September 12, 2019

IRS Proposes to Eliminate Taxpayer Favorable Safe Harbor for Corporations after Ownership Change

On Monday, September 9, 2019, the Internal Revenue Service ("IRS") and the Department of the Treasury ("Treasury") released proposed regulations (the "Proposed Regulations") under Section 382 of the U.S. Internal Revenue Code of 1986, as amended (the "Code") that would reverse a long-standing taxpayer favorable safe harbor relating to the computation of built-in gains and losses when applying Section 382(h).[1] The Proposed Regulations, if finalized as currently proposed, will have a meaningful adverse impact with respect to many companies involved in M&A transactions and restructurings, particularly troubled companies, many of which would be substantially restricted relative to current law in their ability to use net operating losses ("NOLs") and other tax attributes after an ownership change. The Proposed Regulations would also make a number of significant technical changes to computing built-in gains and losses in this area. They would be effective for ownership changes occurring after their publication in final form.

Current Law and Practice

- ***Framework of Section 382.*** Section 382 imposes a limitation on the amount of a "loss corporation's" taxable income that can be offset by pre-change NOLs and certain other tax attributes after an ownership change (the "382 Limitation"). A "loss corporation" is a corporation with certain carryovers and attributes, including NOLs, net capital losses, and certain credits, or a corporation with a net unrealized built-in loss (a "NUBIL"). Pursuant to complex attribution and look-thru rules, an "ownership change" generally occurs when "five percent shareholders" increase their ownership in a loss corporation by more than 50% over a rolling three-year period.

  Section 382(h) provides additional, complex rules that require adjustments to the 382 Limitation for certain built-in items that may be economically accrued at the time of an ownership change but are recognized for U.S. federal income tax purposes after such ownership change. Specifically, Section 382(h) provides that if a loss corporation has a net unrealized built-in gain (a "NUBIG"), the 382 Limitation is increased (allowing greater utilization of pre-change NOLs) when a built-in gain is recognized (a recognized built-in gain, or "RBIG") during the five years following an ownership change (the "Recognition Period"). Conversely, if a loss corporation has a NUBIL, use of any recognized built-in loss ("RBIL") during the Recognition Period is subject to the 382 Limitation.

1 All Section references are to the Code.

- ***Notice 2003-65*** . In 2003, the IRS issued Notice 2003-65 in order to provide more clarity on how to identify items of RBIG and RBIL and how to calculate NUBIG and NUBIL under Section 382. Notice 2003-65 provided two alternative safe-harbor methods; the first was adopted from a rule applicable to converted S corporations which are subject to tax on certain built-in gains (the "1374 Approach") and the second was adopted from Treasury regulations applicable to deemed asset sales under Section 338 (the "338 Approach").

  For purposes of both approaches, NUBIG and NUBIL are generally determined based on a hypothetical sale of the assets of the loss corporation to a third party buyer that assumes all of the loss corporation's liabilities.

  The 1374 Approach generally uses accrual method of accounting principles and identifies RBIG and RBIL based on actual gains and losses during the Recognition Period, limited in each case to the unrealized built-in gain or loss of the applicable asset on the date of the ownership change. Notably, the 1374 Approach treats cancellation of indebtedness income ("CODI") as RBIG only if taken into account during the first 12 months of the Recognition Period (the 338 Approach has no such limitation).[2]

  The 338 Approach generally identifies RBIG and RBIL by comparing the loss corporation's actual items of income, gain, deduction and loss with those that would have resulted if the loss corporation had been sold in a transaction subject to a Section 338 election (treated as a deemed asset sale). In contrast to the 1374 Approach, depreciable or amortizable assets with built-in gain, including goodwill and other intangibles, are treated as giving rise to RBIG even if not disposed during the Recognition Period. This deemed RBIG is equal to the additional depreciation and amortization deductions that would have been generated if the basis of the assets had been stepped-up to fair market value in the hypothetical sale. This rule can be beneficial to taxpayers with a NUBIG because of the resulting increase in the 382 Limitation permitting faster utilization of pre-change tax attributes.

2 With respect to CODI, it should also be noted that for both the 1374 Approach and the 338 Approach, the liabilities giving rise to the CODI may generally be taken into account in the applicable NUBIG/NUBIL calculation. For insolvent taxpayers this is significant because liabilities will be greater than the gross value of the taxpayer's assets, so this rule results in a greater NUBIG (or lesser NUBIL) relative to an approach that did not take into account such liabilities (see the discussion of the Proposed Regulations below). Under Notice 2003-65, there is no distinction drawn based on the tax treatment of the applicable CODI—a result that is also favorable to insolvent and bankrupt taxpayers who may generally avail themselves of certain favorable rules permitting CODI to be excluded from gross income (subject to various limitations and conditions).

The Proposed Regulations

- ***Elimination of the 338 Approach Safe Harbor.*** The Proposed Regulations would mandate the use of the 1374 Approach (as modified by the Proposed Regulations) and eliminate the 338 Approach going forward. The IRS justified this policy decision on several grounds: (1) a relatively weaker connection to the statutory text of section 382(h) compared to the 1374 Approach, (2) the greater complexity of the 338 Approach relative to the 1374 Approach, (3) the potential overstatement of RBIG/RBIL under the 338 Approach relative to the 1374 Approach, and (4) in light of the Tax Cuts and Jobs Act (the "TCJA"), the need to modify the 338 Approach to correct inappropriate results. (The last of these issues had previously been addressed by Notice 2018-30, addressing certain issues raised by the TCJA, which also suggested that additional guidance may be forthcoming.)

- ***Liabilities and Excluded CODI No Longer Taken into Account***. The Proposed Regulations provide that for purposes of determining NUBIG/NUBIL, subject to limited adjustments, the deemed buyer in the hypothetical sale assumes no liabilities of the loss corporation. In addition, with limited exceptions, the Proposed Regulations provide that excluded CODI is generally not taken into account as RBIG. These changes are of particular significance for insolvent and bankrupt taxpayers that would generally have a greater NUBIG (or lesser NUBIL) if assumed liabilities were taken into account and would generally exclude all or a portion of any recognized CODI. The IRS indicated that this change is necessary to correct an overstatement of RBIG (or understatement of RBIL) under Notice 2003-65 and to correct potentially duplicative benefits.

- ***Other Updates***. The Proposed Regulations include many other technical revisions and updates in light of the TCJA. For example, the TCJA added a new category of tax attribute subject to Section 382 and the Proposed Regulations include rules necessary to address this and similar issues.

- ***Effective Date***. The Proposed Regulations are proposed to be effective for ownership changes occurring after publication of the Proposed Regulations in final form (whether or not such ownership changes occur pursuant to binding commitments that predate such publication). The Proposed Regulations have a 60-day comment period ending November 12, 2019; thereafter, they may potentially be quickly finalized.

Practical Implications

- ***Significantly Reduced NOL Valuations***. If finalized in their current form, we expect that many corporate taxpayers involved in M&A transactions and restructurings will find that the value of their tax attributes will be significantly reduced as a result of the application of Section 382 and the Proposed Regulations. In our experience, most corporations undergoing ownership changes, especially profitable corporations (from a GAAP perspective) that may be loss generating from a federal income tax perspective (such as those in capital-intensive industries like manufacturing, infrastructure, etc.), utilize the 338 Approach. Indeed, in many situations, the application of the 338 Approach is very beneficial and can make a difference as to whether a Section 382 Limitation actually impacts the timing and ability to utilize pre-change tax attributes.

- ***Insolvent and Bankrupt Taxpayers Adversely Impacted***. Although it is a more subtle technical revision, the impact of the changes in the Proposed Regulations related to CODI and liabilities will be especially adverse to insolvent and bankrupt corporate taxpayers undergoing restructuring transactions subject to Section 382. We expect that many such taxpayers will find that as a result of the proposed changes, a potential NUBIG is smaller (or NUBIL is greater) than under current law, resulting in less ability to utilize pre-change tax attributes after the restructuring. This can be especially significant in distressed situations where tax attributes often are important assets of the debtor and can be important bargaining chips in attempting to reach consensual restructuring agreements.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Brian S. Grieve +1-212-373-3768 bgrieve@paulweiss.com	Patrick N. Karsnitz +1-212-373-3084 pkarsnitz@paulweiss.com	David W. Mayo +1-212-373-3324 dmayo@paulweiss.com
Brad R. Okun +1-212-373-3727 bokun@paulweiss.com	Lindsay B. Parks +1-212-373-3792 lparks@paulweiss.com	Jeffrey B. Samuels +1-212-373-3112 jsamuels@paulweiss.com
David R. Sicular +1-212-373-3082 dsicular@paulweiss.com	Scott M. Sontag +1-212-373-3015 ssontag@paulweiss.com	Todd Hatcher +1-212-373-3525 thatcher@paulweiss.com

Law clerk Laetitia Baya Yantren also contributed to this Client Alert.