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Proposed Regulations on Built-in Gains and Losses under Section 382(h)

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On September 10, 2019, the Internal Revenue Service ("IRS") and the U.S. Department of the Treasury (the "Treasury") issued proposed regulations (the "Proposed Regulations") on calculation of built-in gains and losses under Section 382(h) of the Internal Revenue Code of 1986, as amended.[1] In general, the Proposed Regulations replace the existing guidance on the calculation of net unrealized built-in gains ("NUBIG"), net unrealized built-in losses ("NUBIL"), realized built-in gains ("RBIG") and realized built-in losses ("RBIL") under Section 382(h). This guidance had largely taken the form of Notice 2003-65[2] (the "Notice"), which had been the key authority relied upon by taxpayers for purposes of the various calculations required under Section 382(h).

By eliminating the Notice's 338 Approach and by making certain other changes, the Proposed Regulations, if finalized in their current form, could significantly cut back on a loss corporation's ability to use pre-change losses and therefore could substantially diminish the valuation of this tax asset in M&A transactions and could hamper reorganizations of distressed companies. In fact, these proposed changes could put more pressure on companies in bankruptcy to attempt to qualify for the benefits of Section 382(l)(5) or to engage in a "Brunos-like" taxable restructuring transaction, and, when those options are not available, could lead to more liquidations rather than restructurings.

The Proposed Regulations are another factor in a series of changes and circumstances that affect the value of tax assets such as net operating losses for corporations. Both the current low applicable federal long-term tax-exempt rate (1.77% for October 2019)—which creates relatively small Section 382 limitations—and the new rule from the 2017 tax reform that limits the usability of net operating losses arising in tax years beginning after December 31, 2017 to 80% of taxable income are developments that, in conjunction with the Proposed Regulations, put downward pressure on the expected value of this tax asset.

The Proposed Regulations are not effective until they are adopted as final regulations and published in the Federal Register, and will apply only with respect to ownership changes occurring after their finalization. Until that happens, taxpayers may continue to rely on the Notice for calculations of NUBIG, NUBIL, RBIG and RBIL.

Background

Overview of Section 382(h)

Section 382 generally limits the ability of a corporation with net operating losses or certain other tax assets (a "loss corporation") to offset its taxable income after an "ownership change"[3] using such losses or other tax assets that are attributable to the pre-ownership-change time period. If Section 382 applies, the corporation may use pre-change tax attributes in each year generally only up to the product of the fair market value of the loss corporation's equity immediately before the ownership change and the applicable long-term tax-exempt rate ("Section 382 limitation").[4] To the extent the Section 382 limitation is not fully used in a taxable year, it cumulates.

Section 382(h) applies to a loss corporation with a significant amount of built-in gains or losses in its assets as of the date of an ownership change (the “change date”). In broad brush, RBIG recognized during the five-year period beginning on the change date (the “recognition period”) increases the loss corporation’s Section 382 limitation (but only up to the amount of NUBIG), while RBIL recognized during the recognition period is subject to the Section 382 limitations, as with other pre-change tax attributes (but only up to the amount of NUBIL).[5] The purpose of the Section 382(h) rules is generally to treat built-in gains or losses of a loss corporation, once recognized in the recognition period, in the same manner as if they had been recognized before the ownership change (a principle referred to in the Proposed Regulations as the “neutrality principle”).

NUBIG and NUBIL is each generally calculated by comparing the fair market value of a loss corporation’s assets immediately before an ownership change against the aggregate adjusted basis of such assets at such time.[6] If the fair market value exceeds the aggregate adjusted basis of the assets, then the loss corporation has NUBIG; NUBIL is defined to be the reverse situation, when the aggregate adjusted basis exceeds the fair market value of the assets. RBIG and RBIL are generally gain or loss, respectively, that is recognized during the recognition period, including any items of income or deduction, respectively, that are recognized in the recognition period and that are attributable to the pre-change period.

Notice 2003-65

The IRS issued the Notice to address many of the questions that arose in practice in calculating NUBIG, NUBIL, RBIG and RBIL. Importantly, the Notice provided for safe harbors for taxpayers to the extent they followed one of the two approaches provided in the Notice: the 338 Approach and the 1374 Approach. Taxpayers are allowed to rely on the Notice and use one of the two approaches until the IRS issues temporary or final regulations, and in particular, can rely on the Notice until the finalization of the Proposed Regulations which have a prospective effective date.

Under both approaches, NUBIG or NUBIL is generally calculated the same: NUBIG or NUBIL is generally the net amount that would be realized by the loss corporation if immediately before the ownership change, the loss corporation had sold all of its assets at fair market value, plus assumption of all of the loss corporation’s liabilities.[7]

The approaches differ in the calculation of RBIG and RBIL—often materially.

Under the 338 Approach, RBIG or RBIL is identified by comparing the loss corporation's actual income or deductions with those that would have resulted if a Section 338 election had been made for a hypothetical purchase of 100% of the loss corporation's outstanding stock on the change date (the "hypothetical purchase"). Therefore, certain built-in gain assets are treated as generating RBIG even when such assets are not disposed of during the recognition period. In general, the 338 Approach treats as RBIG an annual amount equal to the excess of the amount of depreciation and amortization that would have been allowable had a Section 338 election been made on the hypothetical purchase over the actual amount of depreciation and amortization of the loss corporation. This excess amount is treated as RBIG regardless of the loss corporation's gross income in any particular year during the recognition period.[8]

Under the 1374 Approach, in contrast, notional depreciation or amortization based on a deemed Section 338 election does not enter into the calculation of RBIG, and RBIG generally requires the disposition of an asset. In addition, items of income or deduction that are treated as RBIG or RBIL, respectively, are identified generally based on the accrual method of accounting – that is, an item of income or deductions is treated as RBIG or RBIL if such item would have been taken into account before the change date by an accrual method taxpayer. Thus, for example, contingent liabilities that accrue after the change date are not generally treated as RBIL (even though they do factor into the calculation of NUBIG or NUBIL). One key exception to this rule is that excess depreciation, amortization or depletion deductions recognized in the recognition period are treated as RBIL even though they accrue after the change date—the excess depreciation, amortization or depletion could be calculated under any reasonable method—and will be subject to the Section 382 limitation when the loss corporation has NUBIL on the change date.[9]

As a practical matter, many loss corporations in a substantial NUBIG position were able to rely on the 338 Approach under the Notice to increase substantially their Section 382 limitations for the five years following their ownership changes, and thus to increase greatly their use of net operating losses and tax assets after ownership changes over the amount they would have otherwise been able to use in the absence of the 338 Approach. For loss corporations emerging from bankruptcy, the tax savings under the 338 Approach often made the corporations more viable by permitting the pay-down of debt and business expansion.

Both approaches had specific rules for addressing cancellation of debt income ("COD income"). The 1374 Approach generally treated COD income or bad debt deductions recognized during the first 12 months after the change date as RBIG or RBIL, respectively (and had special rules for COD income excluded under Section 108(a) and basis reduction arising therefrom). The 338 Approach concluded that COD income attributable to pre-change debt is RBIG in an amount not exceeding the excess of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date.

The Proposed Regulations

The Proposed Regulations mandate the use of the 1374 Approach, and eliminate the 338 Approach, with certain meaningful modifications. Some of the most significant changes that the Proposed Regulations make to the Notice's safe-harbors are discussed below.

Mandatory use of the 1374 Approach

Perhaps the most significant ramification of the Proposed Regulations is that taxpayers are no longer allowed to rely on the 338 Approach. The Proposed Regulations make the 1374 Approach the only approach to be used when calculating NUBIG, NUBIL, RBIG and RBIL.[10]

Calculation of NUBIG and NUBIL under the Proposed Regulations

The Proposed Regulations deviate somewhat from the NUBIG and NUBIL formulae provided in the Notice, and they attempt to provide a more specific calculation formula based on a "two-step" hypothetical disposition of all of a loss corporation's assets:

- ???In the first step, the loss corporation is treated as satisfying any inadequately secured non-recourse liability by surrendering to each creditor the assets securing such debt.
  - ???For example, if a loss corporation has an asset with a fair market value of $100 and adjusted tax basis of $80 that is subject to non-recourse debt of $120, the loss corporation will be treated as realizing $120 due to its surrender of the asset to the creditor.
- ???In the second step, the loss corporation is treated as selling all remaining assets pertinent to the NUBIG or NUBIL computation in a sale to an unrelated party, with the hypothetical buyer assuming no amount of the seller's liabilities.

The amount realized under the first step is added to the amount realized under second step to create a total amount realized under the hypothetical dispositions. This total amount realized is then:

- ???Decreased by the loss corporation's basis in the assets,
- ???Further decreased by the loss corporation's deductible liabilities (both fixed, deductible when paid, and contingent, deductible when paid or accrued following the elimination of the contingency[11]), and
- ???Further adjusted by the following: (i) generally for a cash basis taxpayer, income and deduction items that accrue as of the change date and are recognized during the recognition period (other than COD income, whose treatment is discussed below), and (ii) the net amount of positive and negative Section 481 adjustments that would be required to be included upon the hypothetical disposition of the loss corporation's assets.

If the final number resulting from this calculation is positive (and in excess of a statutory minimum amount), then the loss corporation has NUBIG equal to this final number. If the final number resulting from this calculation is negative (and in excess of a statutory minimum amount), then the loss corporation has NUBIL equal to this final number.

Of particular interest, NUBIG or NUBIL calculated pursuant to the above formula may be adjusted further, retroactively, based on the amount of certain COD income that is taken into account as RBIG, subject to certain "ceiling limitations" on the amount of COD income treated as RBIG, as discussed below.

Treatment of Contingent Liabilities

Another significant change is the treatment of contingent liabilities under the 1374 Approach. In the Notice, deductible contingent liabilities paid or accrued during the recognition period are not taken into account as RBIL under the 1374 Approach, even though such liabilities are taken into account when calculating NUBIG or NUBIL.

The Proposed Regulations deviate from the 1374 Approach in the Notice by requiring deductible contingent liabilities paid or accrued during the recognition period to be treated as RBIL, using the estimated amount of these liabilities as of the change date reflected in the NUBIG or NUBIL calculation. In essence, the 1374 Approach under the Proposed Regulations incorporates the contingent liability treatment under the Notice's 338 Approach. The contingent liability treatment under the Proposed Regulations appears to depart from the general principle that the 1374 Approach generally follows accrual method of accounting, as contingent liabilities would not have accrued for tax accounting purposes.

COD Income

The Proposed Regulations build upon the treatment of COD income provided under the Notice and provide a much more detailed set of rules on how different types of COD income are to be treated under Section 382(h).

"Excluded" vs. "Included" COD income

Under the Notice, the COD income arising from a debt owed by the loss corporation at the beginning of the recognition period, if taken into account during the first 12 months of the recognition period, is generally treated as RBIG. The Notice did not treat differently COD income that is ultimately excluded from gross income under Section 108 (such COD income, "Excluded COD income") and COD income that is includible in the loss corporation's taxable income under Section 61 ("Included COD income").[12]

The Proposed Regulations, on the other hand, treat COD income in the following manner for purposes of these calculations, subject to ceiling limitations described in the next section:

- ???COD income recognized during the first 12 months of the recognition period generally is RBIG if it is Includible COD income of a recourse debt, and this amount

then is retroactively reflected in the NUBIG or NUBIL calculation.

??? Similar rules apply to treat Includible COD income of a non-recourse debt as RBIG, but the RBIG amount is not retroactively reflected in the NUBIG or NUBIL calculation, as the impairment amount of a non-recourse debt is already included in the initial calculation of NUBIG or NUBIL.

??? With respect to Excluded COD income, the rules specifically provide that the recognition of Excluded COD income does not generate RBIG and the Excluded COD income is not included in the NUBIG or NUBIL calculations, unless the Excluded COD income is recognized within the first 12 months of the recognition period and reduces post-change attributes or basis in assets that are acquired after the ownership change. In that case, such Excluded COD Income is retroactively reflected in the NUBIG or NUBIL calculation.

Under the Proposed Regulations, a loss corporation is required to elect affirmatively to apply the above rules to its COD income.[13] If no such election is made, the COD income recognized during the post-change period generally will not be treated as RBIG.

Recourse vs. Non-recourse—Ceiling Limitations

The Proposed Regulations further expand the Notice by providing separate "ceilings" to RBIG for recourse and non-recourse debt. For recourse debt, (i) the maximum RBIG for COD income taxpayers in a bankruptcy proceeding at the time of the ownership change cannot exceed the amount of indebtedness discharged in that bankruptcy action, and (ii) the maximum RBIG for COD income for other taxpayers cannot exceed the excess of liabilities over asset value immediately before the change date, with certain adjustments. For non-recourse debt, COD income is treated as RBIG only to the extent that the non-recourse debt was under-secured immediately before the ownership change.

Other Changes

In addition, the Proposed Regulations provide rules to clarify that certain items do not constitute RBIG, such as dividends paid on stock during the recognition period, even if the loss corporation has a NUBIG and there is built-in gain in the stock.[14]

The Proposed Regulations also attempt to address possible duplicative RBIL arising from business interest expense carryforwards under Section 163(j), as such business interest expense carryforwards are generally subject to Section 382 limitation under Section 382(d)(3) and the carryforwards may also be treated as RBIL under Section 382(h). Noting the duplicative nature of these limitations on business interest expense carryforwards, the Proposed Regulations do not treat such business interest expense carryforwards as RBIL, if such amounts were allowable as a deduction during the recognition period.

Furthermore, the Proposed Regulations provide rules on the treatment of excess business interest expense of a partnership under Section 382(h). The Proposed Regulations provide that, for purposes of determining RBIL and for computing NUBIG or NUBIL, a loss corporation's adjusted basis in a partnership interest is adjusted as if the loss corporation disposed of all or substantially all of its partnership interests immediately before the ownership change. This rule ensures that RBIL is maintained regardless of whether the excess business interest is deducted in the recognition period or the partnership interest is ultimately disposed of.

[1] Unless otherwise noted, section references are to sections of the Code.

[2] 2003-2 C.B. 747.

[3] For purposes of Section 382, an ownership change occurs if the percentage of a loss corporation's stock owned by any actual or deemed 5-percent shareholders increases by more than 50 percentage points during a specified testing period.

[4] Section 382(f).

[5] Section 382(h)(1)(A).

[6] Section 382(h)(3)(A).

[7] Generally, see Notice 2003-65, Part III. The 1374 Approach.

[8] A similar calculation is done when identifying RBIL under the 338 Approach: the excess of the loss corporation's actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable if a Section 338 election had been made with respect to the hypothetical purchase is treated as RBIL.

[9] One acceptable method spelled out in the Notice would be to compare the amount of the amortization deduction actually allowed to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its fair market value on the change date. Note that this general exception to the "accrual" principle is mandated by the applicable statutory language. *See* Section 382(h)(2)(B).

[10] According to the Proposed Regulations' preamble, one of the main reasons for the abandonment of the 338 Approach is that RBIG calculations for cost recovery deductions are not grounded on the statutory language, which appears to require recognition of income or gain in order for the item to be treated as RBIG. Furthermore, the preamble cites to potential complications in the 338 Approach when dealing with tiered Section 338 elections, as well as dealing with new rules that were enacted as part of the 2017 tax reform, including Sections 168(k) (bonus depreciation), 163(j) (restrictions on business interest deductions) and 172 (limitation on net operating loss deduction to 80% of taxable income).

[11] The Proposed Regulations require a loss corporation to use the estimated value of the contingent liability as of the change date. If such contingent liability is reflected on the most recent financial statement, the Proposed Regulations require using the amount reflected on the financial statement as the estimated value of the contingent liability.

[12] In the Proposed Regulations' preamble, the Treasury notes that this has resulted in the overstatement of RBIG (and corresponding understatement of RBIL), because in the Treasury's view, the treatment of COD income under the Notice violates the neutrality principle. In particular, because most of the Excluded COD income is offset under Section 108(b) by reducing pre-change tax distributes of the loss corporation, the same amount of pre-change income should not be used to increase the Section 382 limitation, which would result in a duplication of Section 382 benefits to the loss corporation.

[13] In order to elect to apply the COD income rules described above, a loss corporation is required to either reflect these adjustments on the statement required to be filed under Treas. Reg. Section 1.382-11(a) or file an amended tax return for the taxable year that includes the change date and include an amended statement required to be filed under Treas. Reg. Section 1.382-11(a).

[14] This generally includes amount of deemed dividend under Section 1248.

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