The Art & Science of Tax Carryovers

Section 382 studies are far too important to leave to amateurs

Many companies get tangled up in Section 382 of the U.S. Tax Code governing the handling of tax carryovers when there's been a change of ownership. ***EisnerAmper*** *tax partner* ***Jeffrey Kelson****, a Section 382 expert, below walks us through the intricacies of Section 382 studies and evaluations. His remarks have been edited for length and style.*

MCC: Please share your background with our readers.

Kelson: I'm tax partner in charge of the New Jersey tax practice of EisnerAmper. I've been with the firm about 10 years. Prior to that, I was with a different national firm for 20 years. I do a lot of corporate work, including M&A, and U.S. Code Section 382 studies.

MCC: Talk about Section 382 tax studies. What's the origin and purpose?

Kelson: About 30 years ago, Congress changed the rules for carryovers of tax attributes when there's been a change in ownership. They enacted a mathematical study that can determine whether there has been a change in ownership for purposes of Section 382 and what restrictions or limitations are placed on these tax attributes.

Prior to 1986, there were a lot of transactions in which companies were purchased for their tax attributes and nothing else. Congress tried to devise a formula and calculation that would determine if there was a change in ownership and, if there was, what limitations and restrictions would be placed on the carryovers. They wanted to separate purchases done for economic reasons – for return on investment – from those done for just the tax benefits.

MCC: Are specific sectors impacted more than others by this rule?

Kelson: You can find any sector that has loss carryovers. Recently, it's been very prevalent with life sciences and technology companies. That's because they take a few years to ramp up – sometimes many years. They're waiting for approval for drugs or for their technology to take root. During this period, the "start-up phase," there typically are large losses and suspended credits that get carried forward. But it applies to any industry. There's a lot of private equity investment coming into companies that might have tax attribute carryforwards, and they're very concerned about what an investment in those companies will mean for the sanctity of those carryforwards.

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MCC: Why and when should a company look to conduct a Section 382 study?

Kelson: A company with carryforwards, whether loss carryforwards or credit carryforwards, should be conducting a contemporaneous study so they know that add-on investment could cause a change in ownership and might restrict the carryforwards. They can plan around that, or, if not, at least be aware of it for financial purposes and, most importantly, tax purposes.

Some companies do not get around to it because they are so busy trying to attract capital and get their operation started up. When some big investment is coming in, or there's some other transaction, the investors want to know if the company has had any studies conducted. Then it's a fire drill. The company is trying to engage firms to do these studies so they can report back to the purchasers or investors on what the history is. So in a perfect world, they should do it as they go along. And public company clients should do it because it's important to know for their financial statements.

MCC: What are some misconceptions about Section 382 studies?

Kelson: The biggest misconception is that they're easy, or that you can feel your way through and kind of approximate it, and that it can be done very quickly. This is one of the most complicated code sections as far as the mixture of concept and calculation – more of an art than a science. These calculations sometimes are counterintuitive. They're intricate. They're laborious. You need to get a lot of information, not only from your immediate investors, but maybe from the investors of your investors. You need to have values of different classes of shares.

So the biggest misconception is, "Oh, we can just knock this out." In no way shape or form can you knock out or approximate a Section 382 study covering multiple years of multiple classes of stock. People that have gotten wind of the complexity of the section don't feel that way once they see the end product and how elaborate the calculations need to be. They change their tune.

MCC: What are the advantages of working with an outside firm like EisnerAmper versus conducting the study in-house?

Kelson: These studies cannot be done by an in-house person as a one-off. You have to be working in this area at least part-time for years to really do it justice. If you dabble, and you open the code and the regulations and think you are going to be able to conduct a study that governs 10-15 years of multiple classes of stock, you'll be in over your head. It requires experts. At EisnerAmper, we do many Section 382 studies. Purchasers are requiring these studies because they want to know the impact of any changes that might have occurred prior to their investment. From a financial statement point of view, these studies are mandatory so a company can talk about the legitimacy of deferred tax assets and whether they're ever going to be realized. So an in-house solution is not really in the cards. The in-house person can assist and gather a lot of the documentation – the facts, the history, the valuations for the different shares. To do it on their own, however, it would require them to be doing this as their job.

MCC: How is evaluation a factor in these studies?

Kelson: That's the million-dollar question. The evaluations are important because the whole study pivots off of the values that have changed hands between what is called "5 percent shareholders." When you have multiple classes of stock, what you see a lot in private companies is that each of those different classes of stock has to be valued at the time any transaction in any of the other classes of stock occurs. Then if there's a change in ownership and you did cross the 50 percent threshold, you need to have an evaluation to determine the actual value of the company.

That's important because it's a formula determining how much of the attributes can be used in the subsequent years. For instance, if the company is worth $10 million, but the IRS requires you to multiply it by the long-term tax-exempt rate, which is almost down to 1.5 percent right now, that's how you determine how much of those net operating losses can be used in subsequent years.

MCC: Please give us an example of a Section 382 study engagement?

Kelson: We see multiple reasons for them. The number one reason is that a company is looking to engage or obtain more capital, or maybe they are going to be sold. The purchaser knows that when they buy their shares, say it's 100 percent, there will be a change in ownership because of the amount they are buying. They want to know if there have been previous limitations prior to their purchase because that might restrict the carryovers from previous years. So even though they know for sure that there's been a change based on their transactions alone, they are not certain of what happened in the past.

A firm would then engage us and say, "The purchaser wants to know the integrity of all tax carryovers." A lot of times we need to go back 10 or 15 years to determine what movement in the shares has occurred that maybe restricted tax carryovers in previous years. That's something we're seeing.

Also, for financial statement purposes, a lot of firms need to declare to their outside auditors whether they've had any of these studies because the net operating loss carryovers, or what are called "deferred tax assets" on their balance sheets, just because of the math of the formula may never be able to be used. For financial statement purposes, they need to back that out of their deferred tax asset footnote to demonstrate that some of those losses are lost permanently.

It's easy to have a change just in the normal course of the business raising capital. A lot of times companies get tangled in the 382 web. Some of those credits and loss carryforwards can be permanently lost.

MCC: Is there anything else that you'd like to add?

Kelson: If a firm or company is contemplating having one of these studies done, it's always better to do it sooner rather than later. As years go by, records of shareholders and previous issuances get stale. Sometimes, they aren't easily recovered. Moreover, if they conduct a study, they know the value of these carryovers and in future transactions they can plan ahead to see what impact they would have. You now have a working model that you can use on a go-forward basis rather than just speculating what the situation might be.

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