

Tax planning opportunities in a recessionary economy

November 10, 2009

Speakers:

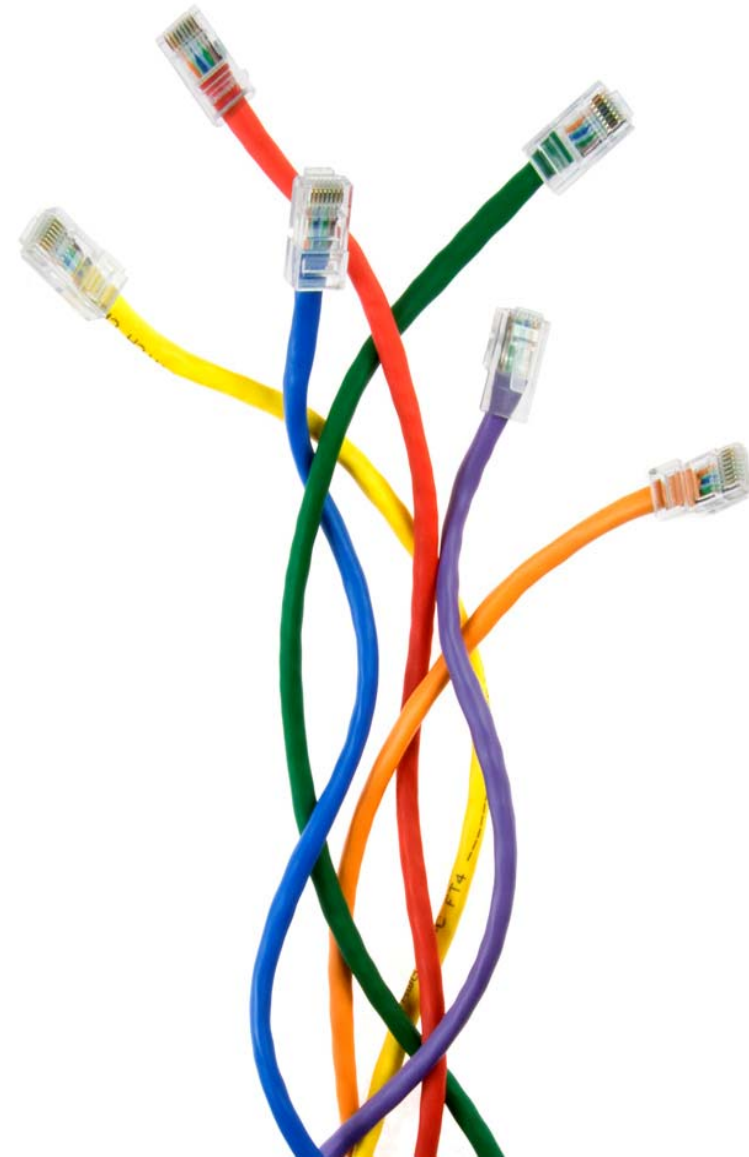
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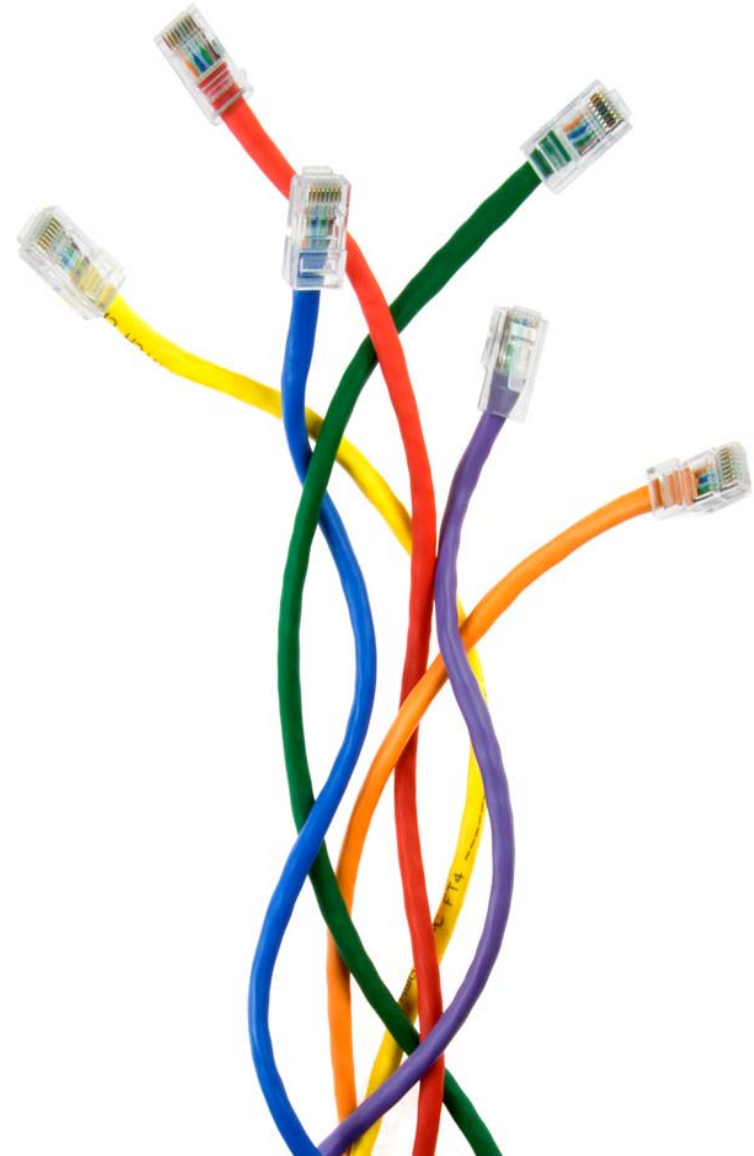
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International tax- Attribute optimization strategies

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November 2009



Time to rebalance?

- During the cheap debt boom, many U.S. based MNC's and their shareholder's pushed for higher leveraging
- Given the returns available, even cash rich companies borrowed to fund global acquisitions, share repurchases, shareholder dividends, etc.
- Several factors drove this increase in borrowings to be funded primarily by U.S. operations:
 - Low U.S. prime rate and weak dollar resulted in lower borrowing costs
 - High U.S. tax rate provides a higher benefit for interest deductions
 - Inherent ETR restrictions on accessing non-U.S. cash/debt capacity to fund payments to shareholders
- At the same time, the same MNC's also focused on optimizing ETR through:
 - Increased reliance on “permanent “deferral planning , and
 - Transfer pricing policies pushing more expenses to high rate jurisdictions like the U.S.
- The result of the increased borrowing in the U.S. and ETR planning offshore has companies right back in the pre-965 environment
- Consider also what is on the horizon:
 - Debt capacity has recently thawed and spreads have come back down, BUT
 - Over \$500bn of corporate bonds to be refinanced by 2012, approx 60% at B1 grade or lower
 - Significant defaults could drive the credit market into the Fall of '08 environment

Opportunities in the current environment

- “Never allow a good crisis go to waste...”
- Economic environment indicates:
 - Historically low valuations (note amount of 142 impairments in 2008/2009)
 - Further tightening of credit markets
 - A continued weakening of the USD
- While the political/regulatory environment indicate:
 - Major overhaul to the U.S. international tax code, affecting:
 - Deferral of foreign income/expenses
 - FTC utilization
 - Repatriation opportunities
 - Enhanced focus on “tax compliance”
- The existing economic and political/regulatory environment provide good opportunities to **rebalance** the Tax and Treasury portfolio, focusing on:
 - Attribute utilization to get cash back to the US:
 - Accessing high tax basis, PTI pools, FTCs
 - Worthless stock/bad debt planning
 - And then foregoing potential ETR for better global cash flexibility
 - Financing foreign subsidiaries with short term loans
 - Transfer pricing for services

Repatriation planning — Distributions and debt repayment

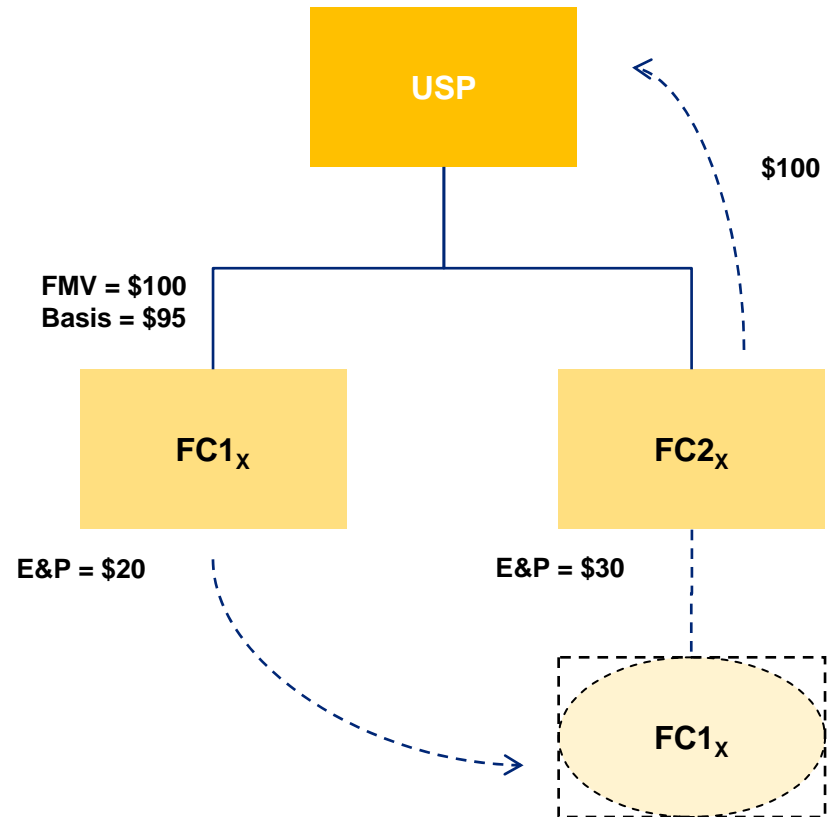
- **Distribution of Previously Taxed Income to the U.S.**
 - Identification and quantification of PTI pools—how good are your records?
 - Determination of tax basis in PTI pools, and baskets (Notice 88-71; Proposed section 959/961 regulations(?))
 - Measurement of section 986(c) gain/loss—109 treatment?
 - APB 23 position should be neutral
 - Local dividend requirements/restrictions, including withholding taxes, statutory profit limitations and regulatory approvals
- **Repayment of Existing Debt Owed to U.S. Parent**
 - 385 classification?
 - For loans denominated in non-FX, measurement of section 988 gain/loss on date of repayments
- **Returns of Capital**
 - Basis in underlying subsidiary
 - Cumulative E&P and nimble dividends
 - Circular cash flow notices

Repatriation planning — Repatriation transactions

- **Subsidiary Loans (Section 956 Loans)**
 - Short-term loans from foreign subsidiaries to U.S. shareholders (Notice 88-108; Notice 2008-91).
 - Determine whether debtor has E&P.
 - Section 956 anti-abuse and anti-conduit rules.
- **Advance Payments**
 - Prepayments with respect to inventory, royalties, and/or services (Treas. Reg. 1.451-Rev. Proc. 2004-34).
- **Section 368(a)(1)(D) Transactions (Type D Reorganization with Boot) (See Illustration)**
 - Repatriation of cash to U.S. parent as part of a reorganization under section 368(a)(1)(D)
 - FMV and tax basis of shares of target
 - “Effect of a dividend”; gain from sale or exchange of property thereafter. Section 356(a)(2).
- **Section 304 Transactions (See Illustration)**
 - Movement of E&P pools allowing for return of tax basis distributions from lower-tier subsidiaries.
 - Dividend equivalence (section 302/301) and exemption from subpart F for foreign-to-foreign transactions (section 954(c)(6)).
 - TD 9444 (February 2009): Disallowance of return of tax basis in certain section 304 transactions.
 - Consider capital gain/stamp duty tax issues in foreign jurisdiction.

Repatriation planning — Section 368(a)(1)(D) reorganizations with boot

- **Assumptions**
 - Offshore cash at FC2.
 - FMV, tax basis, and E&P amounts, as stated.
- **Steps**
 - FC2 purchases 100 percent of the shares of FC1 for \$100 (FMV). Thereafter, FC1 elects to be treated as a disregarded entity (or FC1 actually liquidates).
- **Analysis**
 - Assuming all other requirements are met, the transaction should be treated as a section 368(a)(1)(D) outbound asset reorganization with boot.
 - Gain should be recognized to the extent of the lesser of the boot received (i.e., \$100), or the built in gain associated with the shares of FC1 (i.e., \$5).
 - Gain recognized by USP should be treated as a dividend to the extent of the lesser of the built in gain associated with FC1's stock (i.e., \$5); or the E&P of FC1 plus the E&P of FC2 (\$20 + \$30 = \$50).
- **Considerations**
 - Business purpose and all other reorganization requirements fulfilled.
 - Foreign tax credit capacity at USP.
 - Gain recognition agreement should not be required.
 - Timing



Repatriation planning — section 304(a)(1) transaction

- Assumptions

- Offshore cash at FC2.
- FMV, tax basis, and E&P amounts, as stated.

- Steps

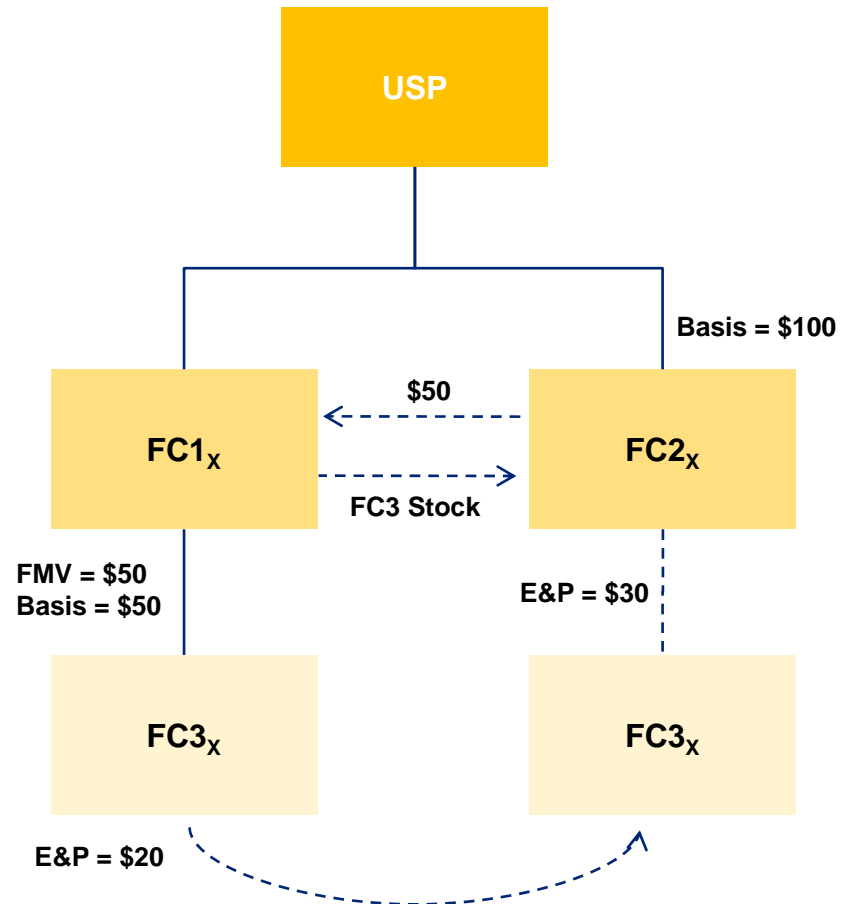
- FC2 purchases 100 percent of the shares of FC1 for \$50 (FMV).

- Analysis

- The sale transaction should be recharacterized pursuant to section 304(a)(1), resulting in (i) FC1's contribution of its FC3 stock to FC2 in exchange for FC2 shares; and (ii) a redemption by FC2 of the shares it was deemed to have issued in the section 351 transaction.
- The redemption is tested under section 302/301, and should be treated as a section 302(d) deemed dividend from FC2 to FC1 to the extent of FCs'2 E&P (i.e., \$30) and then to the extent of FC3's E&P (i.e., \$20).
- The transaction should move FC2's and FC3's E&P to FC1 (along with taxes). Thereafter, FC2 and FC3 will have no E&P.
- The deemed dividend paid to FC1 should qualify for the exception from subpart F income pursuant to section 954(c)(6) (provided FC1 does not have an existing section 952(c) recapture account).

- Considerations

- Basis recovery if payment exceeds E&P of acquiring and issuing corporations
- Fast-pay stock regulations



Repatriation planning — FTC attribute utilization

Foreign tax credit planning — E&P super pools

- **Obama Administration proposal combining E&P and foreign tax pools would have the effect of blending E&P and foreign tax pools for foreign tax credit purposes.**

Planning opportunity:

- **Many taxpayers are in an excess credit position with low FSI, but high allocations of interest, R&D and S,G & A. If under a VA and no plans to otherwise utilize, it may make sense to make selective distributions of high and low-taxed E&P to “refresh” the FTCs—particularly given the impact that the potential deferral of foreign source expenses would have on a company’s need to repatriate in the future and the blended rate at which such repatriation would occur.**

Current economic and political environment — Other thoughts to consider

E&P deficit planning

- Deficit planning may be prudent if the Obama Administration's proposal to create an E&P super pool becomes law.

Section 988 considerations when capitalizing subsidiary debt

- Thin cap issues may lead to the decision to capitalize intercompany debt. Note that capitalization of non-functional currency debt may trigger Section 988 gain/loss costs

Transfer pricing and the current economic environment

- Consider impact of potential U.S. expense deferral and new 482 service regs
- Current cost plus arrangements may also need to be revisited in light of the economic downturn. A cost plus 2 percent arrangement may now be more realistic than a cost plus 6 percent arrangement.

Acquisitions and worthless stock deductions

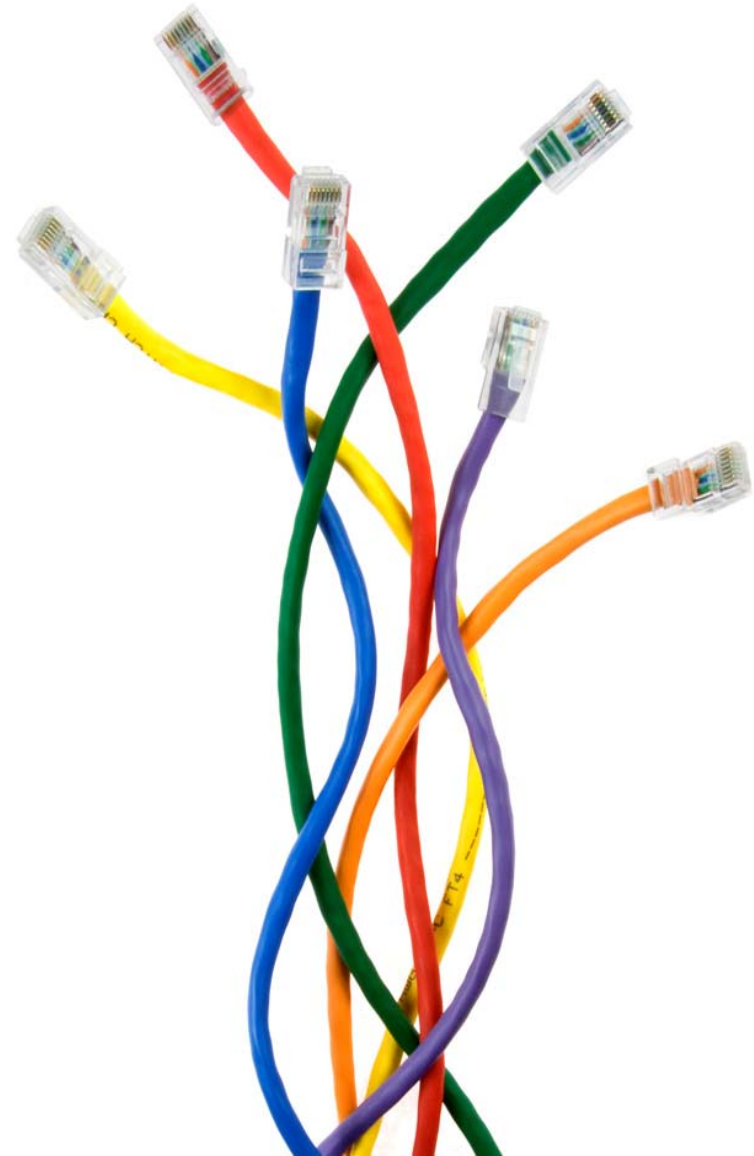
- If share values of targets are down, now may be the time to consider an acquisition.
- Worthless stock deductions under section 165(g)(3) may also be relevant

Federal income tax-Cash optimization strategies

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November 2009



Prepaid expenses and supplies

Description

- For financial statement reporting purposes, numerous types of prepaid expenses are capitalized and then amortized to expense over a defined useful life.

Opportunity

- To the extent prepaid expenditures (such as services, insurance, permits, taxes and licenses) do not have a useful life greater than one year, a deduction is allowed in the year of payment under Treasury Regulation 1.461-4.
- Incrementally, Treasury Regulation 1.263(a) allows taxpayers to deduct, in the year of payment, certain prepaid expenditures (such as supplies or goods) that do not have a useful life of more than one year.

Implement

- File an automatic Form 3115, Application for Change in Method of Accounting

Deferred revenue

Description

- Under GAAP, advance payments received for undelivered maintenance, warranty, upgrades, “bug fixes”, and other similar types of services are capitalized and amortized over the associated contractual period of required performance.

Opportunity

- Taxpayer’s have the ability to defer taxable income associated with these advance payments for one year in accordance with Rev. Proc. 2004-34, so long as the services are performed by the end of next succeeding year and treatment for tax purposes conforms to the treatment for financial statement reporting purposes.
- An opportunity exists to claim an accelerated/upfront deduction for selling commissions, referral fees, and other expenses incurred, yet capitalized for GAAP deferred revenue recognition purposes. This idea is generally applicable for service contracts with terms of 12 months or less. The correct tax method of accounting for these noted expenditures is to deduct them in the tax year incurred. The gross taxable income associated with these advance payments may still be deferred under the guidance of Revenue Procedure 2004-34.

Implement

- File an automatic Form 3115, Application for Change in Method of Accounting

Lien date method for real and personal property taxes

Description

- Under GAAP, the financial statement accounting method for expensing real and personal property taxes is to accrue the annual state tax assessment ratably over the property tax year (ratable accrual method).

Opportunity

- Treasury Regulation 1.461-5 allows for adoption of the modified lien date method for tax purposes.
- The lien date method provides for a deduction of real property tax expense for the year of the lien date, as long as the taxes are paid within the earlier of 8.5 months after the end of the tax year or the filing of the tax return.
- By illustration, a calendar year company with California real property taxes would be able to increase its deduction by 50% on a perpetual basis under this election.

Implement

- File an automatic Form 3115, Application for Change in Method of Accounting

IBNR — Self-insured medical claims

Description

- For financial statement purposes, a medical claims reserve is established for the liability attributable to self-insured medical claims that will be paid to medical service providers in the subsequent year.
- For tax purposes, these incurred but not reported medical claims (IBNR) are often deducted in the year payment is made.

Opportunity

- When medical service providers, rather than employees, submit claims for payment, both the all events and economic performance tests are satisfied in the year in which the medical services are rendered.
- An opportunity therefore exists to accelerate the deductions to the point when the medical service is provided, to the extent that payments are made to medical service providers within 8 1/2 months of year end.
- Additionally, taxpayers may be able to deduct the portion of their worker's compensation reserve related to medical expenses under similar facts.

Implement

- File an automatic Form 3115, Application for Change in Method of Accounting

Third party warranty claims administration

Description

- Under GAAP, for self insured warranty obligations, estimated future warranty costs are often expensed as a cost of product revenue as revenue is recognized, based upon estimates of material, distribution and labor costs that may be incurred.
- For tax purposes, the expense is taken when the expenditure is incurred and a payment is made under section 461.

Opportunity

- Third party costs (similar to the preceding IBNR example) incurred prior to year end, even when associated with “self insured” warranty, may be deducted in accordance with IRC section 461 as a recurring item exception.
- Review the company’s business operations/contractual agreements to determine if opportunities exist to accelerate a deduction for tax purposes.

Implement

- File an automatic Form 3115, Application for Change in Method of Accounting

Payroll tax liabilities

Description

- Under GAAP, payroll tax obligations are generally not accrued on year-end liabilities associated with accrued bonuses, vacation pay and/or compensation that will be paid in the following reporting period.

Opportunity

- Revenue Procedure 2008-25 provides a safe harbor for accrual method taxpayers to account for their FICA and FUTA (“payroll tax”) liabilities under the recurring item exception as set forth in Treasury Regulation 1.451-5. Payroll tax associated with amounts paid out within 8.5 months may be currently deductible.

Implement

- File an automatic Form 3115, Application for Change in Method of Accounting

Domestic manufacturer's deduction — §199

Description

- Section 199 allows most companies with U.S. production activities a special deduction with respect to qualified production activity income (QPAI), for taxable years beginning in 2005 and thereafter. The benefit phases began as a three percent deduction for 2005, increased six percent in 2007 and will increase to a nine percent deduction in 2010. This deduction is applicable to a broad spectrum of domestic taxpayers.
- The Section 199 deduction creates opportunities for permanent tax benefits while complying with complex compliance and documentation requirements. The deduction is limited to the lesser of 6% of QPAI, taxable income after NOL's, or 50% of W-2 wages.
- Specifically assess stock options vested prior to the adoption of IRC Section 199, and exclude from the QPAI calculation.

Implement

- Amend prior year returns for open years due to change in methodology.
- See AM 2009-001 dated December 30, 2008 for “IRS Generic Legal Advice”

Acceleration of bad debt expense

Description

- Under GAAP, a reserve for doubtful accounts is established for estimated losses based upon an assessment of collectibility and aging of the associated accounts receivable balances.
- For income tax purposes, deductions are generally limited to charge-offs against the financial statement bad debt reserve.

Opportunity

- An accelerated bad debt deduction may be available if one can demonstrate partial worthlessness. Specifically, for loans turned over to a collection agency, a deduction may be available for the collection agency fee (e.g. assigned to collection agency for a 35% recovery fee).
- Consider accelerating the book charge-off on uncollectible receivables.

Implement

- Change in facts or accounting method determination.

Disputed sales

Description

- **Purchasers of goods and services may disagree with amounts billed by the taxpayer for a variety of reasons including clerical error, over billing, inadequate performance, poor quality, the wrong goods shipped, etc.**
- **Accrual method taxpayers do not have to recognized income from the sale of goods or services when the right to receive such income is in dispute, whether communicated to the taxpayer before year-end or in the subsequent tax year.**

Implement

- **Prepare and file amended returns for open years due to change in methodology.**
- **Prospective benefits as well from refined methodology of capturing more accurate data.**

Fixed assets

Description

- Identify and reclassify personal property and land improvement assets from real property in order to shorten the depreciable life for tax purposes, as appropriate
- Identify incidental repairs that have been capitalized, which may be currently deductible.
- Economic Stimulus Act of 2008 provides for 50% bonus depreciation for new property placed in service during 2008 and 2009. Consider credit in-lieu of bonus depreciation.
- Rotable spare parts pools may be depreciated over the relevant tax life (Rev. Rul. 2003-37 & Rev. Proc. 2007-48).
- Many of the costs associated with internal use software may be currently deductible under IRC Section 174, or under IRC Section 162. Software related costs not eligible for a current deduction will generally be capitalized and amortized over 36 months.
- GAAP will generally capitalize more interest expense than allowable alternatives for tax.
- Explore “ready and available” placed in service opportunities within CIP

Implement

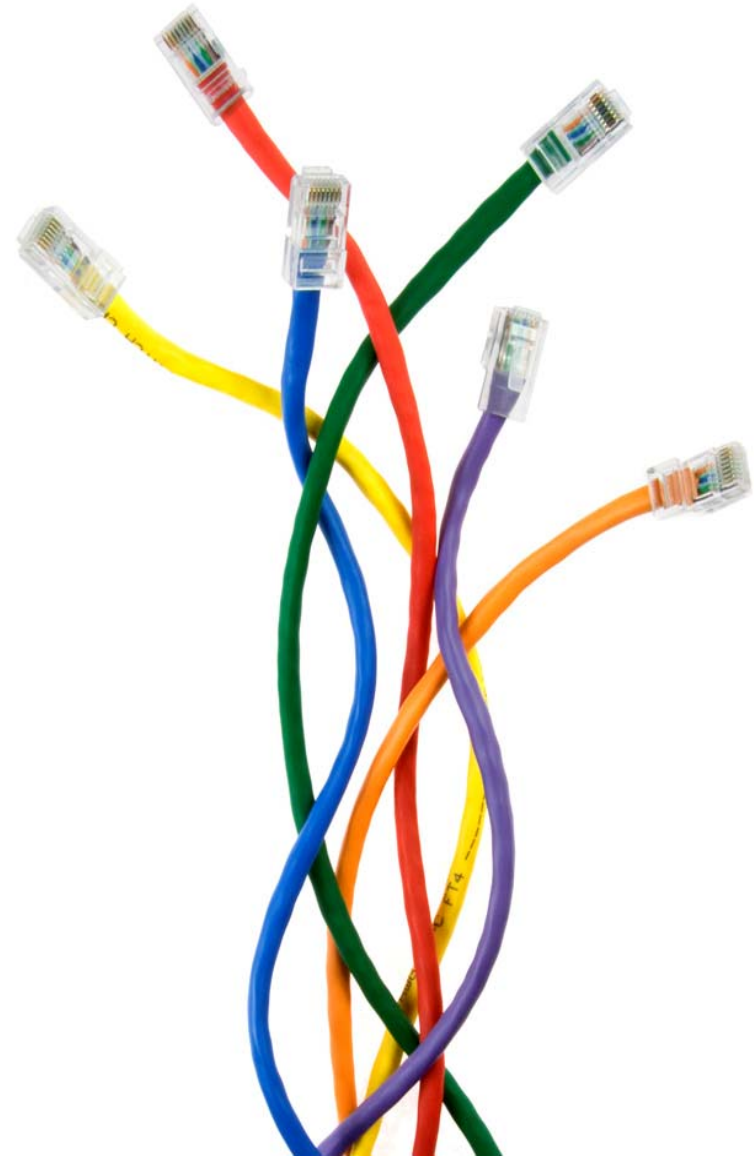
- Likely requirement for a manual/automatic change in accounting method (factually specific requirements).

Tax Issues for Distressed Corporations

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Topics

Section 382 refresher

Section 382 acquisition scenarios

Section 382 in bankruptcy

Section 382 and the public corporation

Treatment of deferred revenue, other contingent liabilities and bargain purchases

Worthless stock issues

Debt restructurings

Section 382 refresher

Use of corporate attributes — Generally

- Stock acquisitions
 - Taxable stock purchases
 - Tax-free stock acquisitions
- Asset acquisitions
 - “A” merger
 - “C” or “D” reorganization
- Net operating losses
 - Back two years, with exceptions (including waiver)
 - Forward 20 years
- Capital losses
 - Back three years
 - Forward five years

Use of corporate attributes — Generally (cont.)

- Business credits
 - Back one year
 - Forward 20 years
- Foreign tax credits
 - Back one year
 - Forward ten years
- Alternative minimum tax credits
 - No carry back permitted
 - Forward indefinitely

General operation of section 382

- Limitations apply following an “ownership change”
- Use of “pre-change” losses to offset “post-change” income subject to annual section 382 limitation
- Limitations may also apply to recognized built-in losses

General operation of section 383

- Similar limitations apply to other attributes, such as:
 - Capital losses
 - Business credits
 - Foreign tax credits
 - Alternative minimum tax credits
- Annual section 382 NOL limitation must be converted to “credit equivalent”
- Limitations may also apply to recognized built-in losses

General policies of section 382

- Anti-trafficking rules
- Neutrality principle regarding use of capital
- Purpose of acquisition is irrelevant

Ownership change defined

- An “ownership change” occurs on a testing date when the stock of the loss corporation owned by one or more five-percent shareholders increases by more than 50 percentage points during a testing period when compared with the lowest ownership by each shareholder during that period

Five-percent shareholders

- An actual direct owner of at least five percent of loss corporation's stock
- An indirect owner of at least five percent through higher-tier entities
- Public group shareholders

Public group rules

- Trading among members of a single public group is ignored
- Trading between members of different public groups is ignored
- Every person is presumed to be in only one public group, and to not be related to any member of another public group
- Stock issuances directly by the corporation result in new (segregated) public groups
- Exceptions to segregation rule:
 - Cash issuance exception
 - Small issuance exception

Testing period

- Generally consists of the three-year period ending on a testing date
- Testing period does not begin before:
 - Day after prior ownership change
 - First day of taxable year from which the corporation is carrying forward a net operating loss, net capital loss, or other attribute

Testing dates

- Acquisition or disposition of stock by a direct five-percent owner
- Acquisition or disposition of interests by an owner of higher-tier entity
- Issuance of stock by a corporation
- Redemption of stock
- Recapitalization

Typical causes of change

- Acquisition of entire company in a single transaction
- Merger or other acquisition of target using stock of acquiring corporation
- Multiple stock issuances, e.g., financings
- Accumulation of stock in public company by five-percent shareholders

Treatment of options

- Broadly defined to include warrants, purchase and conversion rights
- Certain exceptions and safe harbors apply
- Treated as not exercised unless evil intent is present and at least one test is met:
 - Ownership test
 - Control test
 - Income test

Pre-change losses

- Any net operating loss carried from a taxable year that ends before the ownership change
- Any portion of the net operating loss for the taxable year that includes the change date, to the extent attributable to the period preceding the change
- Taxable income or loss for change year allocated based on:
 - Daily pro-ration (default method)
 - Closing of the books (if elected)
- Items of income, gain, or loss subject to section 382(h) are removed from taxable income or loss before allocating.

Section 382 limitation

- Value of the loss corporation's stock, immediately before the ownership change, multiplied by the long-term tax-exempt rate
- Long-term tax-exempt rate for October 2009 ownership changes is 4.48% (likely to be 4.33% for November 2009).

Value of loss corporation

- Fair market value of all stock outstanding immediately before ownership change
- Includes option value
- May apply control premium to market capitalization

Adjustments to value

- Capital contributions under “anti-stuffing” rule
 - Two-year presumption applies
 - May be rebutted under limited circumstances
- Redemption or other corporate contraction
- Presence of substantial non-business assets
- Value of non-consolidated domestic or foreign affiliates (subject to restoration)

Continuity of business enterprise requirements

- Section 382 limitation is zero if the business is not continued for two years following ownership change
- Requirement is the same as for tax-free reorganizations
 - Continue a significant historic business
 - Continue to use a significant portion of the historic business assets in a business

Built-in gains and losses

- Application of built-in gain and loss rules can be helpful or harmful
 - If a loss corporation has a net unrealized built-in gain (“NUBIG”), a recognized built-in gain (“RBIG”) will enhance the annual section 382 limitation
 - If a loss corporation has a net unrealized built-in loss (“NUBIL”), a recognized built-in loss (“RBIL”) will be subject to the annual section 382 limitation
- Appraisal methodologies generally applied

Recognition period

- The five-year period beginning on the change date
- Refers to calendar-year periods, regardless of the number of taxable years involved

NUBIG/NUBIL

- Fair market value of the gross assets of the loss corporation
- Less: Adjusted basis of assets
- Less: Liabilities that would be included in amount realized but deductible upon payment
- Plus or minus: Section 481(a) adjustments from accounting changes

Conventional gains and losses

- Assets with unrealized built-in gain generally must be sold or exchanged to produce RBIG
- Assets with unrealized built-in loss
 - Sale at a loss during recognition period treated as RBIL
 - Loss from complete worthlessness treated as RBIL
 - Depreciation or amortization treated as RBIL

RBIG/RBIL presumptions

- No gain is presumed to be recognized built-in gain except to the extent that the corporation can establish the amount built in.
- Every loss is presumed to be recognized built-in loss except to the extent that the corporation can establish the amount that is not built in.

Built-in income and deductions

- Built-in income is treated as a recognized built-in gain
- Built-in deductions are treated as recognized built-in losses
- Proper adjustment must be made to NUBIG/NUBIL determination for such items

Notice 2003-65 generally

- Provides interim guidance, pending temporary or final regulations, regarding the determination of built-in items using two alternative approaches:
 - Section 1374 approach
 - Section 338 approach
- Taxpayers may rely on the Notice for ownership changes prior to the publication of such regulations.
- Choice generally depends on whether loss corporation has a NUBIG or a NUBIL:
 - Section 338 approach generally preferred by NUBIG taxpayers
 - Section 1374 approach generally preferred by NUBIL taxpayers

Notice 2003-65/section 1374 approach

- Adopts a narrow “accrual method” rule to determine whether items are built in
- Special rules apply to:
 - Nonqualified deferred compensation
 - Bad debts and cancellation of indebtedness income
 - Liabilities requiring payment in order to deduct
- Generally does not result in many built-in income or deduction items for accrual-method taxpayers

Notice 2003-65/section 338 approach

- Requires a hypothetical determination of the consequences of a section 338 election
- Built-in income or deduction items represent the difference between:
 - Amounts of income, deduction, and loss actually reported during the recognition period; and
 - Amounts that would have been reported based on a hypothetical section 338 election

Practical consequences of a section 338 approach

- Absence of cost recovery on appreciated assets is built-in income
- Deduction of some or all of contingent liabilities is a built-in deduction
- Bad debts may be built-in deductions
- Requires more estimation and judgment than actual section 338 election

Section 384 considerations

- Section 384 applies to:
 - Acquisition of stock constituting section 1504(a)(2) control; and
 - Acquisition of assets in an acquisitive reorganization.
- Section 384 prevents offset of RBIG of gain corporation against pre-acquisition losses of the other corporation
- Does a 338 approach apply here?

Special section 382 issues

- Multiple ownership changes
- Application of section 382 to bankruptcy proceedings
 - Section 382(l)(5)
 - Section 382(l)(6)
- Foreign parent companies
- Unclear or ambiguous SEC filings on Schedules 13D and 13G
- Consolidated group considerations
- Treatment of cancellation of indebtedness income
- Fluctuations in relative value of different classes of outstanding stock

Section 382 acquisition scenarios

Section 382 in the acquisition context

- Value/in general
 - Section 382(e)(1) provides that the value of LossCo is the value of the equity of such corporation immediately before the ownership change.
 - Example #1:
 - The stock of LossCo is acquired by ABC, Inc. for \$100M in cash (O/C).
 - The long-term tax-exempt rate for the month of acquisition is 4.5%
 - The annual §382 limitation is \$4.5M per year.
 - Example #2:
 - LossCo issues series C preferred stock on June 30, 2004 (O/C).
 - The pre-money valuation is \$40M (based on the term sheet).
 - The long-term tax-exempt rate for the month of acquisition is 4.5%
 - The annual §382 limitation is \$1.8M per year.
 - Issue: What does the pre-money valuation represent?

Section 382 in the acquisition context (cont.)

- Value/in general
 - **Pitfall:** Improper valuation of various equity classes.
 - **Opportunity/Risk** — There is no specific valuation methodology set forth in the Code or Regulations, so a taxpayer is largely free to employ any reasonable approach. Similarly, the IRS is free to challenge any approach used by the taxpayer.
 - What is reasonable?
 - Example #3:
 - On 1/31/04, LossCo issues series A preferred stock for \$1.00/share.
 - On 4/15/05, LossCo issues series B preferred stock for \$1.75/share.
 - On 10/1/06, LossCo issues series C preferred stock for \$1.25/share.
 - **Issue:** What are the relative values of each series on 4/15/05 and 10/1/06?

Section 382 in the acquisition context (cont.)

- Value/anti-stuffing
 - Section 382(l)(1) states that any capital contribution made during the 2-year period ending on the change date shall, except as provided in regulations, be treated as part of a plan a principal purpose of which is to avoid or increase any limitation and shall not be taken into account for purposes of Section 382.
 - Example #4:
 - Same facts as Example #2 (series C preferred stock issued on 6/30/04).
 - In addition, LossCo issued series B preferred stock on January 1, 2003 for an aggregate capital infusion of \$10M.
 - Under a literal reading of Section 382(l)(1), the value upon which the annual §382 limitation is determined is reduced from \$40M to \$30M.
 - Historically, taxpayers have often sought relief from Section 382(l)(1) in the form of the working capital/general corporate purposes “exception” (legislative history).

Section 382 in the acquisition context (cont.)

- Value/anti-stuffing
 - In Notice 2008-78, the IRS provided relief from this Section by stating that it will not presume a contribution to be part of a plan simply because of it being made within the two-year period of the change.
 - This Notice suggests that capital contributions received by a loss corporation in the two years preceding an ownership change may be considered in calculating the annual §382 limitation so as long as the contribution was not made with a principal purpose of avoiding or increasing the limitation (a facts and circumstances determination).
 - Effective for taxable years ending on or after September 26, 2008.
 - Relevant for prior periods?

Section 382 in the acquisition context (cont.)

- Value/other
 - The appropriate valuation of differing equity classes in an important component of properly applying Section 382 (testing and limitation).
 - Section 382(l)(3)(C) states that “[e]xcept as provided in regulations, any change in proportionate ownership which is attributable **solely** to fluctuations in the relative fair market values of different classes of stock shall not be taken into account.” (emphasis added)
 - **Issue:** What does “solely” mean in this context?
 - The IRS has issued several PLRs where the taxpayer has employed a “freezing” methodology with respect to various equity classes using Section 382(l)(3)(C) as the technical underpinnings for such position. See generally PLR 200411012, PLR 200520011 and PLR 200622011.

Section 382 in the acquisition context (cont.)

- Value/other
 - PLR 200901001 and PLR 200901003
 - In these rulings, the IRS provided certain principles to follow when factoring changes in proportionate ownership of taxpayer's stock that are attributable solely to fluctuations in the relative fair market values of different classes of stock.
 - The IRS held in both cases that on any testing date, in determining the ownership percentage of any five-percent shareholder, the value of such shareholder's stock, relative to the value of all other stock of the taxpayer, would be considered to remain constant since the later date. And, the value of such shareholder's stock relative to the value of all other stock of that taxpayer issued subsequent to such an acquisition date would also be considered to remain constant since that subsequent date.
 - More formal guidance to follow?

Section 382 in the acquisition context (cont.)

- Value/other
 - **Pitfall:** The “bottleneck” effect of multiple ownerships changes and differing annual Section 382 limitations
 - Example:
 - BigCo acquired LossCo on 1/31/09 for \$200M (O/C)
 - As of 12/31/08, LossCo’s aggregate amount of NOLs is \$100M
 - The annual §382 limitation is \$10M.
 - LossCo experienced an ownership change on 1/1/04
 - The amount of pre-change NOLs was \$50M
 - The aggregate equity value was ~\$30M
 - The annual §382 limitation was ~1.5M
 - The 1/1/04 ownership change creates a bottleneck and traps ~\$20M of NOLs because only \$30M of NOL may be used during the 20 year carry-forward period (\$1.5M x 20 years).
 - **Opportunity** — NUBIG/Notice 2003-65 (limited)

Section 382 in the acquisition context (cont.)

- Value/other
 - **Pitfall:** An election under Treas. Reg. §1.382-8 to reattribute value of component members to LossCo.
 - Treas. Reg. §1.382-8(a) generally provides that, for purposes of determining the annual §382 limitation, the value of the stock of each component member is reduced by the value of the stock of any other component member directly owned by the component member immediately after the ownership change.
 - This election must be attached to the tax return for the year of the ownership change.
 - The current regulations, which apply to tax years beginning on or after May 30, 2006, provide that foreign corporations are deemed to reattribute such value; however, an election must be made for prior periods.

Section 382 in bankruptcy

Section 382 in bankruptcy

- **Special rules for troubled loss corporations**
 - Loss corporations that are in bankruptcy or similar proceedings are subject to special Section 382 rules.
 - Section 382(l)(5) generally provides that the annual limitation provided for in Section 382(a) does not apply to the extent:
 - LossCo, immediately before the ownership change, is under the jurisdiction of the court in a title 11 (bankruptcy) or similar case, and
 - The shareholders and creditors of LossCo (determined immediately before the ownership change) own, immediately after the ownership change, at least 50% of the vote and value of the LossCo stock (or stock of a controlling corporation if also in bankruptcy).
 - **Certain Consequences:**
 - The total amount of NOLs carried forward is reduced by the amount of interest deductions claimed during the three prior tax years that are attributable to indebtedness converted to equity in bankruptcy.
 - The §382 limitation is zero in the event LossCo experiences another ownership change within two years of the change subject to Section 382(l)(5).

Section 382 in bankruptcy (cont.)

- Special rules for troubled loss corporations
 - Section 382(l)(6) applies to the extent a LossCo does not qualify for preferential treatment under Section 382(l)(5) or it elects to not have Section 382(l)(5) apply (see election under Section 382(l)(5)(H)).
 - In such circumstances, the occurrence of an ownership change is respected but the annual §382 limitation is calculated by taking into consideration the increase, if any, in value of LossCo resulting from any surrender or cancellation of creditors' claims in the transaction.

Section 382 in bankruptcy (cont.)

- Special rules for troubled loss corporations
 - In **CCA 200915033**, IRS counsel applied certain judicial doctrines to deny taxpayer's use of NOLs, ruling that such NOLs were limited under the general rule in Section 382(a) even though the literal requirements of the bankruptcy exception in Section 382(l)(5) had been satisfied.
 - Facts:
 - Acquiring, through a series of transactions in a pre-packaged bankruptcy, acquired a non-controlling interest in Target upon its emergence from bankruptcy.
 - Following the emergence, the acquirer obtained 100% control by causing Target to redeem the shares held by the remaining shareholders.
 - The redemption was part of an agreement with the principal creditor negotiated prior to the bankruptcy filing to arrange for the target to solicit such stock purchases.
 - Acquiring subsequently utilized all of the Target's NOLs to offset its post-bankruptcy taxable income based on its belief that it qualified for the bankruptcy exception under Section 382(l)(5).

Section 382 in bankruptcy (cont.)

- Special rules for troubled loss corporations
 - **CCA 200915033**
 - IRS Position:
 - IRS counsel posited that the bankruptcy exception does not apply because while the transaction may, in form, satisfy Section 382(l)(5), it did not reflect economic reality.
 - The acquirer, in relation to certain other contemporaneous transactions, received an artificially smaller equity interest in the taxpayer when compared to the amount of consideration it paid.
 - Certain shareholders (who were instrumental in meeting the requirements of Section 382(l)(5)), should not be considered as continuing shareholders because, while their equity interests in the taxpayer were nominally redeemed after emergence from bankruptcy, they were effectively redeemed upon the emergence from bankruptcy via a pre-arranged stock purchase plan.
 - When looking at the “bigger picture” (and broadly applying the economic substance doctrine, the business purpose doctrine, the substance-over-form doctrine and the step transaction doctrine), the transaction did not reflect economic reality.

Section 382 and the public corporation

Section 382 changes of ownership for the public company

- The 5% Shareholder threshold of Section 382 is generally consistent with the SEC filing obligations of 5% Shareholders on Schedules 13D and 13G
- In determining owner shifts, a public loss corporation is generally entitled to rely on the SEC Schedules 13D and 13G filed by reporting entities. Section 1.382-2T(k)(1)(i)
 - Schedule 13D is filed by an entity within 10 days of acquiring more than 5% of the capital stock of a publicly traded corporation and must be updated to reflect non de minimis additional purchases
 - Schedule 13G is filed by an entity under the same circumstances as Schedule 13D, but when the filer has no intent to exercise control of the issues and holds less than 20% of the stock

IRS private letter rulings measuring changes in ownership

- The IRS has issued several rulings with regard to the tracing of stock ownership by a public company, beginning with PLRs 9533024 and most recently in PLR 200902007
- The rulings adopt the position that the owner of stock for Section 382 purposes is the person with the right to dividends and the proceeds of sale (the “Economic Owner”)
- The rulings address the Section 382 analysis applicable to Schedules 13D and 13G filings. The rulings in PLR 200902007 seem to adopt a relatively lenient attitude in the face of ambiguity in the filings
- An investment advisor that files Schedules 13D and 13G and has the power to acquire, hold, vote and dispose of stock (but not the right to dividends and proceeds of sale) is not the Economic Owner of the stock

IRS private letter rulings measuring changes in ownership (cont.)

- Two or more Economic Owners will not constitute a “group” merely because directors or employees of the investment advisor are also directors or employees of the investment advisor, or the investment advisor has the authority to conduct a variety of activities with respect to the stock, e.g., voting, buying and selling, communicating with Company management, etc.
- If the Schedule 13D or 13G does not establish that the filer is the Economic Owner the Loss company may rely on that Schedule to conclude they are not the Economic Owner
- If a Schedule filed by an investment advisor reports ownership on behalf of two or more Economic Owners, but does not affirm the existence of a “group” within the meaning of the Exchange Act, the Company can rely on such filing to determine that the Economic Owners do not constitute an “entity” under the 382 Regulations

Monitoring ownership changes by the public company😊

best practices

- Ongoing tracking of Schedule 13 filings
 - Lag time in filings presents significant compliance issues
- Periodic update of ownership study
- Securities management firm to monitor ownership change analysis and impact of ownership change
- Consideration of defensive measures?

Section 382 defensive measures for the public company

- The 2008-2009 decline in the stock market along with significant domestic losses in many companies have raised the stakes under Section 382
 - An ownership change at a point of low market capitalization could drastically reduce a company’s available net operating losses
- In the face of this potential loss of tax assets, more public companies have adopted protective provisions to attempt to prevent an ownership change
- The more common form of protection is a form of shareholder rights plan (aka “poison pill”) geared to the Section 382 5% Shareholder standard
- As an alternative, some corporations have adopted charter amendments prohibiting transfers creating 5% Shareholders, or increasing the ownership of 5% Shareholders

Shareholder rights plan

- **Shareholder rights plans (or “poison pills”) have been commonly employed as anti-takeover measures**
- **While, historically, Section 382 pills were adopted by less prominent companies, in the last few months a number of such pills have been adopted, including by Ford and Citigroup, under the rubric “Tax Benefit Preservation Plan.”**
- **The basic characteristics of a pill is the issuance of rights to acquire stock upon the acquisition of shares in excess of a particular percentage.**
 - **In Rev. Rul. 90-11, the IRS ruled on the tax aspects of the adoption of a typical pill**
 - **The adoption of the pill is a form of tax-free recapitalization**
- **Pills are typically triggered by share acquisitions in excess of 15%-however, loss companies have been adopting plans with lower thresholds of 4.99% to protect against Section 382 ownership changes**
- **While purely anti-takeover poison pills have not been favored by shareholder advocacy organizations, NOL-driven poison pills have acquired some measure of acceptance.**

Shareholder rights plan (cont.)

- A pill is adopted with no intention that it be triggered—its effect is in “terrorem.” In the roughly three decades in which pills have been in use, no pill had ever been triggered
- In 2008 a pill was triggered involving a Section 382-driven pill adopted by Selectica, Inc.
- The pill was triggered by an acquisition of stock by a competitor of Selectica
- The triggering of the pill caused significant confusion and a halt in the trading of Selectica stock

Charter amendment to preserve NOLs

- A poison pill does not prevent stock purchases. A charter amendment on the other hand prohibits increase in stock ownership by a 5% stockholder, and prohibits transfers to the extent such transfer would result in a stockholder becoming a 5% stockholder
- An exception is made if the transferee obtains the prior written approval of the Board or a duly authorized committee of the Board
- Upon written demand by the company to a 5% stockholder in violation of the transfer restrictions, the 5% stockholder must deliver the stock in question to a designated agent, and the agent is thereupon authorized to sell the stock in an arm's length transaction. Employees and agents are also restricted from recording a prohibited transfer
- Provisions typically expire at a future date tied to NOL expiration.
- Provisions designed to permit general trading on public markets
- The details of enforcement are somewhat uncertain

Charter amendment to preserve NOLs (cont)

- Amendment to change certificate of incorporation requires a majority vote of shareholders
 - A shareholder rights plan only requires Board of Directors approval
- Because of the shareholder vote requirement, more of the companies adopting this approach have been companies emerging from bankruptcy
 - Eddie Bauer Holdings
 - Mirant
 - UAL Corp.
- The practice has begun to make its way into the mainstream, however, with charter amendments recently adopted by —
 - Infospace
 - Stamps.com
- Cons
 - Limits on accumulation might be viewed negatively by some (including shareholder) as blocking activists/inhibiting takeovers
 - Extra time, effort and cost to implement

Treatment of deferred revenue, other contingent liabilities and bargain purchases

Deferred revenue in acquisitions

- Example
 - Assume S Corp. has assets with a value of \$100, deferred revenue of \$10, and other liabilities of \$20
 - P Corp. is willing to pay \$70 for the assets and assume all liabilities, including the deferred revenue liability
- What are the tax consequences to P and S?

Deferred revenue in acquisitions (cont.)

- Bases for deferral
 - Advance payments for goods (Treas. Reg. § 1.451-5(f))
 - Advance payments for subscriptions (section 455(b))
 - Other advance payments (Rev. Proc. 2004-34, section 5.02(5))
- Treatment as assumed liability?

Deferred revenue in acquisitions (cont.)

- Seller's treatment, Rev. Rul. 68-112
 - Accelerated recognition of income
 - Treat amount realized as having been “grossed up”
 - Deduct amounts paid to P to assume liability
- Purchaser's treatment, Rev. Rul. 71-450
 - Include amount paid by S in income
 - Treat amount paid for assets as having been “grossed up” by payment received

Deferred revenue in acquisitions (cont.)

- Unsettled questions
 - Can the revenue rulings be applied where there is no explicit payment by S to P?
 - Can the rulings be applied to a deemed asset purchase and sale with a section 338 election?
 - Is the relevant amount the seller's balance sheet liability?
 - Does Rev. Rul. 76-520 have any continuing relevance?

Contingent liabilities

- Purchaser's treatment
 - Liabilities generally taken into account by accrual-basis taxpayer under three-part all-events test (Treas. Reg. § 1.461-1(a)(2))
 - Contingent liabilities may not be taken into account by purchasers until they become fixed and determinable (or paid)
 - May require subsequent redetermination of purchase price or AGUB (Treas. Reg. § 1.338-7(e), **Example 1**)
- Seller's treatment (less certain)
 - Estimate value and include immediately?
 - Installment method analogies?
 - Ignore?

Contingent consideration

- Purchaser's treatment
 - Similar to assumption of contingent liabilities (Treas. Reg. § 1.338-7(e), **Example 4**)
- Seller's treatment
 - Use of installment method
 - Stated maximum selling price
 - Fixed period for payments
 - Neither stated maximum selling price nor fixed period
- Electing out requires valuation and immediate inclusion of contingent payments

Bargain purchases

- The problem:
 - Whether a section 1060 asset acquisition or stock purchase with a section 338 election, basis is allocated to assets under a seven-class residual method
 - Contingent liabilities may not be taken into account by purchasers until they become fixed and determinable (or paid)
 - Allocable consideration (AGUB) may run out before Class V (fixed assets)
- Income events for discounted classes
 - Accounts receivable (Class III) are collected
 - Inventories (Class IV) are sold

Extreme bargain purchases

- Buyer receives cash from the seller to complete the acquisition
 - **Oxford Paper Co. v. United States (Oxford I)**
 - **Oxford Paper Co. v. Commissioner (Oxford II)**
- Allocable consideration (AGUB) is less than the amount of money received (Class I)
 - Income recognition for new target (Treas. Reg. § 1.338-6(b)(1))
 - Similar result for asset acquisition (Treas. Reg. § 1.1060-1(c)(2))

Worthless stock issues

Worthless stock

- In challenging economic times, the viability of a particular enterprise may be called into question. Typically, the most salient tax consequence of a failing company is whether and when to claim a worthless stock deduction with respect to the underlying enterprise.
- The general rule, under Section 165(g)(1), is that a worthless stock loss is capital in nature (“If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall ... be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.”).
- Section 165(g)(3) provides an exception to the general rule by providing that certain affiliated stock is treated as an ordinary loss to the extent:
 - The taxpayer owns directly stock in such corporation meeting the requirements of Section 1504(a)(2) (i.e., 80% vote and value), and
 - More than 90% of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities (the “gross receipts test”).

Worthless stock (cont.)

- The IRS recently issued two PLRs that, for the time being, appear to relax the gross receipts test and appear to indicate the IRS' willingness to take a more reasoned and balanced approach to the gross receipts.
- **PLR 200914021** — The IRS concluded that the taxpayer (a corporation) could claim an ordinary loss with respect to the worthless stock of its controlled foreign corporation (“FSub”) even though FSub never had any gross receipts and was unable to satisfy the literal requirements of the gross receipts test.
 - Given that FSub never had any gross receipts, it technically could not meet the requirements of the gross receipts test.
 - The IRS concluded that FSub was an operating company (for reasons unstated) and the gross receipts test was inapplicable to the present case.
 - The IRS reasoned that the gross receipts test was designed to determine whether a company was an operating company and should not be read narrowly to impose an exclusive test.

Worthless stock (cont.)

- **PLR 200924040** — The IRS ruled that a software corporation's license fees should be excluded from the definition of royalties in applying the gross receipts test because the corporate subsidiary was engaged in the conduct of an active trade or business.
 - The IRS reasoned that, in this circumstance, the gross receipts for licensing should be excluded from the definition of royalties because the corporate subsidiary was engaged in the active conduct of a trade or business (developing, manufacturing or producing software customized to its customers and providing service for the software).
 - Where do we go from here?

Debt restructurings

Debt for debt exchanges

- Many high technology companies have issued convertible debt in non-registered, (i.e., “private”) 144A Offerings
- To the extent the conversion features is deeply out of the money and the issuers’ credit has deteriorated, the outstanding debt may be worth significantly less than the face amount
- Companies seeking to refinance such debt must face the question of whether cancellation of debt (“COD”) will result
- If COD income results, it may make sense to elect deferral of such amounts under Section 108(i) added in 2009

Basic debt for debt fact pattern

- In 2007 Public Tech Co issued for cash \$1,000 principal bonds due in 2014, paying interest at 2% and convertible into Tech Co stock at \$24.00/share, when the stock was at \$20.00/share
- Tech Co's stock is now trading at \$12.00/share and Tech Co is under stress financially
- Tech Co would like to swap out the existing bonds for bonds with a lower conversion price but a higher interest rate and a longer maturity to give it more breathing room
 - The principal would remain at \$1,000/bond
- Isolated sales of the Tech Co bonds indicate that the existing bonds may be worth approximately \$600/bond

Tax effect to tech co

- COD income will result in the “issue price” of the new debt is less than the adjusted issue price of the old debt, in this case its principal amount
- If neither the old bonds nor the new bonds are publicly traded then Tech Co will not recognize COD income
- If either the old bonds or the new bonds are “publicly traded,” however, then Tech Co will recognize COD income in the exchange
 - The new bonds will also have substantial original issue discount, which may be subject to limitation under the AHYDO rules
 - AHYDO rules temporarily suspended in certain cases under Section 165(e)(3)(F)(i), added by the 2009 Tax Act
- Result is the same whether an actual exchange or a modification resulting in a “deemed” exchange under the Section 1001 regulations, and regardless of whether exchange is a “recapitalization” under Section 368

Tax effect to tech co (cont.)

- This is little meaningful guidance on the meaning of “publicly traded” in this context
- The definition in Regulation Section 1273-2(f) is broad, however, and includes “a system of general circulation ... that provides a reasonable basis to determine fair market value by disseminating either recent price quotations ... or actual prices ... of recent sales transactions....”
- The possibility exists that a relatively few number of trades reported by private trading systems will result in a class of bonds being treated as publicly traded, with COD resulting in the exchange

Section 108(i)

- If Tech Co recognizes COD, it may avail itself of the deferral provisions of Section 108(i) added by the 2009 Act
- New Section 108(i) permits a taxpayer to elect to defer COD income arising from a “reacquisition” of “an applicable debt instrument” after December 31, 2008 and before January 1, 2011
- Deferred COD income must be ratably included in the taxpayer’s gross income over the years 2014 through 2018 (the “inclusion period”)
- The election to defer is irrevocable, and precludes any other elections under Section 108
- The deferral income will be accelerated in connection with certain events, including a sale of assets (e.g., under Title 11)
- State conformity must be determined in each case

Effect of debt restructuring under section 382 PLR 20093810

- Ordinarily, the issuance of debt does not implicate Section 382
- However, where debt has certain equity like characteristics, in particular the interest “offers a potential significant participation in the growth of the corporation,” it may be treated as stock. Section 1.382-2T(f)(18)(iii)
- Practitioners have speculated whether following a debt swap or other restructuring resulting in an “exchange” under Section 1001, the holders of the debt might be viewed as having such potentially significant participation
- In PLR 20093810, the IRS addresses those concerns in the context of a refinancing involving payment in kind (“PIK”) notes
 - The value of the issuer was such that it was unclear whether the common or preferred stock had any value
 - The PIK debt was also believed to have traded at a significant discount from face

Effect of debt restructuring under section 382 PLR 20093810 (cont.)

- The IRS ruled that the PIK debt would not be considered “stock” for Section 382 purposes based on representations on the following matters:
 - At the time of the issuance of the PIK debt financial projections indicated that principal and interest could be paid as it came in
 - The PIK debt conveyed no right to dividend or liquidation proceeds
 - The PIK debt holders had no director seats, management or control rights

