# Proposed Changes on Loss Carryforwards Are a (R)BIG Deal for M&A

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## Introduction

On September 9, 2019, the Internal Revenue Service ("**IRS**") released proposed regulations (the "**Proposed Regulations**") that, if finalized in their current form, would in many cases dramatically reduce the portion of a company's net operating loss ("**NOL**") carryforward that is available to be used following a so-called ownership change of the company. The Proposed Regulations would be effective for ownership changes occurring after they are finalized.

The Proposed Regulations would make other significant changes potentially applicable to distressed companies. Those aspects of the Proposed Regulations are beyond the scope of this memorandum. To learn more about any aspect of the Proposed Regulations, please contact one of the undersigned.

## Background

The Proposed Regulations set forth rules for how a loss corporation (e.g., a corporation that has pre-change NOLs, NOL carryforwards or a "net unrealized built-in loss") determines the annual limitation on the use of such attributes prescribed by Section 382. Among other things, the Proposed Regulations would eliminate a loss corporation's ability to use the "**338 Approach**," described in IRS Notice 2003-65, which effectively permitted a loss corporation with built-in gain assets to treat a specified amount of its post-change income as if it were gain recognized on those assets, without actually being required to sell or exchange those assets and recognize the gain. In many cases, this had the effect of significantly increasing a loss corporation's Section 382 limitation, and thus its ability to use its pre-change tax assets to shelter post-change income. Rather, the Proposed Regulations would require a loss corporation to use the "**1374 Approach**," which requires the actual recognition of gain and thus is significantly more restrictive, with the likely effect of reducing the value of a loss corporation's pre-change tax assets.

In general, Section 382 limits the ability of a loss corporation to use NOLs (such losses, "**pre-change losses**") that are generated prior to the date of an ownership change (the date of the ownership change, the "**change date**"), as well as certain built-in losses and deductions that are recognized or claimed after the change date, to shelter taxable income earned after the change date. Subject to certain adjustments, a loss corporation's ability to deduct pre-change losses in taxable years following the change date is generally limited to an amount equal to the fair market value of the stock of the loss corporation multiplied by the Federal long-term tax-exempt rate (the "**Section 382 limitation**").

The Section 382 limitation is increased by recognized built-in gain ("**RBIG**") in the five-year period following the change date (the "recognition period") to the extent that the loss corporation had a "net unrealized built-in gain" on the change date ("**NUBIG**") (generally, the extent to which the fair market value of the assets of the loss corporation exceeded the aggregate adjusted basis of such assets). In addition, the use of any recognized built-in loss ("**RBIL**") during the recognition period is subject to the Section 382 limitation to the extent that the loss corporation had a "net unrealized built-in loss" on the change date ("**NUBIL**") (generally, the extent to which the aggregate adjusted basis of the assets of the loss corporation exceeded the fair market value of such assets).

Section 382(h) defines RBIG and RBIL as gain or loss, respectively, that is recognized during the recognition period on the disposition of any asset that was held by the loss corporation immediately before the change date and that does not exceed the built-in gain or loss in that asset on such date. RBIG and RBIL also include items of income and deduction, respectively, that are taken into account in a post-change year but that are “attributable to periods before the change date” (“**pre-change periods**”).

The rules relating to RBIG and RBIL are intended to implement the “neutrality principle” underlying Section 382, pursuant to which the built-in gains and losses of a loss corporation, if recognized during the recognition period, generally are to be treated in the same manner as if they had been recognized before the ownership change.

## Notice 2003-65

In Notice 2003-65, the IRS provided two safe harbor approaches for the treatment of RBIG and RBIL - the 1374 Approach and the 338 Approach. The following is a summary of certain of the principal elements of each approach.

- *1374 Approach*. Under the 1374 Approach, RBIG or RBIL is generally recognized with respect to an asset with built-in gain or loss only to the extent gain or loss is recognized on a sale or exchange of the asset during the recognition period. Income generated by a built-in gain asset during the recognition period is not treated as RBIG because such income does not accrue before the change date. In addition, items of income or deduction properly included in income or allowed as a deduction during the recognition period are attributable to a pre-change period (and thus treated as RBIG or RBIL, respectively) if an accrual-method taxpayer would have included the item of income or would have been allowed a deduction for the item before the change date (ignoring for this purpose certain rules which otherwise defer the deduction of an accrued liability until payment occurs). Finally, amounts allowable as depreciation, amortization or depletion deductions (or "cost-recovery deductions") on a built-in loss asset during the recognition period are treated as RBIL, except to the extent the loss corporation establishes that the amount is not attributable to the excess of the basis over fair market value of the built-in loss asset at the time of the change date.
- *338 Approach*. Under the 338 Approach, the loss corporation compares actual items of income, gain, deduction and loss with the same items calculated as if a Section 338 election had been made with respect to a purchase of all the outstanding stock of the loss corporation on the change date (which would generally result in a deemed sale of all of the loss corporation's assets). For loss corporations with a NUBIG, the 338 Approach treats certain built-in gain assets as generating RBIG even if these assets are not disposed of during the recognition period. Specifically, the 338 Approach assumes that a built-in gain asset generates post-change date income equal to the hypothetical cost-recovery deductions that would have been allowed if a Section 338 election had been made, with the amount that is treated as RBIG being an amount that is equal to the excess of the hypothetical cost-recovery deductions over actual cost-recovery deductions. (An analogous rule applies in the reverse with respect to cost-recovery deductions on built-in loss assets of a loss corporation with a NUBIL.)

Taxpayers are permitted to rely on the safe harbors in Notice 2003-65 prior to the effective date of temporary or final regulations under Section 382(h).

In many cases, the 338 Approach offers significant benefits to an acquiror of a target corporation with pre-change losses that is in an overall NUBIG position (e.g., a start-up company that has incurred substantial losses in developing valuable IP or a valuable business), because the 338 Approach increases the Section 382 limitation with respect to the target corporation's pre-change losses during each year in the recognition period by an amount equal to the incremental hypothetical cost-recovery deductions to which the target corporation would have been entitled had a Section 338 election been made. In such cases, the Section 382 limitation under the 338 Approach could be a multiple of both the "base" Section 382 limitation and the Section 382 limitation under the 1374 Approach, thereby significantly increasing the acquiror's ability to use the target corporation's pre-change losses to shelter post-acquisition income, without the need to actually recognize gain in one or more of the target corporation's built-in gain assets. By contrast, the 1374 Approach is often much less favorable, because none of the income generated after the change date by a built-in gain asset is treated as RBIG, and built-in gain in the asset is treated as RBIG only to the extent it is recognized in a sale or exchange of the asset during the recognition period. (In many cases, selling a built-in gain asset to recognize such gain may not be feasible.)

To illustrate the potentially significant advantage of the 338 Approach as compared to the 1374 Approach, assume that P acquires all of the stock of T, a start-up company, for $1 billion. At the time of the acquisition, T has $200 million in NOL carryforwards and no liabilities, and its only asset is zero-basis IP with a value of $1 billion (which means that T has a NUBIG of $1 billion). The following table shows the annual Section 382 limitation applicable to T during each of the five years after the acquisition under the 338 Approach and the 1374 Approach.

| | **338 Approach** | **1374 Approach** |
|---|---|---|
| Value of T stock | $1 billion | $1 billion |
| Federal long-term tax-exempt rate | 1.89% | 1.89% |
| Base Section 382 limitation | $18.9 million | $18.9 million |
| RBIG | $66.7 million (annual amortization over 15 years for $1 billion IP asset) | 0 (asset never sold) |
| Adjusted Section 382 limitation | $85.6 million | $18.9 million |

## Proposed Regulations

As noted above, the Proposed Regulations would eliminate the 338 Approach introduced in Notice 2003-65, because, in Treasury's view, the 338 Approach "lacks sufficient grounding in the statutory text of [S]ection 382(h)," is inherently more complex than the 1374 Approach and could result in overstatements of RBIG and RBIL. Accordingly, absent a reversal of Treasury's current determination, following finalization of the Proposed Regulations, the 1374 Approach would be the only approved method for calculating RBIG and RBIL for purposes of the Section 382 limitation.

We expect the elimination of the 338 Approach to reduce the value of the tax attributes of many acquired loss corporations and, as a result, in certain cases, chill M&A activity with respect to such corporations. Treasury explicitly acknowledges this possibility, but states that any merger or acquisition that is dissuaded by the Proposed Regulations would tend to have been economically inefficient except for the possibility of increased potential NOL usage, and that the elimination of the 338 Approach moves the rules under Section 382 to a neutral, economically efficient position. Treasury did not address the possibility that the elimination of the 338 Approach would encourage economically inefficient dispositions of built-in gain assets during the recognition period.

## Effective Date

The Proposed Regulations will be effective for ownership changes that occur after Treasury adopts such regulations as final, but taxpayers may apply the Proposed Regulations prior to such date. Importantly, Treasury explicitly acknowledges that, as stated in Notice 2003-65, taxpayers can continue to use the 338 Approach until the Proposed Regulations are finalized. As a result, a taxpayer that closes the acquisition of a loss corporation before the Proposed Regulations are finalized will be able to use the 338 Approach with respect to the loss corporation even if the final regulations are later issued during the recognition period, but the 338 Approach will not be available if the Proposed Regulations are finalized before the transaction closes. It is possible that commentators will request a "binding contract" or similar grandfathering exception to the effective date of the final regulations, but it is unclear whether Treasury will be willing to include such an exception.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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|---|---|---|
| **Neil Barr** | 212 450 4125 | **neil.barr@davispolk.com** |
| **William A. Curran** | 212 450 3020 | **william.curran@davispolk.com** |
| **Lucy W. Farr** | 212 450 4026 | **lucy.farr@davispolk.com** |
| **Rachel D. Kleinberg** | 650 752 2054 | **rachel.kleinberg@davispolk.com** |
| **Michael Mollerus** | 212 450 4471 | **michael.mollerus@davispolk.com** |
| **David H. Schnabel** | 212 450 4910 | **david.schnabel@davispolk.com** |
| **Patrick E. Sigmon** | 212 450 4814 | **patrick.sigmon@davispolk.com** |