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Treasury and IRS Release Proposed Regulations Restricting NOL Utilization Under Section 382

Proposed Regulations Eliminate Taxpayer-Friendly Safe Harbor for Calculating Section 382 Recognized Built-In Gains and Losses

SUMMARY

On September 9, the Internal Revenue Service ("IRS") and the Treasury Department issued proposed regulations ("Proposed Regulations") that would alter existing guidance regarding the use of tax attributes, such as net operating losses ("NOLs"), following an ownership change under Section 382 of the Internal Revenue Code ("Code").[1] Specifically, the Proposed Regulations would eliminate the so-called "Section 338 Approach" (as more fully described below) for calculating limits on NOL utilization.

The Proposed Regulations would also add several technical changes to calculations related to the determination of gains and losses in this area, including specific guidance addressing the effects of contingent liabilities, dividends, and cancellation of indebtedness income. The Proposed Regulations would also add rules aimed to mitigate potential duplicative applications of Section 382 and changes to the business interest expense limitation enacted by the Tax Cuts and Jobs Act ("TCJA").

BACKGROUND

Section 382 limits the ability of a corporation to offset its taxable income with tax attributes and losses incurred before an ownership change. For this purpose, an ownership change generally means a 50 percent or greater shift in ownership over a three-year period.

Such limitation (the "Section 382 Limit") is generally equal to the fair market value of the corporation immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate.[2] The

Section 382 Limit may also be increased by recognized built-in gain ("RBIG") arising during the five-year period following an ownership change (the "Recognition Period"), which allows for greater utilization of pre-change tax attributes provided the corporation also has net unrealized built-in gain ("NUBIG") at the time of an ownership change. On the other hand, if a corporation has net unrealized built-in loss ("NUBIL") at the time of an ownership change, any recognized built-in loss ("RBIL") is subject to the Section 382 Limit.

NUBIG and NUBIL generally represent the differential between the fair market value and aggregate adjusted bases of a corporation's assets immediately before an ownership change. RBIG and RBIL consist of gains and losses from dispositions of assets during the Recognition Period, as well as income or deductions includable or allowable during the Recognition Period but attributable to periods before the ownership change.[3]

In calculating RBIG and RBIL, taxpayers have typically relied on one of the two IRS "safe harbor" approaches: the Section 1374 approach and the Section 338 approach.[4] Under the 1374 approach, RBIG and RBIL include the actual amount of gain or loss recognized during the Recognition Period on the sale of assets. Items of income or deduction reported during the Recognition Period are also generally included in RBIG or RBIL, respectively, if an accrual method taxpayer would have included such items in income, or been allowed a deduction, for the items before the ownership change.[5]

The Section 338 approach differs in identifying RBIG and RBIL by comparing actual items of income, gain, deduction, and loss recognized during the Recognition Period with those that would have resulted if the corporation had been sold on the ownership change date in a transaction subject to a Section 338 election (i.e., treated as a deemed asset sale, thereby allowing a stepped-up basis in the assets of the acquired company). For each year of the Recognition Period, the Section 338 approach treats assets with built-in gain on the ownership change date as generating RBIG equal to the excess of the hypothetical depreciation deductions that would have been allowed had a Section 338 election been made, over the actual cost recovery deductions.[6] Accordingly, the Section 338 approach provides an advantage because it allows an asset with built-in gain to generate RBIG even if that asset is never disposed of during the Recognition Period.

For example, suppose that immediately before an ownership change, LossCo owns a patent with a tax basis of $50 and fair market value of $450. LossCo is amortizing the patent over 15 years under Section 197 and has five years of remaining amortization. During the Recognition Period, LossCo earns royalties of $15 per year from licensing the patent. Under the Section 338 approach, LossCo would recognize $20 of built-in gain each year during the Recognition Period. This $20 represents the excess of the annual amortization deduction that LossCo would have been allowed had it made a Section 338 election with respect to a hypothetical purchase of all of its outstanding stock (i.e., $450 fair market value divided by 15 years, or $30) over LossCo's actual allowable amortization deduction (i.e., $10 per year for the remaining five years). LossCo would have a total of $100 of RBIG during the Recognition Period and thus could be able to increase its Section 382 Limit by $100, regardless of LossCo's income for the year or whether or not the patent actually generates $15 of annual royalty income.[7] Under the Section 1374 approach, however, none of LossCo's $75 of royalty income (i.e., $15 per year multiplied by five years) gives rise to RBIG because an accrual method taxpayer would not have accounted for such income prior to the ownership change. As such, LossCo's Section 382 Limit for the year would not be increased.[8]

DISCUSSION

A. ELIMINATION OF THE SECTION 338 APPROACH

As the example above illustrates, the Section 338 approach allows an asset with built-in gain to generate RBIG even if that asset is never disposed of during the Recognition Period, thus providing additional means over the Section 1374 approach to increase the Section 382 Limit, which may be important for certain corporations undergoing a change in ownership with unutilized NOLs, particularly those with self-created intangibles. The Proposed Regulations would eliminate the Section 338 approach.

Although taxpayers may continue to rely on the Section 338 approach as a safe harbor for calculating the Section 382 Limit with respect to ownership changes occurring before the effective date of temporary or final regulations,[9] the Proposed Regulations, if adopted, would not include relief for ownership changes arising from transactions subject to a binding commitment at the time of such adoption. This effective date provision may affect the evaluation of currently pending deals.

B. ADOPTION OF THE SECTION 1374 APPROACH

If finalized, the Proposed Regulations would mandate a modified Section 1374 approach, and therefore would not allow taxpayers to use built-in gain assets to increase their available loss utilization on a year-by-year basis. These modifications include certain clarifications and adjustments from existing guidance, such as below:

- *Contingent liabilities.* Diverging from previous guidance, the Proposed Regulations would include in RBIL the amount of any deductible contingent liability paid or accrued during the Recognition Period to the extent of its value on the change date.[10]
- *Dividends and GILTI*. The Proposed Regulations would add a rule that dividends and global intangible low-taxed income ("GILTI") included during the Recognition Period are not RBIG. This rule would also apply to gain taxable as a dividend (e.g., under section 1248).[11]
- *Cancellation of Indebtedness Income.* Generally income from the cancellation of indebtedness ("CODI") is included in gross income, subject to exceptions for bankruptcy or to the extent that the taxpayer is insolvent ("excluded CODI").[12] Excluded CODI is in effect "shielded" from inclusion by the elimination of tax attributes such as NOL carryforwards which normally will have existed at the time of the ownership change (and which would have offset the CODI had it been included in income). Excluded CODI is generally omitted from the calculation of RBIG and NUBIG or NUBIL under the Proposed Regulations so as not to permit "double usage" of such tax attributes through an additional increase in the Section 382 Limit. The Proposed Regulations would include exceptions for certain limited cases where CODI is not shielded by a reduction in tax attributes existing at the time of the ownership change. The exceptions would only apply where (a) in the case of recourse debt, the taxpayer makes an appropriate election, (b) the CODI was recognized during the 1-year period following the change

date, and (c) the CODI was either (i) included in gross income or (ii) excluded from gross income but reduced tax attributes not existing at the time of the ownership change (including the basis of assets not held at the time of the ownership change).[13] These rules would apply to nonrecourse liabilities only to the extent that the relevant indebtedness was impaired (i.e., that the value of the assets securing such indebtedness was less than the amount of the indebtedness) and only for purposes of RBIG.[14]

- *Interaction with interest deduction limitations.* The Proposed Regulations attempt to address the possibility of duplicative applications of Section 382 to certain disallowed business interest expense carryforwards. To address this concern, the Proposed Regulations would provide that a Section 382 disallowed business interest carryforward is not treated as RBIL.[15] The Proposed Regulations also contain specific provisions applicable to partnership structures to coordinate with the proposed rules on Section 163(j) interest limitations, including, for example, providing for basis adjustment rules for NUBIG and NUBIL purposes to reflect Section 163(j) excess business interest from a partnership attributable to a pre-change year.

C. REQUEST FOR COMMENTS AND APPLICABILITY DATE

The IRS and Treasury Department will accept comments on the Proposed Regulations until November 12, 2019. In particular, the IRS and Treasury Department specifically invite comments on several aspects of the Proposed Regulations, including the proposed adoption of the modified Section 1374 approach, and elimination of the Section 338 approach, for determining RBIG and RBIL; special rules for insolvent or bankrupt loss corporations; whether dividends paid on built-in gain stock should constitute RBIG; and CODI on recourse and nonrecourse debt.

The Proposed Regulations will generally become effective for ownership changes occurring after the date the Treasury Department adopts the Proposed Regulations as final by publishing them in the *Federal Register*. It is further expected that the Treasury decision adopting the Proposed Regulations as final will withdraw and obsolete other guidance for topics addressed by the Proposed Regulations.

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ENDNOTES

[1] References herein to a "Section" are to sections of the Code and the Treasury regulations ("Treasury Regulations" or "Treas. Reg.") promulgated thereunder.

[2] Section 382(b)(1).

[3] Section 382(h)(2), (6).

[4] Notice 2003-65, 2003-40 I.R.B. 747

[5] *See* Notice 2003-65 ¶ III.B.

[6] *See* Notice 2003-65 ¶ IV.B.2.

[7] *See* Notice 2003-65 ¶ IV.B.2 example (11).

[8] *See* Notice 2003-65 ¶ III.B.2.(a)(i) and example (6).

[9] Notice 2003-65 ¶ V.

[10] Prop. Treas. Reg. 1.382-7(d)(3)(v). Payment of the contingent liability in excess of such value would not be treated as RBIL. *See* Prop. Treas. Reg. 1.382-7(f), Example 1.

[11] Prop. Treas. Reg. 1.382-7(d)(2)(ii); *see also* Section 951A.

[12] Section 108.

[13] Prop. Treas. Reg. 1.382-7(c)(3)(ii)(B), (d)(2)(iii).

[14] Prop. Treas. Reg. 1.382-7(b)(5), (b)(3), (d)(2)(iv)(A).

[15] Prop. Treas. Reg. 1.382-7(d)(5).

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