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Valuation updates | Valuation for IRC § 382

This thought leadership paper provides insights on valuation requirements under IRC § 382

IRC § 382 - An understanding

Acquisitions are motivated by various factors some of them being operating synergies with existing businesses, foray into new business segments, as a part of a turn-around strategy etc. However, many a time acquisitions are effected to capitalize on the tax attributes of a loss making target corporation which have the consequence of reducing the future tax liabilities of the acquirer. Based on this understanding, a corporation with accumulated tax loss carry-overs is theoretically more valuable than an otherwise similar corporation without loss carry-overs.

Assuming the two corporations project the same future stream of pre-tax income, the corporation with loss carry-overs will anticipate higher after-tax yields. An acquirer should be willing to pay an additional amount for the loss corporation up to the present value of the projected future tax savings resulting from the anticipated use of loss carry-overs to offset future income. One of the many perils of acquisitions effected with such intent is defeating the principle of tax neutrality, which posits that tax implications should neither impede nor induce business transactions.

The US Congress enacted IRC § 382 to prevent taxpayers from such **'trafficking'** in tax losses. The tax benefits that can be limited through this section include net operating losses (*'NOL's*), net capital losses (*'NCL's*), and net unrealized built-in losses and depreciation deductions attributable to those built-in losses, thereby increasing the corporation's corporate tax liability.

Valuation consideration under IRC § 382

Valuation consideration stems from the definition of 'value' per IRC § 382(k) (5) to be **'Fair Market Value (FMV)'**.

Internal Revenue Service (*'IRS'*) revenue ruling 59-60 defines FMV as *'the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts'*.

Limitations under IRC § 382 is enforced by capping the annual net operating losses that can be utilized by a **loss corporation** against future taxable income in an event of an **ownership change**.

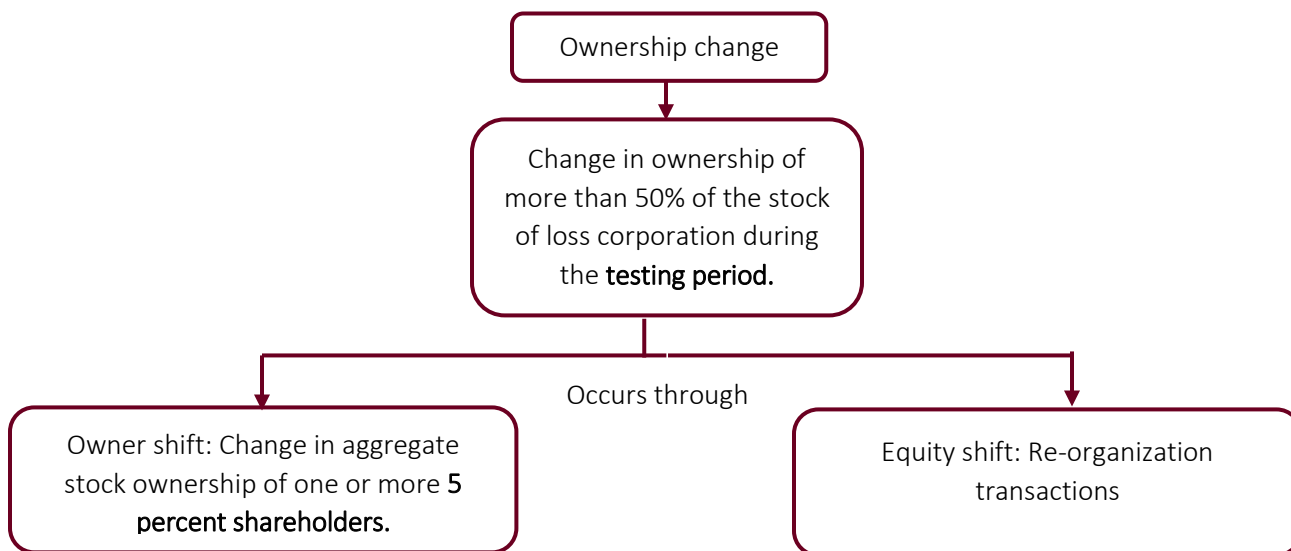
The annual limitation of net operating losses that may be utilized is computed as under:

$$\text{Limitation under IRC } \S \text{ 382} = \text{Value of old loss corporation ('FMV')} \times \text{Long-term tax exempt rate}$$

Some key tax based concepts and definitions are included that explains the triggering event and applicability of IRC § 382

When is IRC § 382 triggered?

IRC § 382 is triggered when an **ownership change** occurs in a **loss corporation**.



- **Loss corporation:** The term ‘loss corporation’ means a corporation entitled to use a net operating loss carry-over or having a net operating loss for the taxable year in which the ownership change occurs;
- **5-percent shareholder:** A ‘5-percent shareholder’ includes any person holding (including indirect holding) 5% or more of the loss corporation's stock during the ‘testing period’; &
- **Testing period:** The ‘testing period’ is generally the 3-year period ending on the date of ownership change.

Illustration 1: An individual that previously did not own stock of the loss corporation acquires 52 percent of the stock via a tender offer. Following the tender offer, the individual is a ‘5-percent shareholder’ whose percentage ownership has increased by more than 50 percentage points, triggering an ownership change.

Illustration 2: Company is a ‘loss corporation’. Ten unrelated individuals that previously did not own any company stock each acquire 6% of company's stock. Following the acquisitions, each individual is a ‘5-percent shareholder’ and each has separately caused a 6 percentage point increase. In the aggregate, they have caused a 60 percentage point increase, triggering an ownership change.

As per IRC § 382(e)(1), ‘Except as otherwise provided in this subsection, the **value of the old loss corporation** is the value of the stock of such corporation (including the value of any ‘plain vanilla’ preferred stock) immediately before the ownership change’.

The limitation under IRC § 382 is similar though less restrictive than the provisions of section 79 of the Income Tax Act, 1961 of India. According to this section, in case of a change in shareholding of a private company, carry forward and set off of losses incurred in any prior year shall not be allowed for any future period barring a few exceptions.

The value of a loss corporation:

Includes	Excludes
Common stock of loss corporation, convertible preferred stock, voting preferred stock of loss corporation	Capital contribution made primarily to decrease the impact of annual limitation
	Substantive non-business assets (exceeding 1/3 rd of total value of loss corporation's assets)
	Capital contributions made 2 years prior to an ownership change

Determining the value of the stock involves a consideration of the following:

- For publicly traded companies the IRS has acknowledged that the stock value does not necessarily equal the trading value on an exchange, i.e. certain blocks of stock may have higher value due to control rights; &
- For privately held companies, different classes of stock may have different rights and vary in value.

In non-public corporations, where there are no recent sales, the corporation may wish to acquire an independent appraisal to support the value.

Taxation and valuation in sync

IRC § 382 is one of the few provisions of the IRS that require a professional appraisal to be made to satisfy the regulator's requirements as the value conclusion is a significant determinant of the limitation under the section. This is a striking example of how the diverse practices of the corporate world harmonize in sync for better reporting practices and enhanced regulatory compliances.

Case study - IRC § 382

Company A acquires 75% stake in Company B. Company B is a loss corporation having NOL's of USD 10 million that can be carried forward for 4 years. This is an ownership change of a loss corporation triggering IRC § 382. Company B has a FMV of USD 100 million as of the ownership change date.

Annual limitation of NOL's under IRC § 382 will be computed as follows:

Particulars	
i. FMV of Company B	USD 100 million
ii. Long term federal rate (<i>assumed</i>)	2%
Annual IRC § 382 deduction limit (i) * (ii)	USD 2 million

Scenario 1: Without limitation of IRC § 382

(All amounts in USD millions)

Particulars	2016	2017	2018	2019
i. Earnings before NOL's	2.0	3.0	4.0	5.0
ii. NOL's deduction	(2.0)	(3.0)	(4.0)	(1.0)
iii. Earnings after NOL's (i)-(ii)	-	-	-	4.0
iv. Tax @ 20%	-	-	-	0.8
Earnings after tax (iii)-(iv)	-	-	-	4.8

The NOL's of USD 10 million have been utilized by 2019.

Scenario 2: With limitation under IRC § 382

(All amounts in USD millions)

Particulars	2016	2017	2018	2019
i. Earnings before NOL's	2.0	3.0	4.0	5.0
ii. NOL's deduction*	(2.0)	(2.0)	(2.0)	(2.0)
iii. Earnings after NOL's (i)-(ii)	-	1.0	2.0	3.0
iv. Tax @20%	-	0.2	0.4	0.6
Earnings after tax (iii)-(iv)	-	1.2	2.4	3.6

* Per limitation under IRC § 382

The annual deduction of NOL's has been restricted to USD 2 million. As the NOL's can be carry forwarded for 4 years, the balance NOL's USD 2 million shall lapse beyond 2019.

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