxpayer may generally carry its NOLs forward for up to 20 years to offset its income in those tax years. However, in the case of a corporation, careful tax planning is required to prevent substantial restrictions on the corporation's use of such NOLs under Section 382 of the Internal Revenue Code of 1986, as amended (the "Code").

## The WHBAA

In general, a taxpayer may carry back NOLs two years. However, the WHBAA extended this period to up to five years. (A separate act, The American Recovery and Reinvestment Act ("AARA"), enacted in February 2009, applies only to the 2008 NOLs of a business with average annual gross receipts of $15 million or less for the previous three-year period. Because the WHBAA is much broader than the AARA, this article focuses on the WHBAA).

Under the WHBAA, any taxpayer (other than a taxpayer that received Troubled Asset Relief Program funds) may elect to carry back NOLs generated in eligible tax years for three, four or five years (as selected by the taxpayer). For this purpose, an eligible tax year is a tax year beginning or ending in either 2008 or 2009. Thus, for a calendar year taxpayer, WHBAA applies to NOLs incurred in 2008 or 2009. For a fiscal year taxpayer, it applies to NOLs incurred in tax years ending as early as January 31, 2008, or as late as November 30, 2010. A taxpayer may elect the extended carry back provisions of WHBAA for only one eligible tax year.

Under WHBAA, if a taxpayer elects to carry back its NOLs from an eligible tax year to the fifth preceding tax year, the NOL can offset only 50 percent of the taxpayer's income in that year. This limitation does not apply if the taxpayer elects to carry back its NOLs to the fourth or third preceding tax years.

To utilize the extended carry back period under WHBAA, a taxpayer must: (1) file an election statement for the extended carryback; and (2) request a refund, in each case under specific procedures set forth by the Internal Revenue Service ("IRS"). Whether the election is made with respect to 2008 NOLs or 2009 NOLs, the election must be made by the due date (including extensions) for filing the tax return for the last tax year beginning in 2009. Thus, in the case of a calendar year taxpayer (for example), the election may be made with respect to 2008 NOLs or 2009 NOLs as late as September 15, 2010. (If the tax return for 2008 or 2009, as applicable, has already been filed, an amended return or an amended carry back statement can be filed).

## Section 382 Restrictions a Corporation's Use of NOLs

If the NOLs of a taxpayer are not fully utilized under the above carry back provisions, or the taxpayer waives its ability to carry back NOLs, the taxpayer will generally be able to carry forward its NOLs for up to 20 years to reduce taxable income in those years. However, tax plan-

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## Recent Tax Legislation Expands Opportunities to Utilize Net Operating Losses for Tax Refund (cont'd.)

ning is critical. Under Section 382 of the Code, the ability of a corporation to carry forward losses can be severely limited. (Although not the focus of this article, Section 382 also limits the ability of a corporation to utilize certain "built-in losses").

Under Section 382, if a corporation undergoes an "ownership change," an annual limit on the corporation's use of its NOLs is imposed. The annual limit is generally equal to the product of a statutory rate published monthly by the IRS and the fair market value of the corporation's stock immediately before the ownership change.

For example, suppose a corporation whose stock is worth $100 million undergoes an ownership change in April 2010, at a time when the corporation has $20 million NOLs. For April 2010, the statutory rate for purposes of Section 382 is 4.03 percent. Under Section 382, the corporation would be permitted to utilize a maximum of $4.03 million per year of its $20 million NOLs ($100 million x 4.03 percent).

An ownership change generally occurs where the percentage of stock owned by any one or more "5-percent shareholders" of the corporation increases by more than 50 percent during a three-year period. For this purpose, the meaning of a 5-percent shareholder is determined by applicable tax rules and is not the same as for securities law purposes. A company is required to identify and monitor its 5-percent shareholders in order to determine if it is subject to Section 382.

In the case of a publicly traded company, the identification of the company's 5-percent shareholders can be extraordinarily complex. Due to the differences in the meaning of 5-percent shareholder for tax purposes and securities law purposes, the company may rely on filings with the Securities and Exchange Commission only to a limited extent. Typically, the company must obtain additional information from its significant shareholders regarding their stock ownership through the use of questionnaires, telephone calls, and/or email. This process involves an ongoing coordinated effort between the company and its tax advisors.

An increasing number of companies have adopted shareholder rights plans (or "poison pills") to prevent an ownership change, thereby preventing the company from being subject to Section 382. These plans generally seek to prevent a shareholder from acquiring five percent or more of the company's stock (subject to waiver by the company's board of directors). In *Selectica, Inc. vs. Versata Enterprises, Inc.*, 2010 WL 703062 (Del. Ch. Feb. 26, 2010), the Delaware Court of Chancery recently upheld the use of such a plan under the particular facts of that case.

A corporation that has NOLs is subject to certain record keeping and reporting requirements. Pursuant to these requirements, the corporation must identify its 5-percent shareholders and determine the percentage of stock owned by each 5-percent shareholder. The corporation must also determine whether the Section 382 limitations apply. In addition, for each year in which the corporation has NOLs, the corporation must file a statement with its federal income tax return setting forth the amount of its NOLs and the dates on which any changes in ownership by a 5-percent shareholder occur.

### About the Author

Andrew Betaque is a partner at Locke Lord. He provides counsel on a wide range of business tax matters for both publicly traded and private companies. His practice focuses on corporate and partnership taxation. Mr. Betaque has extensive experience with corporate formations, liquidations, reorganizations and acquisitions. He also has extensive experience with the taxation of partnerships, joint ventures and limited liability companies.



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