IRS Proposes New Section 382 Regulations To Further Limit Use of Tax Losses

Skadden

09 / 27 / 19

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

Four Times Square
New York, NY 10036
212.735.3000

1440 New York Avenue, N.W.
Washington, D.C. 20005
202.371.7000

On September 9, 2019, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) proposed regulations (proposed regulations) addressing items of income and deduction that are included in the calculation of built-in gains and losses under Section 382 of the Internal Revenue Code. Section 382 (together with Section 383) generally affects corporations that undergo a greater-than-50% change in ownership during any three-year period and that have significant net operating loss carryforwards (NOLs), and interest, capital loss and foreign tax credit carryforwards (together with NOLs, carryforwards) before the ownership change (a loss corporation).

Generally, the proposed regulations are likely to have the greatest impact on two groups of loss corporations. First, are loss corporations with significant carryforwards and with unrealized built-in gains in their assets, such as certain tech companies or pharmaceutical companies that have made significant investments to develop self-created intangible assets. Second, are loss corporations with significant built-in losses, such as struggling banks and distressed companies.

As discussed in greater detail below, the proposed regulations, if finalized in their current form, would reverse key aspects of a long-standing IRS position, contained in Notice 2003-65, which permits these types of loss corporations to utilize significant portions of their carryforwards and built-in losses following an ownership change. By reversing a carryforward-usage mechanism that has been in place for over 15 years, the proposed regulations would significantly increase the income tax burden experienced by many of these loss corporations and their acquirers following an ownership change. Absent careful planning, the proposed regulations could be expected to reduce the after-tax cash flow of many loss corporations after an ownership change, which could in certain instances have an adverse impact on either the value of the loss corporation or the ability of the loss corporation to engage in certain types of M&A activity outside the bankruptcy context. Because the proposed regulations are not effective until their finalization, their existence could, depending on the IRS' response to taxpayers' criticism, accelerate M&A activity involving loss corporations, as parties may be encouraged to protect their valuation and cash flow expectations by completing transactions before the proposed regulations are finalized.

Section 382

As noted above, Section 382 (together with Section 383) establishes a limitation on the ability of carryforwards to be used by a loss corporation after an ownership change (Section 382 limitation). The Section 382 limitation is determined by multiplying the value of the loss corporation's equity before the ownership change by a specified rate that is determined each month by Treasury and the IRS.

Example 1: Assume an acquirer purchases all the stock of LossCo for $100. Assume also that the long-term tax-exempt rate is 2%. The Section 382 limitation for any post-change year would therefore be $2.

Section 382(h) addresses the interaction of the Section 382 limitation with built-in gains and losses recognized during the five-year period beginning with the date on which ownership of the loss corporation changes (recognition period and change date, respectively).

For example, where a loss corporation, immediately prior to a change date, has a net unrealized built-in gain in its assets (NUBIG), which is defined as the amount by which the fair market value of the assets of the loss corporation immediately before the change date exceeds the aggregate adjusted basis of such assets at that date, the loss corporation's Section 382 limitation for any year in the recognition period is increased by the amount of recognized built-in gain (RBIG) recognized during such year.

Example 2: Assume LossCo has assets with an aggregate fair market value of $100 and an aggregate adjusted basis of $30. LossCo undergoes a change in ownership and has a NUBIG of $70 because of the built-in gain in its assets.

RBIGs are defined as any gain recognized during the recognition period on the disposition of any asset if the loss corporation establishes that it held the asset immediately before the change date, and the gain does not exceed the built-in gain in the asset on the change date.

Example 3: Assume the same facts as in Example 2 above. In year two, after the change in ownership, LossCo sells one of its assets for $80. At the time of the ownership change, the asset had a value of $90 and an adjusted basis of $20. LossCo would have an RBIG of $60 (the gain recognized on the asset sale). LossCo's Section 382 limitation for year two would thus be increased by $60 (thereby permitting use of $60 of pre-change NOLs against the gain so recognized).

Conversely, where a loss corporation, immediately prior to the change date, has a net unrealized built-in loss in its assets (NUBIL), which is defined as the amount by which the fair market value of the assets of the loss corporation immediately before an ownership change is less than the aggregate adjusted basis of such assets at such time, the recognized built-in loss (RBIL) during each year in the recognition period is subject to the loss corporation's Section 382 limitation.

Example 4: Assume LossCo has assets with an aggregate fair market value of $100 and an aggregate adjusted basis of $140. LossCo undergoes a change in ownership. LossCo has a NUBIL of $40 because of the built-in loss in its assets.

RBILs are defined as any losses recognized during the recognition period on the disposition of any asset except to the extent the loss corporation establishes that it did not hold such asset immediately before the change date, or such loss exceeds the built-in loss of such asset on the change date.

Example 5: Assume the same facts as in Example 4 above. In year two, after the change in ownership, LossCo sells one of its assets for $20. At the time of the ownership change, the asset had a value of $20 and an adjusted basis of $50. LossCo would have an RBIL of $30 (the loss recognized on its asset sale). The use of the $30 loss would be subject to LossCo's Section 382 limitation as if it were a pre-change loss.

Section 382(h)(6) provides that an item of income that is properly taken into account during the recognition period but is attributable to the period before the change date will be treated as an RBIG, and an amount that is allowable as a deduction during the recognition period, but is attributable to the period before the change date will be treated as an RBIL. NUBIGs and NUBILs must be properly adjusted to account for income and deduction items that would be RBIGs or RBILs if such amounts were taken into account (or allowable as deductions) during the recognition period.

Notice 2003-65

Notice 2003-65 provides guidance on the calculation of NUBIG and NUBIL, and the identification of RBIGs and RBILs. In the absence of regulations, Notice 2003-65 introduced two alternative safe harbor methods for identifying NUBIGs, NUBILs, RBIGs and RBILs that the taxpayer could elect to use: the 1374 approach and the 338 approach. Both approaches calculate NUBIGs and NUBILs in the same manner, but they differ significantly with respect to the identification of RBIGs and RBILs.

Under the 1374 approach, which is generally favored by loss corporations that have NUBILs, RBIGs and RBILs are gains and losses, respectively, recognized during the recognition period on the sale or exchange of assets, and only a very limited range of income items and deduction items, respectively. Generally, only those items that an accrual method taxpayer would have included in income or for which a deduction would have been allowed before the change date are included as RBIGs and RBILs, respectively. In addition, depreciation, amortization or depletion deductions during the recognition period, regardless of whether they accrued before the change date, are treated as RBILs, except to the extent the loss corporation establishes that the amount is not attributable to the NUBIL. In Notice 2003-65, the 1374 approach also generally treated as RBIG any income properly taken into account during the first 12 months of the recognition period as discharge of indebtedness income (COD income) that is included in gross income if the item arises from a debt owed by the loss corporation on the change date. Conversely, the 1374 approach in Notice 2003-65 generally treated as RBIL any deduction item properly taken into account during the first 12 months of the recognition period as a bad debt deduction if the item arises from a debt owed to the loss corporation on the change date.

Example 6: Assume LossCo has NOLs of $30. LossCo owns land with a value of $10 and an adjusted basis of $10, and also owns an amortizable asset with a fair market value of $90 and an adjusted basis of $20. Assume that 10 years of amortization remain, but the amortization period was initially 15 years. Also assume that the long-term tax-exempt rate is 2%.

IRS Proposes New Section 382 Regulations To Further Limit Use of Tax Losses

An acquirer purchases LossCo stock for $100. The Section 382 limitation for any post-change year would therefore be $2.

Under either the 338 approach or the 1374 approach, LossCo has a NUBIG of $70 because of the aggregate built-in gain in its assets.

Under the 1374 approach, there would be no RBIGs in the recognition period if LossCo retains its assets because LossCo did not actually recognize any gain. LossCo's Section 382 limitation for any year in the recognition period would not be increased, and only $2 of the NOLs of LossCo would be eligible to offset any income of LossCo each year.

Alternatively, the 338 approach, which is generally favored by loss corporations that have NUBIGs, is much more expansive. It identifies RBIGs and RBILs by comparing the loss corporation's actual items of income, gain, deduction and loss with those that would have resulted if a Section 338 election had been made on the change date with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation. In respect of wasting assets with a built-in gain held by a loss corporation with a NUBIG, the effect is that the assets generate RBIG even if such assets are not disposed of during the recognition period. The 338 approach treats as RBIG the amount equal to the excess of the cost recovery deduction that would have been allowed with respect to the asset had a Section 338 election been made over the loss corporation's actual allowable cost recovery deduction. The hypothetical deduction is determined based on the asset's fair market value on the change date and a new cost recovery period beginning on the change date. The reasoning underpinning the 338 approach's inclusion of incremental hypothetical depreciation, depletion or amortization deductions with respect to built-in gain assets reflects an estimate of income generated by a wasting asset during a particular period. With respect to COD income, the 338 approach treats COD income that is included in gross income, and that is attributable to any pre-change date debt of the loss corporation, as an RBIG in an amount not exceeding the excess, if any, of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date.

Example 7: Assume the same facts as Example 6 above. Applying the 338 approach, however, for any year in the recognition period, the RBIG attributable to the amortizable asset would be $4 (the excess of the $6 amortization deduction that would have been allowed had a Section 338 election been made with respect to a hypothetical purchase of all of the stock of LossCo ($90 fair market value divided by 15 years, the amortization period) over $2 (the actual allowable amortization deduction)). This $4 of RBIG would increase LossCo's Section 382 Limitation for any year in the recognition period by $4 to $6 for the year. As a result, $6 of pre-change NOLs of LossCo would be eligible to offset income of LossCo in any year in the recognition period.

Proposed Changes and Affected Taxpayers

Elimination of the 338 Approach

The proposed regulations would adopt as mandatory the 1374 approach with certain modifications (and therefore would preclude the use of the 338 approach for identifying RBIGs and RBILs).

Generally, the proposed regulations' proposal of a single method for identifying RBIGs and RBILs may adversely impact loss corporations with significant carryforwards and with unrealized built-in gains in their assets, such as certain tech companies or pharmaceutical companies, that undergo ownership changes.

Currently, loss corporations with NUBIGs are often able to apply the 338 approach to significantly increase their Section 382 limitations and mitigate the practical impact of Section 382. The proposed regulations are likely to change that result. As an illustration, compare the results of Example 6 with those of Example 7, above.

Modification of the 1374 Approach

The proposed regulations also would modify in certain ways the 1374 approach introduced in Notice 2003-65. For example, the proposed regulations generally would not allow COD income to be included in the calculation of NUBIG/NUBIL, with certain exceptions. Similarly, the proposed regulations would provide limitations on the extent to which COD income that is excluded from gross income due to the bankruptcy or insolvency of the debtor corporation is treated as RBIG. Treasury and the IRS also propose to modify the 1374 approach to include as RBIL the amount of any deductible contingent liabilities paid or accrued during the recognition period, to the extent of the estimated value of those liabilities on the change date. The proposed regulations also would provide special rules addressing nonrecourse debt.

Generally speaking, distressed companies with built-in losses in their assets that have an ownership change may be negatively affected by the proposed regulations' changes to rules under the 1374 approach for COD income and contingent liabilities (*e.g.*, companies with significant contingent environmental or tort liabilities).

The proposed regulations also would modify the 1374 approach by removing the 12 month limitation on bad debt deductions, so that bad debt deductions on debt held on the change date could be treated as built-in throughout the recognition period. This change — in effect, the opposite of the policy pursued by the administration during the last recession — would impact potential transactions involving distressed banks in any future financial crisis.

IRS Proposes New Section 382 Regulations To Further Limit Use of Tax Losses

Incentives for Taxpayers

For both loss corporations with NUBIGs and loss corporations with NUBILs, the proposed regulations could incentivize taxpayers to undertake planning strategies to avoid transactions that trigger ownership changes that are subject to the Section 382 limitation.

Furthermore, the proposed regulations may incentivize loss corporations to structure transactions to ameliorate the adverse impact of the 1374 approach. For example, loss corporations with significant built-in gain assets may pursue asset disposition transactions to recognize gains prior to a change in ownership. Alternatively, other taxpayers may seek out planning strategies to realize actual gains on, as opposed to income from, appreciated assets during the recognition period.

Reasons for Change Offered in the Proposed Regulations

The proposed regulations provide several reasons supporting the adoption of the 1374 approach (with modifications) and elimination of the 338 approach.

First, Treasury and the IRS concluded that the 1374 approach is more consistent with the text and the purpose of Section 382. For example, the 338 approach allows a taxpayer to take into account certain RBIGs even though no actual recognition of gain or income has occurred. Seemingly concerned with the statutory language in Section 382(h)(6)(A), Treasury and the IRS note that the statute itself does not authorize RBIG treatment in the absence of actual gain or income recognized by the loss corporation. Some commentators already have suggested that this reasoning is tenuous, particularly in light of the regulatory authority provided in Section 382(m).

Second, the proposed regulations rely on the rationale that the accrual-based 1374 approach is simpler to apply. In particular, Treasury and the IRS state that the 338 approach is complicated by various changes made by the Tax Cuts and Jobs Act (TCJA). For example, the application of additional first-year depreciation under amended Section 168(k) would not provide a reasonable estimate of the income produced by a built-in gain asset during the recognition period. Furthermore, the proposed regulations note that income inclusions under Section 951A (the GILTI regime) also add to existing concerns, including as a result of potential changes in hypothetical qualified business asset investment (QBAI) from deemed tiered section 338 elections under the 338 approach (*i.e.*, a concern that foreign income will free up domestic carryforwards that can offset income taxable at 21%).

Effective Dates

The proposed regulations would apply to ownership changes occurring after their publication as final regulations. Loss corporations that undergo an ownership change prior to publications of final regulations could continue to rely on Notice 2003-65, even after the final regulations' publication, although they also would be offered the generally unattractive option to elect the rules of the proposed regulations if the period of limitation on filing a claim for the tax year of the change date has not expired.

Notably, the proposed regulations offer no "grandfathering" for ownership changes in the pipeline before the publication of final regulations, even those for which binding contracts existed before the proposed regulations were released, or for corporations seeking to emerge from bankruptcy. Commentators have noted the uncertainty created by the absence of transitional relief and its potential effect on transactions that might become subject to the new rules depending on the date of their publication. It is not yet clear if Treasury and the IRS will provide relief for these scenarios and, if so, when they will announce it.

Parties considering potential transactions involving a change in ownership of a loss corporation with significant carryforwards should carefully consider the implications of the proposed regulations. The changes proposed also should be weighed alongside recent changes in the TCJA that have affected the usefulness of carryforwards, including the TCJA's amendments to Sections 163(j) and 172.

The deadline for formal comments on the proposed regulations is November 12, 2019.

IRS Proposes New Section 382 Regulations To Further Limit Use of Tax Losses

Contacts

Cliff Gross
Washington, D.C.
202.371.7308
cliff.gross@skadden.com

Jessica A. Hough
Washington, D.C.
202.371.7054
jessica.hough@skadden.com

William Alexander
Washington, D.C.
202.371.7230
william.alexander@skadden.com

Paul Schockett
Washington, D.C.
202.371.7815
paul.schockett@skadden.com

Jared H. Binstock
Washington, D.C.
202.371.7166
jared.binstock@skadden.com