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Protecting the Unknown: The Impact of the Liberalization of NOL Carrybacks in Acquisitions

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Abstract

This paper explores the impact of section 382 of the Code and its limitations on Net Operating Losses (NOLs) and advocates for new method for valuing NOL limitations.

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I. Introduction

This paper explores the impact of section 382[1] of the Code[2] and its limitations on Net Operating Losses (NOLs) and advocates for new method for valuing NOL limitations. Section 382 limits the corporation's future ability to use its NOLs if there is an ownership change or an equity structure shift.[3] To corporations, NOLs are assets that provide value in tax-benefits; to potential acquirers, NOLs provide a valuable option for corporations to offset future income gains.[4]

This paper suggests that Congress should revise section 382 of the code to reflect the intent of the transaction.[5] Abusive transactions[6] should not be allowed to utilize any benefits from NOLs. Conversely, transactions meant to raise capital for a firm should not cause any NOL revaluation. And merger transactions should have a NOL limitation that is proportional to the value added to the firm in the acquisition.

Part II presents a broad overview of section 382 applied to corporate transactions. Part III focuses on the economics of NOLs and some assumptions related to NOL poison pills. Part IV presents an alternative method to address NOL limitations, advocating for no NOL limitations for certain transactions and proportional NOL limitations for other transactions. Part V defends the approach advocated in Part IV by looking at the market benefits, ultimately concluding that the proposed changes to section 382 will more closely approximate the legislative intent.

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[1]I.R.C. § 382.

[2]The Code refers to the Internal Revenue Code. This paper utilizes the stylistic requirements set forth by the TAX LAWYER. Explanations are provided when deemed necessary for the purposes of the workshop.

[3]I.R.C. § 382.

[4]Craig Eaton, *M&A Deal Structures and the Value of NOLs*, MFA, http://www.mfa-cpa.com/alerts-and-insights/blog/2009/06/m-and-a-deal-structures-and-the-value-of-nols (last updated Jun. 9, 2009)

[5]I.R.C. § 382.

[6]This paper will go on to elaborate on what constitutes an abusive NOL transaction.

II. The Current State of Net Operating Losses

Section II of the paper presents a broad overview of NOLs. Part A discuses the mechanics of NOLs, and Part B introduces the policy reasons in favor of having a NOL limitation in. Part C illustrates the negative impact a section 382 trigger has on NOL value. Part D discusses the legality of a corporation instituting a poison pill to protect NOLs. Finally, Part E explores the addition of section 382(n) in relation to the government bailouts during the 2008 financial crisis.

A. *The Background and Mechanics of Net Operating Losses*

A taxable entity generates a net operating loss when its expense exceeds its income.[7] Section 172 of the Code defines a net operating loss as the amount of section 172 deductions in excess of gross income. In practice, a net operating loss occurs when tax-deductible expenses exceed taxable revenues.[8] A company that has a NOL (also known as a loss corporation)[9] can elect either to offset profits from a different year by "carrying back" the losses[10] (up to two years) or by "carrying forward" the losses (up to twenty years).[11] Carry-backs can result in a tax refund after a corporation files an amended tax return.[12] Carry-forwards reduce the amount of future income tax that must be paid. Both provide value to the firm in the form of cash flows, even if they are

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[7]I.R.C. § 172; *see* Andrew J. DeJoseph, *Protecting and Preserving Net Operating Losses*, 79 CPA JOURNAL, 30, 30 (2009).

[8]DeJoseph, *supra* note 7, at 30.

[9]I.R.C. § 382(k)(1). Additionally, a loss corporation includes a corporation that is entitled to use capital loss, excess foreign tax, general business credit, or minimum tax credit carryovers. Reg. § 1.382-2(a)(1). The term also includes any corporation with a net unrealized built-in loss (the aggregate adjusted basis of the corporation's assets exceed the fair market value of the assets immediately before an ownership change). I.R.C. § 382(k)(1), (h)(3)(A)(i).

[10]In 2002 the government allowed for a five-year carryback provision of losses. Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147, § 102, 116 Stat. 21 (2002). For a further discussion on the benefits in a longer carryback period *see* Phillip J. Korb & Thomas E. Vermeer, *Temporary Changes in Carryback Period for Net Operating Losses,* CATALYST, Sep/Oct 2002, at 22 *and* Altstair M. Nevius, *Carrying Back Net Operating Losses*, 212 J. ACCOUNTANCY 60, 60 (2011).

[11]Alstair M. Nevius, *Carrying Back Net Operating Losses*, 212 J. ACCOUNTANCY 60, 60 (2011)

[12]The specific processes in which carrybacks are elected are beyond the scope of this paper. *See* Steven C. Colburn ET AL, *Gain Valuable Tax Benefits from Net Operating Losses*, 77 PRACTICAL TAX STRATEGIES 132, 132 (2006) (providing a more detailed discussion on utilizing NOLs).

"uncertain in terms of timing and amount."[13] Further, NOLs are considered a "contingent asset; their value is contingent upon the firm's reporting a future profit or having an immediate past profit."[14]

To illustrate the impact of carrybacks, imagine a company that has earned taxable income in 2008, 2009, and 2010 of $300k, $340k, and $420k, respectively. At the end of 2011, the company experiences a $500,000 loss that it elects to carryback. In doing so, Table 1 shows that, assuming a tax rate of 35%, the loss corporation is able to receive a full return of all taxes paid in 2010 and a partial refund for taxes paid in 2009, yielding the company a $175,000 tax refund.

Table 1- Example of NOL Carrybacks

Example of NOL Carryback (with no subsequent carry-forward)

Year	Taxable Income	Tax Rate	Taxes Paid	NOL Carryback	Tax Refund
2008	$300,000	35%	$105,000		
2009	$340,000	35%	$119,000	$80,000	$28,000
2010	$420,000	35%	$147,000	$420,000	$147,000
2011	($500,000)	35%	$0.00	**Total Refund**	**$175,000**

If the company is unable to use all of its NOLs in a carryback, the remaining balance can be carried forward to offset future income.[15] The loss carry-forward creates a deferred tax asset as long as it is more likely than not that the company will continue to be profitable. Otherwise the

[13] Merle Erickson & Shane Heitzman, *NOL Poison Pills*: Selectica v. Versata, 127 TAX NOTES (TA) 1369, 1370 (Jun. 21 2010).
[14] Selectica v. Versata, C.A. No. 4241-VCN, 2010 WL 703062, at *1 (Del. Ch. Feb. 26, 2010).
[15] *Id.*

company would have to create a valuation allowance to reduce the carrying value[16] of the asset to what the company anticipates realizing as a benefit.[17] The ability of NOLs to offset future or past income and reduce or eliminate debt on a tax-free basis makes them a powerful tool.

Prior to the enactment of any substantial regulation of NOLs, the Service[18] litigated against companies using NOLs to avoid paying income taxes. In *Alprosa Watch Corp. v. Commissioner*,[19] a corporation purchased a loss corporation, liquidated all of the loss corporation's historic businesses, and used the proceeds to begin a new business. The court held that a change in stock ownership does not produce a new corporate entity. The corporation was able to reduce the taxable income of its new business line with the old business's NOLs.[20]

The drafters of the Code attempted to limit "the exploitation of net operating losses by persons other than those who incurred the loss."[21] This led the government to impose limits and restrictions[22] on the transferability of entities having net operating losses.[23] In a merger, transferor NOLs may carry over to the acquirer in a limited number of transactions, such as "a liquidation of controlled subsidiary under section 332 (upstream mergers)"[24] or a series of tax-free

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[16]The carrying value of an asset is based on the assets original value less any depreciation, amortization, or impairment costs made against the asset. Thus, a NOL that is originally worth 100 but is only expected to yield 70 worth of benefit to the firm should be written down to reflect a carrying value of 70.

[17]The carrying value of the deferred tax asset should be reflected in the balance sheet at the anticipated future benefit that will be utilized.

[18]The Service refers to the Internal Revenue Service. This is a stylistic element for the Tax Lawyer.

[19]Alprosa Watch Corp. v. Commissioner, 11 T.C. 240 (1948).

[20]*Id*. at 242.

[21]H.R. REP. NO. 83-1337, at 4057 (1954).

[22]*See* The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986)(making sweeping changes to the rules governing the use and availability of NOL carryovers).

[23]Andrew J. DeJoseph, *Protecting and Preserving Net Operating Losses*, 79 CPA JOURNAL, 30, 32 (2009).

[24]Mari S. Domingo, *Carryover of NOL Tax Attribute in General*, 2011 Bender's Business Tax Articles § 101; *see also* I.R.C. § 332; Reg. § 1.381(a)-1(b)(1)(i).

acquisitive reorganization transactions.[25] The income that can be offset by the purchase of the loss corporation is limited to post-acquisition taxable income.[26]

B. *Policy Considerations in Proposing Section 382*

A consequence of the litigation surrounding NOLs was the proposal of section 382. Congress attempted to prevent a taxpayer from purchasing a loss corporation for tax benefits.[27] Perhaps one of the greatest policy reasons advanced for imposing special limitations on NOLs is the prevention of loss trafficking.[28]

Another justification for imposing special limitations involved the prevention of government subsidies of corporate losses. A company with large losses (and thus NOLs) can become more valuable to an acquiring corporation if its losses increase. Without special limitations "the tax collection process may be harmed if such continued losses could be offset against income from other profitable business."[29] This would be a transfer payment from the government to the corporations, as the government would experience lost tax revenue.

The most interesting view, perhaps, and least understood policy reason for NOL limitations is the government's desire to prevent acquiring corporations from receiving windfall

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[25]The specifics of the transactions are beyond the scope of this paper. However, for reference *see* I.R.C. § 368, which lists five transactions (A, C, D, F, and G Reorganizations) that fall within the scope of a tax-free acquisitive reorganization transaction.

[26]Martin Williams, *A&M Tax Advisor Weekly*, ALVAREZ & MARSAL, http://www.alvarezandmarsal.com/en/global_services/tax/enewsletter/archives/DisplayEnewsletter.aspx?enewsletter_id=177, (last visited Nov. 18 2011).

[27]*E.g.*, Alprosa Watch Corp. v. Commissioner, 11 T.C. 240 (1948); ALI, FEDERAL INCOME TAX PROJECT SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS, at 207-209 and 216-225 (1982).

[28]H.R. REP. NO. 83-1337, at 42 (1954). ("This special limitation on net operating loss carryovers provides an objective standard governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss. It treats a business which experiences a substantial change in its ownership, to the extent of such change, as a new entity for such tax purposes.")

[29]I.R.C. § 382; Mark J. Silverman, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, 790 PLI/TAX 599, 643 (2007).

profits. The full value of a corporation's carryovers is not frequently reflected in the purchase price of a corporation's stock.[30] Consequently, new owners often receive an un-paid-for windfall.

However, some have argued that the special limitations themselves are what cause the discounted purchase price. Purchasing corporations may not be able to use all of the NOLs, so they will purchase the loss corporation stock at a discount. The government did not find this argument persuasive.[31] In response to the proposed legislation, the American Law Institute conducted a study in 1982 and suggested that NOL carryovers should be allowed in certain cases. The study concluded that NOLs should only be applied against a fraction of the new corporation's earnings relative to the old corporation's earnings.[32]

C. *Section 382 in Action*

An illustrative example of a synergistic acquisition motivated by NOLs is the 2006 Alcatel SA merger with Lucent Technologies Inc.[33] During the Dot-Com bubble in 2000, Lucent generated $10 billion in NOLs, and even though Lucent returned to profitability in 2003, it was not able to fully utilize the NOL benefits.[34] At the time of the merger, Alcatel projected that the Lucent NOLs could generate $3.5 billion in U.S. tax savings.[35] This would allow the post-merger entity to enjoy substantial profits in the U.S. without having to pay any federal income tax.

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[30] Mark J. Silverman, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, 790 PLI/TAX 599, 643 (2007).

[31] *Id.*

[32] ALI, FEDERAL INCOME TAX PROJECT SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS, at 237 (1982).

[33] PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 612, (3d ed. 2002).

[34] Jesse Drucker & Sara Silver, *Alcatel Stands to Reap Tax Benefit on Merger*, WALL STREET JOURNAL, Apr. 26, 2006, at C3.

[35] *Id.*

An ownership change or an equity structure shift might cause section 382 to apply and limit the corporation's future ability to use its NOLs.[36] An ownership change triggers the section 382 limitation if, immediately following the ownership change, the shareholdings (by value) of one or more 5% shareholders increases by more than 50 percentage points over the lowest percentage of stock owned by said shareholders at any time during the testing period.[37] The testing period is the 3-year period ending on the day of any ownership shift involving a 5% shareholder.[38]

On the other hand, an equity structure shift is any tax-free reorganization, such as an A, B, C, or E reorganization[39] except for a

> (1) divisive D ([where] a corporation transfers all or part of its assets to another corporation and immediately after the transfer, the transferring corporation, its shareholders, or both, control the new corporation) and G ([where] a corporation transfers all or part of its assets to another corporation in Title 11 or a similar case) reorganizations, and (2) F reorganizations ([resulting in] a mere change in identity, form, or place of organization).[40]

To illustrate, assume there are two corporations, Alpha Enterprise, fully owned by shareholder A, and Beta Corporation, fully owned by shareholder B. Alpha merges into Beta in an "A" reorganization (a statutory merger or consolidation). After the merger, shareholder A holds 25% and shareholder B holds 75% of Beta Corporation. The merger would be considered an equity structure shift and an ownership structure shift, because it affects stock owned by a five

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[36]I.R.C. §§ 382(g)(1), (3). This paper focuses on ownership shifts and provides a simple overview of equity structure shifts.

[37]Suzanne Baierl ET AL, *Section 382: Recent Developments and the New Poison Pill*, 38 J. CORP. TAX. 3, 3 (2011).

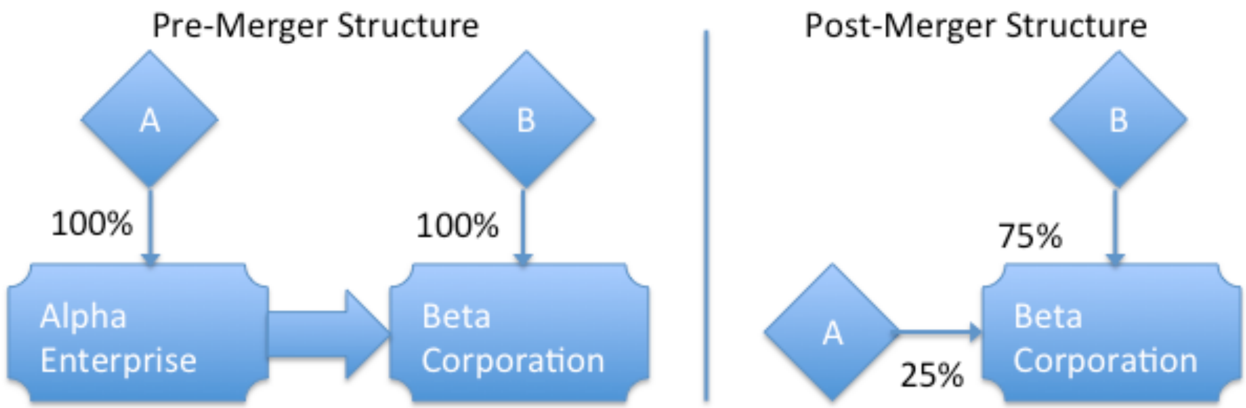
[38]I.R.C. § 382(i)(1). There is also an 'equity shift' testing that can arise, but that is beyond the scope of this paper.

[39]I.R.C. § 368(A), (B), (C), (E).

[40]Maria S. Domingo, *Carryover of NOL Tax Attribute*, 2011 Bender's Business Tax Articles § 1.02[b]; *see also* I.R.C. §§ 382(g)(3)(A), 368(a)(1)(D), (G), (F).

percent shareholder. Because an ownership change occurred after the merger, Beta Corporation will be considered a "new loss corporation,"[41] or a corporation that is a loss corporation after an ownership change and subject to the section 382 limitations.[42]

Figure 1- A Sample Merger



1. *An Illustration of an Ownership Change*[43]

Suppose NOL Firm (herein Loss Corporation) has accumulated NOLs over the past several years and, as of 6/30/11, had 500 shares of common stock outstanding. The stock was owned as follows: Shareholder A, 50 shares; Shareholder B, 100 shares; Shareholder C, 200 shares; Shareholder D, 140 shares; and Shareholder E, 10 shares. On 9/30/11, Shareholder C purchased all of the stock held by Shareholder D, increasing Shareholder C's ownership from 200 to 340 shares. Since Shareholder C is a five percent shareholder, the September 30 transaction triggered a testing date, being the 3-year period ending on the day of any owner shift involving a 5% shareholder or equity structure shift, that extends back to 10/1/07.[44]

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[41]I.R.C. § 382(k)(3).
[42]Reg. § 1.382-2T(e)(2)(iv).
[43]This is a hypothetical situation that was created by the author.
[44]I.R.C. § 382(g).

Table 2- Example of an Ownership Change

	10/1/08		**6/30/09**		**9/30/11**	
Shareholder	Shares	% Owned	Shares	% Owned	Shares	% Owned
A	175	35%	50	10%	50	10%
B	100	20%	100	20%	100	20%
C	75	15%	200	40%	340	68%
D	140	28%	140	28%	0	0%
E	10	2%	10	2%	10	2%
Total	**500**	**1**	**500**	**1**	**500**	**1**

As seen in **Table 2**, Shareholder C owned only 15% of the stock when the testing period began. C's ownership did not increase to 40% until 6/30/09. Subtracting C's lowest percentage ownership, 15%, from the September 30 post change percentage ownership, 68%, results in a 53 percentage-point change that triggers the section 382 limitation.

If section 382 is triggered,[45] the corporation will have to limit its annual NOL deduction to an amount calculated by multiplying the firm's market value of equity at the time of the ownership change by the Federal Long-Term Tax-Exempt Rate.[46] The Long-Term Tax-Exempt rate is calculated by taking the "highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs."[47]

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[45] *See* Baier l, *supra* note 37, and Deanna W. Harris & Mark Hoffenberg, *Code Sections Interact: Is Section 382's Treasure Section's 384 Trash*? 36 CORP. TAX'N 17 (2009).
[46] I.R.C. § 382(b)(1).
[47] I.R.C. § 382(f)(1).

2. *An Illustration on the Impact of Section 382*

In the following illustration, suppose there is a firm worth $800 at the time of the ownership change, facing a 35% corporate tax rate, a discount rate of 5%, and the current Federal Long-Term Tax-Exempt Rate is 3.5%.[48]

Table 3 below illustrates the impact of section 382 on a corporation. Further, the company has $200 of annual cash flows, and NOLs equal to $800, which the firm fully anticipates on using in the next four years.

Without a section 382 trigger, the firm has $248.22 in tax savings over the four-year period. In general the trigger of section 382 can have devastating consequences on the firm's tax liability, where in the current example, the present value of the tax savings is reduced from $248.22 to $34.75. This is a significant haircut and the firm would lose out on $213.47 of tax savings.

[48]The current rate as of November 2011 is 3.41%. *See* Rev. Rul. 2011-25, 2011-45 I.R.B. 695.

Table 3: A Simple NOL Valuation

NOL Valuation for Profitable Company

Gross NOLs	$800
Remaining life of NOLs (years)	4
Expected Annual Income	$200
Firm Value when ownership change is triggered	$800
Federal long-term tax exempt rate	3.50%
NOL value after section 382 limitation	$28
Corporate Tax Rate	35%
Discount Rate	5%

Value of NOL Assuming Full Usage

Year	Taxable Income	NOL used	Tax Savings from NOL	Present Value of Tax Savings[49]
1	$200.00	$200.00	$70.00	$66.67
2	$200.00	$200.00	$70.00	$63.49
3	$200.00	$200.00	$70.00	$60.47
4	$200.00	$200.00	$70.00	$57.59
Total	**$800.00**	**$800.00**	**$280.00**	**$248.22**

Value of NOL After a Section 382 Limitation

Year	Taxable Income	NOL used	Tax Savings from NOL	Present Value of Tax Savings
1	$200.00	$28.00	$9.80	$9.33
2	$200.00	$28.00	$9.80	$8.89
3	$200.00	$28.00	$9.80	$8.47
4	$200.00	$28.00	$9.80	$8.06
Total	**$800.00**	**$112.00**	**$39.20**	**$34.75**

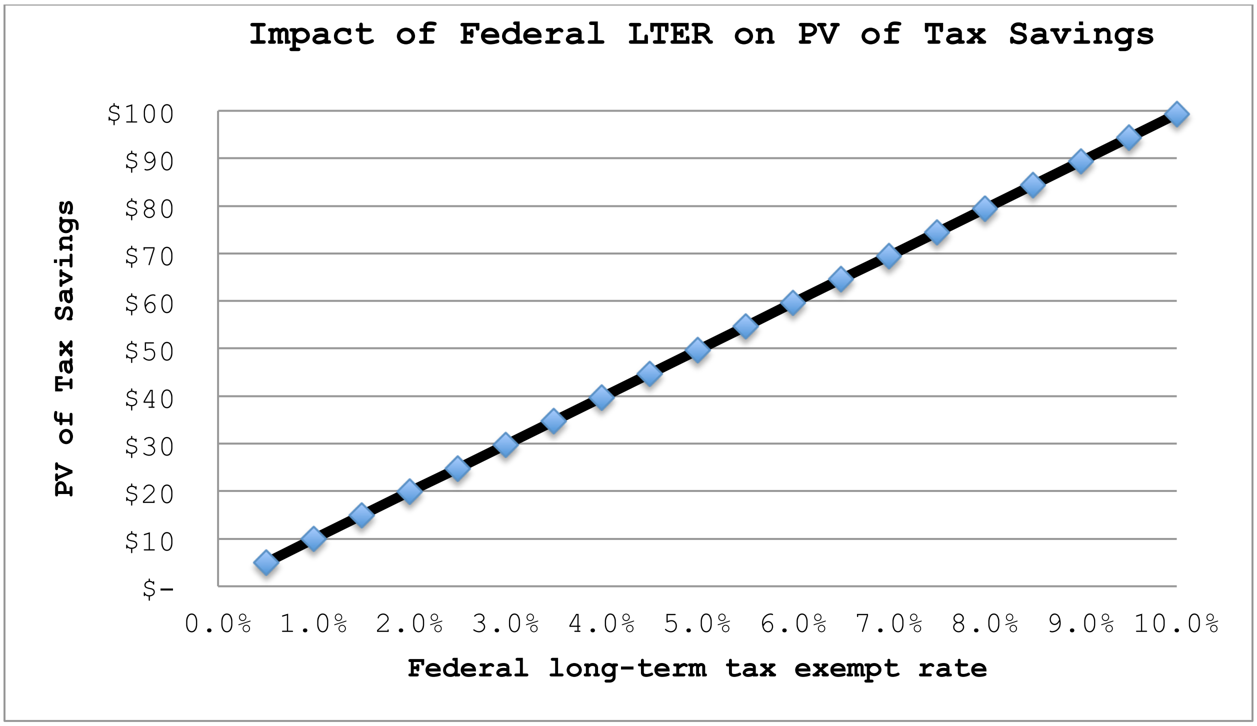
3. *The Impact of the LTER on NOL Benefits*

The Federal Long-Term Tax-Exempt (LTER) rate, set every month by the Service, impacts the annual limitations on NOLs available for use. Between the period of 2008 and 2011, the LTER

[49]The Discount Rate (r) reflects the "time cost" of money – to compensate investors for delaying consumption – and the riskiness (uncertainty and volatility) of the projected Net Cash Flows. When calculating the PV of tax the tax savings it is discounted by the time value of money. Mathematically, this is achieved by taking the cash flow and dividing it by $(1+r)^y$ where (y) represents the number of years in future the cash flow is occurring.

decreased from 5.4%[50] to 3.41%[51]. The following chart uses the same information from sub-section 2, and tracks the changes to the present value of tax savings for a corporation as the LTER changes (which is 34.75 when the LTER is 3.5%) assuming a section 382 trigger has taken place. With the decreasing trend in the LTER, a section 382 trigger becomes more harmful to firms.[52]

Table 4: Impact of Federal Long-Term Tax-Exempt Rate on the Present Value of Tax Savings



This issue is further complicated by the limitation's dependence on the market value of the corporation's equity at the time of the trigger. Thus, if the same company was temporarily devalued to $500 (from $800), then the present value of the tax savings would be reduced even further to $21.72.

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[50]Rev. Rul. 2008-53, 2008-49 I.R.B. 1231.

[51]Rev. Rul. 2011-25, 2011-45 I.R.B. 695.

[52]In December 2008, the adjusted federal long-term rate was 5.40%(Rev. Rul. 2008-53, 2008-49 I.R.B. 1231), December 2009, 4.14%(Rev. Rul. 2009-38, 2009-49 I.R.B. 736), and December 2010, 3.67%(Rev. Rul. 2010-29, 2010-50 I.R.B. 818).

Clearly, the value lost by firms can be magnified if a section 382 trigger occurs when the firm's value is depressed. The conundrum: when a firm's share price is low due to a sluggish market, the firm fears losing its NOLs if an investor triggers the limitations by purchasing a large amount of shares.

D. *The Use of Poison Pills to Protect NOLs*

Many firms recognize the danger that low equity values can have on NOLs. Firms have implemented poison pills to protect the value of NOLs from being reduced by section 382. Poison pills "enable the target board of directors to prevent the acquisition of a majority of the company's stock through a coercive tender offer." [53] The pill gives the "target board leverage to negotiate with a would-be acquiror [sic] so as to improve the offer as well as the breathing room to explore alternatives to and examine the merits of an unsolicited bid."[54]

At least one court has held that NOLs have value, most notably in a recent Delaware Court of Chancery decision, *Selectica v. Versata*. Selectica was a software company that went public in 2000 and was not profitable in its starting years. Selectica accumulated approximately $160 million in NOLs for federal tax purposes over the period 2000–2010.[55] The Selectica board was fearful of the consequences that the acquisitions of its stock by its competitor, Versata, would have on Selectica's NOLs. After consulting with an investment banker, an outside tax advisor retained to evaluate Selectica's NOLs, and counsel, the board decided to amend the existing shareholder rights plan (poison pill) trigger from 15% to 4.99.[56] Versata (and its parent company Trilogy) sued Selectica claiming that the NOL pill should be declared invalid "because

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[53]In re Gaylord Container Corp. Shareholders Litigation, 753 A.2d 462, 481 (Del. Ch. 2000).

[54]*Id.*

[55]Selectica, 2010 WL 703062, at *2.

[56]Selectica, 2010 WL 703062, at *10. *See also* Bradley R. Aronstam & David E. Ross, *Retracing Delaware's Corporate Root Through Recent Decisions*, 12 DEL. L. REV. 1, 5 (2010).

the board failed to establish that the NOLs had a value worth protecting and that this value was threatened by Trilogy's purchases."[57]

Judge Noble held that the Selectica board acted reasonably in concluding "a company's NOLs are worth protecting where it does so reasonabl[y] and in reliance upon expert advice."[58] This was upheld on appeal to the Supreme Court of Delaware, where the court held that the board's defensive response was reasonable in relation to the threat.[59] This is important for corporate policy, as many firms adopted NOL poison pills during the economic downturn in 2008 and 2009.[60]

The Chancery Court's holding in *Selectica* demonstrates how the pill is an important tool in protecting the corporate asset. It is important for firms to make section 382 part of their business strategy, lest they lose a valuable corporate asset. The fact that corporations need to expend resources to save an uncertain asset suggests that section 382 should be revised to avoid waste. Protecting NOLs is also an issue of importance for the US government, which made sure to protect the NOLs in bailed out firms by issuing various notices and enacting section 382(n).

E. *Government Bailouts, IRS Notices, & the Section 382(n) Exception*

Some firms with large NOLs[61] were hit especially hard during the recent recession and required substantial cash infusions to stay afloat, *e.g.*, Citigroup.[62] Government bailouts of financial and housing institutions *should* have triggered the revaluation the respective firm's NOLs. The government did not want companies in which it has a financial interest to lose value because of a

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[57]Selectica, 2010 WL 703062, at *11.

[58]Selectica, 2010 WL 703062, at *43.

[59]Versata v. Selectica, 5 A.3d 586, 606. (Del. 2010).

[60]Erickson & Heitzman, *supra* note 13, at 1376.

[61]Erickson & Heitzman, *supra* note 13, at 1376.

[62]Bradley Keoun, *Citigroup Gets U.S. Rescue From Losses, Cash Infusion*, BLOOMBERG(November 24, 2008 16:14 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a957XI5bBv7g.

NOL limitation. Thus, the Service issued a series of section 382 notices in 2008, 2009, and 2010 addressing the government bailouts.[63] Certain loss corporations, in which the government was a financing party, were exempt from NOL limitations. These notices follow the logic that an investment by the U.S. government does not result in the NOL trafficking that section 382 was designed to prevent.[64] Thus, when the U.S. (or any agency or instrumentality thereof) acquires either stock or an option to acquire stock in a loss corporation, that acquisition is not considered a section 382 testing date.[65] With no testing date imposed, section 382 is not triggered.

The guidance from the Service excludes "any date as of the close of which the United States directly or indirectly owns more-than-50-percent interest in the loss corporation."[66] The loss corporation would have "to start tracking its section 382 position on any date as of the close of which the United States does not directly or indirectly own more-than-a-50-percent interest in the loss corporation."[67] In 2009, the Service provided guidance to expand the scope of the section 382 exemptions to the Asset Guarantee Program, Systemically Significant Failing Institutions Program, and Capital Assistance Program for publicly traded issuers.[68]

Beyond the Service notices, Congress also amended section 382 by enacting section 382(n) (known as "the GM Rule"). The section 382 limitation does not apply to taxpayers' restructuring plans that are required under a loan agreement or a commitment for a line of credit entered into with the Department of Treasury under the Emergency Economic Stabilization Act of 2008 and intended to result in a rationalization of the costs, capitalization, and capacity with

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[63] *See generally* Notice 2008-76, 2008-39 I.R.B. 768; Notice 2008-84, 2008-41 I.R.B. 855.

[64] Alla Kaslinskaya & Rob Liquerman, *Section 382: Take Notice*, KPMG, (Jan. 25 2010); *see, e.g.*, Notice 2008-76, 2008-39 I.R.B. 768; Notice 2008-84, 2008-41 I.R.B. 855.

[65] Notice 2008-76, 2008-39 I.R.B. 768. A testing date is the 3-year period ending on the day of any owner shift involving a 5% shareholder or equity structure shift. I.R.C. § 382(i)(1).

[66] Alla Kaslinskaya & Rob Liquerman, *Section 382: Take Notice*, KPMG, 3 (Jan. 25 2010);

[67] *Id.*, *see also* Notice 2008-84, 2008-41 I.R.B. 855.

[68] Notice 2009-39, 2009-18 I.R.B 902.

respect to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries.[69] This will help companies that have restructured protect their valuable NOL assets. However, the limited scope of the provision makes it applicable to only a handful of companies. As the financial crisis continues to unfold, it is very possible that the government will have to provide further guidance and exceed the scope of the current provisions.

III. NOLs Unleashed

This section delves into the market costs and benefits of NOLs. Part A begins by exploring the economics of NOLs and posits a few assumptions related to the value proposition of NOLs. Part B demonstrates the costs of a section 382 trigger by conducting a discounted cash-flow analysis and provides examples in which section 382 can benefit and can cost the marketplace.

A. *The Economics of NOLs and Some Assumptions*

An inherent problem of section 382 is the possibility that losses associated with an acquired corporation will never be fully recognized for tax purposes. This problem was exacerbated in the Great Recession, when profitable companies purchased failing companies with large losses.[70] Shareholders of loss corporations have reason for concern, because a portion of the value of a loss company lies in its NOLs.

To demonstrate that section 382 in fact hinders business transactions and that the protection of NOLs is a valuable proposition, four assumptions will be put forth. Using those assumptions, the paper will make two conjectures that will provide a basis for a discounted cash flow (DCF) model demonstrating the negative effects of section 382.

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[69] I.R.C. § 382(n).

[70] For example, healthy banks, such as JPMorgan Chase, acquired banks with large portfolios of losses, such as Bear Stearns.

Assumption 1: *Markets are efficient and as such the share price of a corporation reflects all available public information.*

In an efficient capital market, security prices reflect all available information about the security. Traders adjust prices rapidly to new information presented. When markets are efficient, the share prices of investments tend to reflect the investments' intrinsic values driven by risk and return differentials.[71]

Assumption 2: *NOLs are a form of modified options, as they provide value to a corporation if they can offset income.*

A NOL has no value to a corporation that is not profitable, as it will not be able to offset past or future gains. This is similar to an option, which only has value when it is "in the money."[72] If a loss corporation expects to produce no income in the future, the NOLs are valueless to the loss corporation.

Assumption 3: *Value of NOLs depends on the party analyzing them.*

Unlike an option that has a uniform price for all parties,[73] NOLs have a subjective value. For a loss corporation, the value of a NOL at any moment is the present value of tax savings on future taxable income that can be offset with NOLs. For a purchaser of a loss corporation, the value of the NOLs depends on the present value of the taxable "income stream following acquisition of the loss [corporation]."[74] Thus, an important factor in the value for NOLs is the

[71] *See* Michael Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95 (1978)(For more information regarding the Efficient Market Theory).

[72] An in the money option is one where the stock price is greater than the strike price.

[73] This is based on the Black-Scholes option pricing formula. *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 644 (May-Jun. 1973).

[74] Daniel L. Simmons, *Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers*, 63 TUL. L. REV. 1045, 1057 (1989).

differences in projected cash flows of each corporation and their ability to utilize the NOLs in a timely manner.

Assumption 4: *NOL poison pills are not the same as traditional poison pills. As such, their impact on firm value differs, as well.*

In a typical poison pill, all holders of common stock (absent the party triggering the pill) would be allowed to acquire additional shares, thus diluting the acquiring party's holdings.[75] The idea is to make the costs of acquisition so high in a hostile takeover that the acquiring board would have to negotiate with the target board of directors—essentially coercing a would-be hostile purchaser to pay a price suitable to the target company.[76] The most recent evidence regarding the adoption of poison pills suggests that existing shareholders are not harmed when boards adopt a poison pill, although the general academic literature is mixed.[77]

A NOL poison pill differs from the traditional poison pill as the NOL pill is concerned with the preservation of a corporate asset. A NOL pill "deter[s] investors from acquiring ownership stakes large enough to trigger the limitations of section 382."[78] It functions by limiting the percentage of the target firm a shareholder can acquire by threatening to "explode into thousands of new, discount-priced share[s] of stock for all investors except the suitor, thus making control too costly."[79] The triggers for a NOL Pill are usually set below a 5% acquisition, as a result of section 382 of the Code.[80]

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[75]Nicholas Evan ET AL, *How Low Can You Go? An Insiders' Perspective on* Selectica v. Versata *and NOL Poison Pills*, 39 SEC. REG. L.J. ART 1 (Summer 2011).

[76]*Id.*

[77]*See* Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakover Measures*, 39 J. FIN. ECON. 3 (1995).

[78]Erickson & Heitzman, *supra* note 13, at 1370.

[79]25 No. 7 WESTLAW J. DE. CORP. 2, 1 (Oct. 18, 2010).

[80]I.R.C. §382 causes an ownership trigger when there is a 5% shift in ownership structure

As the objectives between the two pills are different, the current academic literature concerning poison pills does not address the impact that NOL pill adoption will have on value. With these assumptions in mind, I surmise that 1) NOL pills create value for firms and 2) this value can be demonstrated via a market for loss carryovers.

Proposition 1: *NOL Pills Create Value for Firms*

Although the literature regarding the value of poison pills varies,[81] the introduction of a NOL poison pill increases corporate value. By taking an uncertain asset (being the NOL fully exposed to section 382 triggers) and protecting it with a pill, thus making it a certain asset, a firm's balance sheet can better reflect enterprise value. However, as Assumption 3 suggests, NOL valuation can be subjective and this creates a market for loss carryovers.

Proposition 2: *Differences in NOL Valuation Create a Market for Loss Carryovers*

NOLs can be a valuable asset in the context of price negotiations between a buyer and a seller of a corporation. A buyer of a company with NOLs can potentially increase its bid based on the tax savings it anticipates to realize from the NOLs, while a seller can demand a premium from buyers for the NOLs knowing that the buyer will view that favorably. The purchaser and seller would negotiate a price for the corporation somewhere between the value of the NOLs to the loss corporation and the value of the NOLs to the purchasing corporation.

B. *Bringing it All Together: The Negative Value Effects of Section 382 Demonstrated*

The above-mentioned propositions provide the necessary framework in which to analyze the negative value effects of section 382. When triggered, section 382 can cause a loss in the

[81] *Compare* Thomas A. Turk ET AL, *The Effect of Takeover Defenses on Long Term and Short Term Analysts Earning Forecasts: The Case of Poison Pills*, 4 J. CORP. OWNERSHIP AND CONTROL 127 (Summer 2007) *with* John S. Strong & John R. Meyer, *An Analysis of Shareholder Rights Plans*, 11 MANAGERIAL AND DECISION ECON. 73 (1990).

enterprise value of the corporation, and a corresponding decrease in the share price. The following section will illustrate the impact of a section 382 trigger on a hypothetical firm's value using a discounted cash flow model.

1. *Benefits of a DCF Model*

When a firm uses its NOLs, it has a corresponding increase in cash flows. A DCF analysis will effectively capture the tax benefit to the corporation. To conduct a DCF analysis, numerous inputs would have to be assumed about the company.[82] For the sake of simplicity, the inputs will be kept constant in both scenarios. The only variable in the analysis is the tax benefit associated with the NOLs.

Furthermore, the DCF model utilizes the MVBS (Market Value Balance Sheet) approach.[83] The model is premised on the basic accounting principle that Assets = Liabilities + Owners Equity. This can then be broken down by assuming Assets = Cash + Enterprise Value (EV), since EV is just a proxy for the value of the assets. Liabilities are simply the company's debt. To calculate the Equity Value of a given firm, one would first solve for the Enterprise Value by conducting a DCF. One can derive the equity value (or shareholders equity) using all the necessary information. Calculating equity value is simple once the other three inputs are determined.

[82]Factors such as growth rate, interest rate, the discount rate, among others.

[83]This method is described in unpublished class materials created by Gregg A. Jarrell, Ph.D., a renowned expert witness in financial valuation cases.

Table 5- Simple MVBS Analysis

Assets		**Liabilities**	
Cash	100	Debt	200
Enterprise Value	300	Equity Value	**SOLVE** for Equity Value= 200
Market Value Assets	**400**	**Market Value Liabilities**	**400**

2. *DCF Model Applied*

Let us assume there is a hypothetical company, called Beer Stearns, which has usable NOLs of $100 in 2008 that have five more useful years. In 2008, assuming full use of its NOLs, it has an equity value of $347.92. Now assuming that in 2008, there was a section 382 trigger that applied due to an ownership change, the annual NOL Limitation kicks in, and the firm would have to take its equity value, in our case $347.92 and multiply it by the Federal Long-Term Tax-Exempt Rate, which I assume to be at 3.51%. The annual NOL usage will be reduced to $12.49 a year, and only usable for the following five years (a haircut of $25, assuming the firm can completely use all of the NOLs).

Assuming no limitation, the company is able to offset $100 worth of income over the 5-year period. With a section 382 limitation, the company is able to offset only $75 worth of income over the same period.[84] The potential for a NOL haircut demonstrates Selectica's justification in instituting a NOL poison pill, in addition to other companies who adopted NOL pills in the wake of the financial crisis.[85]

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[84] *See* the Appendix for the valuation calculation and assumptions.
[85] *See* the Appendix for a chart of companies that adopted NOL Pills.

B. *Burden on the Marketplace*

Looking at the negative impact of section 382 on equity values, one could conclude that it is an ill-conceived piece of legislation. Some have argued that section 382 influences corporate decision making as "[s]tressed companies are too often inhibited by fear that otherwise rational economic decisions will precipitate an ownership change."[86] Consequently "stock-for-debt exchanges outside of bankruptcy may be avoided, or pared back, and so may stock offerings to raise needed cash."[87]

This paper will provide two examples[88] of business decisions that are hindered by section 382. The first is the situation of a tender offer by the firm, which results in no new majority holder. The second is the tax-free merger of a Loss Co. into a changed loss corporation.

Example 1: *Stock Redemption – No New Majority Holder*

> Loss Co. has more than 1,000 shareholders, none owning more than two percent of Loss Co. stock. Loss Co. makes a successful tender offer for 51 percent of its outstanding shares. Following the tender offer, no shareholder of Loss Co. owns five percent or more of Loss Co. stock. Under current law, Loss Co. has an ownership change because of the segregation rules. Specifically, the "public group" that ends up owning 100 percent of Loss Co. stock (Public A) is deemed to have increased its ownership percentage from 49 percent to 100 percent. Since Public A is treated as a five-percent shareholder, the statutory definition of an "ownership change" is met.[89]

In this example, there is no good reason to limit the firm's utilization of its NOLs. To begin with, the tender offer will cause a reduction in Loss Co.'s equity value. As a loss corporation, the company has produced losses and negative earnings. This reduction in earnings reduces the rate at which the NOLs are utilized. As the example Part II(C)(2) illustrated, timing

[86]Sam Dimon, *Limit My Practice Instead! Thoughts on Reforming Section 382*, TAXES-THE TAX MAGAZINE, March 2010, at 65.

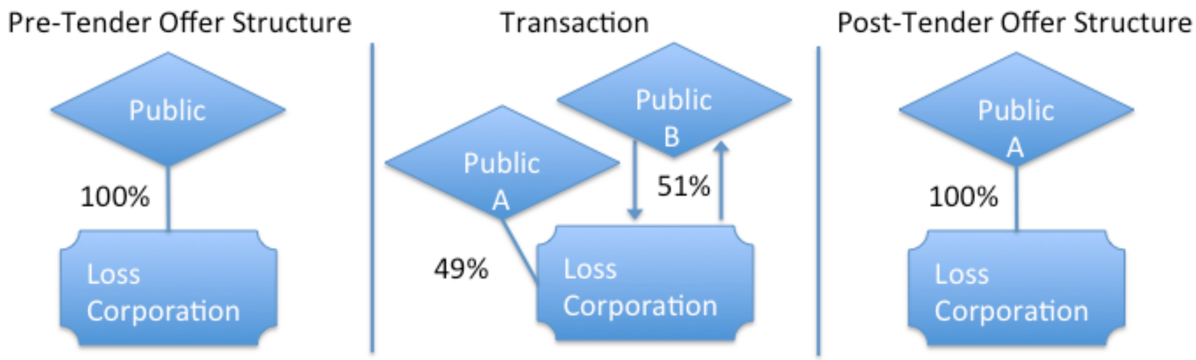
[87]*Id*.

[88]The examples presented have been adapted from adapted from Sam Dimon's paper, *supra* note 86.

[89]Dimon, *supra* note 86, at 67.

issues can be crucial in causing a valuation reduction. Thus, in this case, the firm's value would be decreased twice: once as a result of the tender offer and once as a result of the NOL usage reduction.

Figure 2- Stock Redemption Illustrated



Further, under the semi-strong form of efficient capital markets (a view advocated by our courts),[90] the section 382 limitations would serve as a hindrance in a firm's ability to raise capital, placing it at a disadvantage to new market entrants. A firm that tries to raise capital using a tender-offer or debt for stock transaction would be subject to section 382. This is contrary to the view of the legislative history, which instituted section 382 to prevent a tax bias in favor of acquisitions stemming from "the ability to use acquired losses against such unrelated income."[91]

[90] *See, e.g.*, Cammer v. Bloom, 711 F. Supp. 1264, 1280 (D.N.J. 1989); In re LTV Securities Litigation, 88 F.R.D. 134 (N.D. Tex. 1980); *see also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV 549, 549-500 (1984)(discussing the legal cultures adoption of the Efficient Market Hypothesis).

[91] STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (Comm. Print 1987), at 295 ("[T]he ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions").

Example 2: *Tax-Free Merger of Loss Co. into Changed Loss Corporation*

> Loss Co. merges into Changed Loss Corporation in a transaction that is tax free under Code Sec. 368(a)(1)(A). Loss Co.'s shareholders receive 20 percent of the stock of NMH [New Majority Holder] in the merger.[92]

This is an example of a situation where section 382 may provide a valuable deterrence effect in the market. This transaction demonstrates a clear change of ownership. If there were no limitations imposed by section 382 then large companies would have an incentive to acquire loss corporations in order to create tax shelters.

Depending on the scenario, the haircut that a section 382 trigger takes on a firm's existing NOLs can be too high. The following section of the paper explores a new method for valuing NOL limitations. The Code can limit abusive transactions and still allow for positive ones. Reforming the current regulation will enable companies to focus on growth. Not requiring decision-makers to devise strategies in avoidance of section 382 can allow companies to spend their resources on other productive outlets.

IV. A New Method for Valuing NOL Limitations

To be clear, having limitations on loss trafficking, the primary purpose of section 382, is not entirely undesirable. However, the fact that section 382 will virtually apply to every business transaction that takes place suggests that the scope of 382 is too broad.

The current haircut is calculated by multiplying the fair market value of the equity by the federal long-term tax-exempt rate.[93] This calculation has no relation to the firm's income level or the ability to use the NOLs in the future. Transactions can be separated into three categories to differentiate between the scenarios in which section 382 can apply. The first category involves

[92]Dimon, *supra* note 86, at 73.
[93]I.R.C. § 382(b)(1).

abusive trafficking which section 382 does an adequate job of policing. However, the current section 382 limitation hinders 1) transactions meant to raise capital for the firm and 2) mergers and acquisitions, respectively the second and third category.

To reflect market conditions, section 382 should be revised to reflect the following principles:

1. Disallowing NOL usage for abusive transactions
2. Allowing for unlimited NOL usage in a financing transaction
3. Proportionally limiting NOL usage in a merger or acquisition

A. *Category 1 Transactions – Abusive Transactions*

In general, abusive transactions involve the joining of new capital and old NOLs. The new corporation formed in an abusive transaction would potentially have some of the following characteristics:

a. High ratio of NOLs to pre-change active business assets
b. Low ratio of the value of pre-change active business assets to the amount of "new" capital
c. Insignificant gross revenues or gross costs

In an abusive transaction we might expect to find some or all of the following:

a. Lack of meaningful business continuity
b. A large percentage of investment assets
c. Risk reduction devices for new capital (*e.g.*, tracking stock linked to investment assets).[94]

[94]Dimon, *supra* note 86, at 76.

Corporations that are creating tax shelters or other mechanisms to avoid paying taxes should not be allowed to utilize any benefits associated with NOLs. This would prevent loss corporations from further accumulating losses to be more attractive to purchasers and prevent purchasers from acquiring a corporation and then shutting it down for the sake of using the firm's NOLs. In a sense, section 382 is only useful in protecting against abusive transactions, but ends up punishing the other two legitimate types.

B. *Category 2 Transactions – Raising Capital*

In a Category 2 transaction, a firm will raise capital for a legitimate business purpose and will continue its existing business operations.[95] These transactions could be characterized as stock-for-debt transactions, tender offers, and issuance of new shares, among other financing options available to a firm that is in a glut, but is trying to avoid bankruptcy.

The law as applied to corporations that are trying to survive an economic downturn by finding sources of financing should be exempt from having to take any haircut at all. The federal government has no legitimate reason to limit the amount of NOLs that a distressed company should be able to use. Moreover, distressed companies should not have to structure financing deals in a way to avoid a section 382 trigger either. The government has recognized this in creating the section 382(n) exception, the "GM Rule," but that is not enough, as it only applies to a handful of corporations.

[95] I.R.C. § 382(c).

C. *Category 3 Transactions – Mergers & Acquisitions*

A Category 3 transaction focuses on the situation in which an acquirer purchases a company with NOLs. These could be plain-vanilla mergers[96], or other tax-free mergers as discussed in section 368.

The Code should adopt a new formula for adopting the NOL limitations applied to this category. A proportional methodology by using the proportion of Loss Co. shares to New Company (NewCo)[97] shares or equity value of the Loss Co. as a percentage of the NewCo would be a fairer NOL limitation to impose on the acquiring firm. Further study is needed to determine which method might better represent the proportion of NOLs that should be allowed annually, but, as argued in the following section, either method is a more accurate value proxy than the current legislation.

Method 1:

$$NOL\ Limitation = \frac{\#\ of\ Loss\ Co\ Shares\ in\ NewCo}{Total\ \#\ of\ Shares\ in\ NewCo}$$

Method 2:

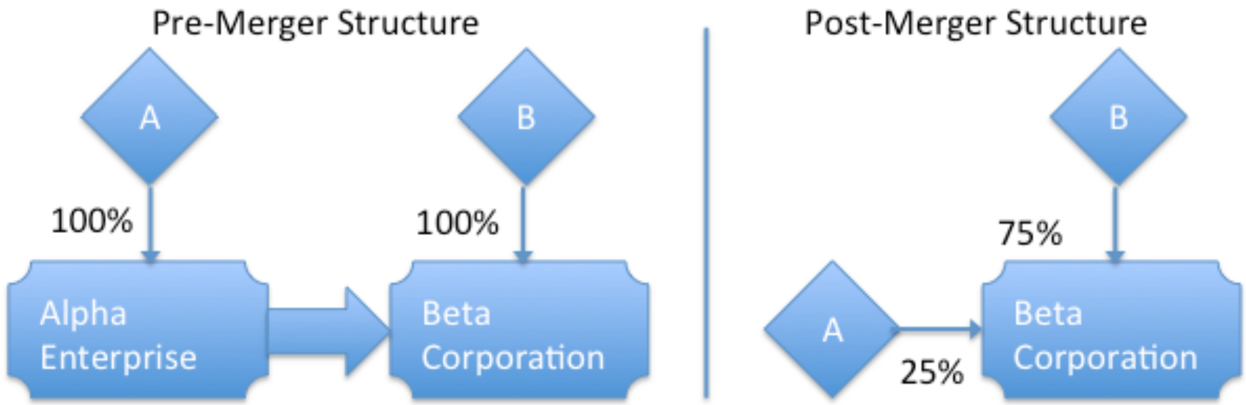
$$NOL\ Limitation = \frac{Equity\ Value\ of\ Loss\ Co}{Equity\ Value\ of\ NewCo}$$

1. *Proportional NOL Limits Illustrated*

The following section will demonstrate how proportional NOL limits function. Let us revisit the transaction where Beta Corporation merges with Alpha Enterprise. After the merger, Alpha shareholders hold 25% of the shares, thus under Method 1, the annual NOL limitation should be limited to 25% of the value of the NOLs.

[96]Plain Vanilla merger refers to a standard form merger, where one company merges into another company, with only one surviving entity left.

[97]NewCo is a term of art used for a newly formed company after a merger.



Using the same corporate structure, and assigning equity values, we can demonstrate the ease of using Method 2, as well. Assume Alpha Enterprise has an equity value of 250, and Beta Corporation has an equity value of 750. After the merger NewCo has an equity value of 1,000. Thus, the annual NOL limitation under Method 2 should also be 25%.

These are both simplified illustrations, and further study would be necessary to see which would be a better proxy. However, this simple method will preserve the value of NOLs while preventing loss trafficking, which section 382 attempts to prevent.

V. The Case for Revamping Section 382

A. *Disallowing NOL Usage for Abusive Transactions*

The original purpose of NOL carry-backs and carry-forwards was based on the averaging concept of income taxes. Its goal was to "mitigate the harshness of the annual accounting system that otherwise allowed the taxpayer to offset only the current year's income with net losses."[98] Congress was attempting to reduce the disparity between the average tax rates faced by

[98]Simmons, *supra* note 74, at 1051.

companies that had stable incomes and the tax rates faced by companies with fluctuating incomes.[99]

Abusive transactions that attempt to undermine the legislative intent and purpose of a regulation should be prohibited. Allowing for loss trafficking of NOLs would result in a tax subsidy to the acquiring corporation paid for by the taxpayer. The acquirer will have access to tax write-offs, which will never be recouped by the Service. Beyond the scope of congressional intent, by prohibiting a loss corporation from being acquired for its tax attributes, the loss corporation will cease to accumulate losses to become more attractive to a potential acquirer. By removing the economic incentive for going deeper in the hole, a rational firm will have to make decisions that will help the firm recover or seek bankruptcy.

B. *Allowing for Unlimited NOL Usage in a Financing Transaction*

With the legislative intent of section 382 in mind, Congress should allow a company that is seeking capital to finance operations unlimited use of the company's existing NOLs. To be clear, unlimited NOL usage suggests that a section 382 revaluation will not take place. The NOLs should still be subject to other requirements imposed by the Code. A firm in this category is not changing its operations or its business purpose. It is only seeking a cash infusion. The corporation and its shareholders should be considered separate entities in this instance and a change in ownership structure (absent a merger or divestiture) should not trigger a 382 NOL limitation.

By updating the regulation to reflect unlimited NOL usage, Congress will allow a loss corporation to stay afloat and utilize the losses it incurred to offset future income. While this will reduce the tax paid by the loss corporation in the short run, in the long run (assuming the firm is

[99] S. REP. NO. 99-313, at 225 (1986).

able to become profitable and grow after receiving an infusion of cash) the tax coffers will be better off. Instead of having a company go under and no longer pay taxes, a company can recover and start paying taxes once it has utilized its existing NOLs.[100] This would stimulate growth on a macro-level and confer a benefit to the taxpayers at large.

C. *Proportionally Limiting NOL Usage in a Merger or Acquisition*

Under the current state of section 382, a firm making an acquisition (or similar transaction) of a loss corporation will have to revalue the acquired NOLs to a fraction of their original value. Proportional valuation allows for the company to retain usage of NOLs for the portion of the LossCo that is part of the NewCo. On a very basic level it simplifies an overcomplicated tax provision. As many tax practitioners have noted, section 382 is "hideously complicated."[101] The current limitation was based on a fear that "the loss corporation could simply liquidate its assets and purchase taxable securities, yielding a steady, risk-free flow of taxable income which could be offset by any available losses." [102]

There are multiple rationales behind simplifying section 382. Simplifying the NOL limitations creates an environment of neutrality–allowing for tax considerations to have as little influence as possible on nontax decision-making. Less complicated and burdensome regulation is desirable for any business environment.

Furthermore, the regulation goes beyond the scope and impedes on other corporate transactions. The cost of a section 382 haircut has been demonstrated in this paper, and consequently numerous firms have already spent considerable resources in implementing poison

[100]Keep in mind that NOLs can be carried forward for a statutorily limited amount of time. *See* I.R.C. §172.

[101]Dimon, *supra* note 86, at 80.

[102]Dimon, *supra* note 86, at 96, *citing* STAFF OF THE COMMITTEE ON FINANCE, THE SUBCHAPTER C REVISION ACT OF 1985 (S. Print 99-47, 1985).

pills to protect the NOLs. That is money that could have been spent on other projects for the firm, which (assuming success in business transactions) would have yielded income to the firm and increased tax payments to the Service.

Furthermore, proportional NOL usage is not a radically new concept. The 1982 ALI Report suggested that in mergers where a loss corporation NOLs were met with new capital that the "NOL carryovers would be limited to a fraction of the new corporation's earnings based on the relative value of the loss corporation to the corporation surviving the merger."[103] Congress failed to pay attention to this suggestion back in 1982.[104]

Proportional valuation allows for the newly formed enterprise to use NOLs that were a proper asset of the loss corporation. The loss carryover that could be utilized after a reorganization would be no more than a proportion of the resulting corporations net income. The author is unable to say which method presented would function as a better proxy for percentage of income earned in the NewCo is from the LossCo. Nonetheless, this method prevents the disappearance of NOLs. It would also cause companies to merge[105] for reasons other than the acquisition of NOLs while serving as a deterrence to loss trafficking. Thus, proportional NOL valuation is a more sensible alterative to the LTER method.

V. Conclusion

NOLs, although not often discussed in the literature, prove to be an important aspect of a company's valuation. Thus, companies have been justified in implementing poison pills to

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[103]ALI, FEDERAL INCOME TAX PROJECT SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS, at 237 (1982).

[104]It is not clear why Congress rejected the ALI proposal, however I would suggest that it is based on their extreme fear of loss trafficking.

[105]Although the costs and benefits of a merger transaction are beyond the scope of this paper, it is suffice to say that many mergers fail to achieve the synergies that they propose. *See* Rikard Larsson & Sydney Finkelstein, *Integrating Strategic, Organizational, and Human Resource Perspectives on Mergers and Acquisitions: A Case Survey of Synergy Realization*, 10 ORG. SCI. 1(Jan. - Feb., 1999).

protect the value of their NOL asset, and courts have upheld the usage of pills to be a valid exercise of business judgment.[106] The market costs imposed by a section 382 limitation demonstrate that the legislation hinders business strategy, and that, in some cases, the costs of regulation are too high. Thus, it makes sense to revisit the 382 limitations under certain scenarios, and utilize a better benchmark for limiting NOLS. This paper is only the starting point, as much more work needs to be done.

[106] *See generally* Selectica v. Versata, C.A. No. 4241-VCN, 2010 WL 703062, at *1 (Del. Ch. Feb. 26, 2010).