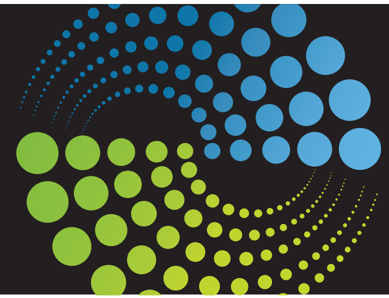
Deloitte.

# M&A Tax Talk

## Proposed regulations would significantly impact the value of tax attributes following an ownership change



**On September 9, 2019, the Treasury and IRS issued proposed regulations (REG-125710-18) (the "Proposed Regulations"), regarding a corporation's ability to utilize net operating losses (NOLs) and other tax attributes following an "ownership change." Most significantly, the Proposed Regulations would eliminate the benefit of "foregone amortization," which would, in many cases, materially reduce the ability of distressed and non-distressed corporations alike to utilize NOLs and other tax attributes following an ownership change. As illustrated in the example below, the Proposed Regulations are uniformly less favorable than the existing guidance that has been in effect for the past 16 years.**

The Proposed Regulations would apply prospectively only to ownership changes occurring after the date the Proposed Regulations are adopted as final. Nonetheless, corporations—whether distressed or non-distressed—that have significant loss attributes, as well as buyers of such corporations, should consider the following:

1. In the case of pending or contemplated acquisitions, buyers should assess the impact of the Proposed Regulations, including potential valuation implications, and explore options for contractual or other flexibility.
2. Monitoring Section 382 ownership shifts to understand whether an ownership change is likely.
3. If an ownership change is anticipated, and the adoption of the Proposed Regulations appears imminent, loss corporations should evaluate:
   - Whether it is possible to trigger an ownership change prior to the publication date of the final regulations to utilize the more-advantageous rules currently in effect;
   - Adopting stock trading restrictions or other defensive measures (e.g., poison pill) to reduce the risk of an ownership change; and
   - Selective asset sales, accounting method changes, depreciation elections, or other transactions that accelerate income to the pre-change period.

Additional considerations of particular interest to distressed corporations, including proposed changes to the rules concerning cancellation of indebtedness income (CODI) and the treatment of recourse liabilities, are not addressed in this communication but should also be evaluated.

### Overview of Section 382

When a corporation experiences an "ownership change," Section 382 imposes an annual limitation (the "Section 382 Limitation") on the utilization of NOLs, certain built-in losses or deductions (including disallowed business interest under Section 163(j)), and other favorable tax attributes.

The Section 382 Limitation has two components: (1) the annual Section 382 base limitation (the "Base Limitation") and (2) adjustments for certain built-in items.

### Section 382 Base Limitation

The Base Limitation is generally equal to the value of the stock of the loss corporation multiplied by the federal long-term tax-exempt rate, which has been approximately 2 percent for the past few years.

### Adjustments for built-in items

For loss corporations that have a net unrealized built-in gain (NUBIG) in their assets, the Section 382 Limitation is increased by recognized built-in gains (RBIGs). On the other hand, for loss corporations that have a net unrealized built-in loss (NUBIL) in their assets, recognized built-in losses (RBILs) are subject to the Section 382 Limitation. To determine whether a corporation has a NUBIG or a NUBIL, the value of the corporation's assets (or the amount of the corporation's liabilities, if liabilities exceed asset value) is compared to the tax basis in those assets, and that amount is adjusted by built-in income and deduction items.

**Built-in gains:** RBIG is defined as built-in gain or income recognized during the five-year period beginning on the change date. The maximum amount of RBIG in the five-year period that increases the Section 382 Limitation is limited to the NUBIG on the ownership change date.

**Built-in losses:** RBIL is defined as any built-in losses or deductions recognized during the five-year period beginning on the change date. The maximum amount of RBIL in the five-year period that is subject to the Section 382 Limitation is limited to the NUBIL on the ownership change date.

### 338 Approach and 1374 Approach

Under long-standing IRS guidance, corporations have two alternative "safe-harbor" methods to determine items of RBIG and RBIL. One such method, known as the "338 Approach," has historically resulted in significant increases to the Section 382 Limitation for many loss corporations and has ameliorated the impact of Section 382 even when the loss corporation does not actually dispose of built-in gain assets. Specifically, the 338 Approach allows corporations to determine items of RBIG or RBIL by comparing actual items of income, gain, loss or deduction, with those items

that would have resulted had the loss corporation engaged in a hypothetical sale of its assets under Section 338. Under this approach, corporations with a NUBIG have been able to treat as RBIG—i.e., have been able to increase their Section 382 Limitation by—additional depreciation and amortization that would have been available on built-in gain assets if those assets had been purchased in a hypothetical sale on the change date (i.e., foregone amortization).

Under the alternative method, known as the "1374 Approach," items of RBIG or RBIL are determined using an accrual model method of accounting with minor modifications. Importantly, under this approach corporations are not entitled to generate RBIG from the additional depreciation and amortization that would have resulted after a hypothetical purchase. As a result, corporations with a NUBIG have universally applied the 338 Approach. Note that for purposes of determining items of RBIL, the 1374 Approach does treat depreciation deductions as RBIL to the extent they are attributable to built-in losses.

### Summary of changes in proposed regulations

As compared to current guidance, the Proposed Regulations no longer provide corporations the electivity to choose between the two methods. The Proposed Regulations abandon the more favorable 338 Approach and instead adopt a modified version of the 1374 Approach. Without the increase in the Section 382 Limitation for foregone amortization offered by the 338 Approach, it is expected that there would be a substantial reduction in the ability of many corporations to utilize NOLs and other tax attributes following an ownership change. For corporations with a NUBIL, the Proposed Regulations also make certain unfavorable changes with respect to the rules concerning contingent liabilities. Specifically, the Proposed Regulations would mandate that contingent liabilities arising before an ownership change that are deductible during the five-year recognition period following the ownership be treated as RBIL subject to the Section 382 Limitation.

## LossCo example

LossCo's sole asset is intellectual property, which was purchased 15 years ago for $15M. Over those 15 years, the value of the intellectual property has increased to $60M, and LossCo has claimed $1M of annual amortization, leaving LossCo with an adjusted basis in the intellectual property of $0. Assume further that LossCo has a federal NOL carryforward of $25M and no liabilities. LossCo is acquired in a stock purchase for $60M, resulting in an ownership change under Section 382. With an assumed equity value of $60M and a current long-term tax-exempt rate of 1.77 percent, LossCo's annual Base Limitation is approximately $1M.

Under current guidance, LossCo has a NUBIG of $60M ($60M fair market value of assets minus $0 tax basis) and, under the 338 Approach, $20M of RBIG in the form of "foregone amortization" ($4M of additional yearly amortization in the five-year recognition period due to the hypothetical "step-up" in tax basis to $60M). The $4M of RBIG per year would increase LossCo's annual Section 382 Limitation from $1M to $5M.

Under the Proposed Regulations, LossCo would also have a NUBIG of $60M. However, because the foregone amortization offered by the 338 Approach is not available, LossCo would not receive any increase to its annual Base Limitation unless the asset is actually sold at a gain during the five-year recognition period. As a result, LossCo's annual Section 382 Limitation is limited to approximately $1M under the Proposed Regulations. The net impact in this example is that $20M fewer NOLs would be available for use in the first five years following the ownership change.

### Conclusion

For both distressed and non-distressed corporations, the Proposed Regulations are uniformly less favorable than existing guidance and would, in many cases, result in a substantial reduction in the ability to utilize tax attributes following an ownership change. Although the Proposed Regulations are prospective only, any corporation that has significant loss attributes, as well as potential buyers of such corporations, should discuss the potential impact of the Proposed Regulations with your lead Deloitte M&A Tax advisor.

**Want to learn more?**
Reach out to our contacts:

**David Hoffman**
M&A Services
Tax Partner
dhoffman@deloitte.com
Deloitte Tax LLP

**Elias Tzavelis**
M&A Services
Tax Partner
etzavelis@deloitte.com
Deloitte Tax LLP

**Stephen Fielding**
M&A Services
Tax Senior Manager
sfielding@deloitte.com
Deloitte Tax LLP

**Mike Butler**
M&A Services
Tax Manager
mibutler@deloitte.com
Deloitte Tax LLP

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte network") is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

**About Deloitte**
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the "Deloitte" name in the United States, and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.

Copyright © 2019 Deloitte Development LLC. All rights reserved.