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Federal tax practice

Getting the Most Out of Section 382 Limitations

Section 382 of the Internal Revenue Code serves to limit corporate tax attributes such as net operating losses following an "ownership change." Generally an ownership change occurs when, within a 3-year period, there is an increase in the stock ownership by one or more five-percent shareholders of more than 50 percentage points. Issuing stock warrants or convertible debt to raise funds are two activities that may trigger an ownership change.

After an ownership change, the post-change corporation may only deduct its pre-change losses against taxable income in an amount equal to the Section 382 limitation amount. The rules generally limit the amount that may be used annually to a percentage of the entity value of the corporation at the date on which ownership changed. The percentage is the highest federal long-term tax-exempt rate (as determined by the IRS) for the month in which the change in ownership occurs and the preceding two months.

Various special rules and limitations apply, including provisions dealing with built-in gains and losses that have the potential to limit additional realized losses or that can increase the amount of Section 382 limitation. Additionally, net operating losses may be subject to additional Section 382 limitations caused by earlier ownership changes incurred during rounds of financing.

Optimizing a Section 382 limitation is crucial to your company's ability to offset future taxable income.

Valuations for Section 382 purposes are generally complex and include:

Determining when an ownership change occurs;
Calculating a Section 382 limitation; and
Identifying built-in gains and losses for impact on the Section 382 limitation.

Any startup or existing corporation that has completed or is contemplating a round of funding or acquiring a loss corporation must consider the effects of Section 382 on its ability to offset future taxable income. If your company has accumulated net operating loss (NOL) and tax credit carryforwards, these scenarios can significantly impair the value of those tax assets.

Determining whether a corporation has even experienced an ownership change is a complex undertaking, and deep knowledge of the various rules and exceptions may avoid one. While avoiding an ownership change is clearly the best situation, a thorough understanding of the ways in which the limitation can be optimized is critical to the reduction of future income tax when one has occurred. Consult one of our advisors to provide the necessary analysis.

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