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# Proposed Regulations May Significantly Impact Tax Assets of Distressed Companies

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On September 9, 2019, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS" or "Service") issued proposed regulations addressing the application of certain rules under Sections 382 and 383 of the Internal Revenue Code (the "Code" and, such regulations, the "Proposed Regulations" or "Regulations").[1] These Proposed Regulations would only apply to "ownership changes" occurring after the publication of final Regulations. Nevertheless, taxpayers should be aware of the potential consequences of these Proposed Regulations now, because the Regulations would make radical changes to current law that will adversely affect the value of tax attributes that exist today and may influence decisions taxpayers must make in filing their 2018 tax returns.

If the Proposed Regulations are adopted in their current form, they will significantly reduce the ability of many companies to utilize net operating losses ("NOLs") and other tax attributes following an "ownership change"[2] under Section 382. The Regulations accomplish this by adopting certain highly unfavorable rules for calculating the "annual limitation" on the ability of a company to apply pre-change tax attributes to offset post-change taxable income. The Regulations will have a particularly severe effect on financially troubled companies, whose pre-change tax attributes are often a valuable asset that supports the company's ability to restructure. Such changes will also have an adverse effect on the value that should be ascribed to such tax attributes in M&A activity, and may increase the number of public companies that consider adopting "NOL poison pills" to avoid the application of Section 382.

These Proposed Regulations are adverse to taxpayers on a number of different levels:

**First and foremost**, the Regulations reverse 16 years of guidance from the Service, settled practice, and taxpayer expectations regarding the value of tax attributes in connection with ownership changes. These new rules are likely to reduce the value of NOLs and other tax attributes, including attributes that have already been "priced in" to investment decisions and contractual arrangements.

**Second**, the Regulations follow the enactment less than two years ago of the Tax Cuts and Jobs Act of 2017 ("TCJA"). The TCJA eliminated taxpayers' ability to carry back net operating losses, imposed an 80% cap on the ability to offset taxable income with NOLs generated after 2018 and imposed significant limitations on the ability of distressed companies to deduct interest expense, all of which have serious negative effects on financially distressed companies. These Proposed Regulations "pile on" and make that bad situation worse.

**And third**, the Treasury issued these Regulations close to the time when many corporate taxpayers must file their 2018 tax returns. One of the most important issues that corporate taxpayers face in filing their 2018 returns is whether to elect bonus depreciation for capital expenditures. Given the new limitations on the value of tax attribute carryforwards that would apply if the Proposed Regulations were to be finalized in their current form, corporate taxpayers must quickly reconsider whether to elect bonus depreciation for 2018, particularly if such election would give rise to a net operating loss that could be subject to these rules upon any future ownership change.

## Existing Guidance Under Section 382

When an ownership change occurs under Section 382, unless a special bankruptcy-specific rule applies, a company's ability to offset post-change taxable income with tax attributes (such as NOLs) attributable to the period prior to the ownership change ("Pre-Change Losses") is subject to an annual limitation. This annual limitation has two components. The first component, typically referred to as the "base limitation," is determined by multiplying the value of the company's equity **immediately before**[3] the transaction by a specified rate that is published by the IRS and applicable to such ownership change. The applicable rate has been around 2% for many years,[4] which means that the base limitation is generally quite low.

The second component of the annual limitation is based on a calculation that, under existing guidance, compares the tax basis of the company's assets to the value (or, if liabilities exceed value, the amount of the company's liabilities) of those assets.[5] If tax basis is lower than value or liabilities, the company has a "net unrealized built-in gain"

("NUBIG"). If a company has a NUBIG then its annual limitation may be increased to the extent of its "recognized built-in gains" ("RBIG") during the five-year period following the ownership change. As discussed below, under current guidance, a favorable calculation could apply to the determination of RBIG that compares "deemed" depreciation from a hypothetical asset sale to a company's current — often lower — depreciation schedule. As a result, this NUBIG/RBIG calculation has historically resulted in significant increases in the annual limitation for many companies. Without this NUBIG/RBIG increase, the base limitation alone typically results in virtually no ability to utilize post-change NOLs, particularly for troubled companies.[6]

## Changes Under Proposed Regulations

Unfortunately, as discussed below, the Proposed Regulations make unfavorable changes to both the NUBIG and "net unrealized built-in loss" ("NUBIL") "prongs," as well as the RBIG and "recognized built-in loss" ("RBIL") "prongs" of this portion of the calculation of the annual limitation. The result is that many companies will not be permitted to use any tax attributes in excess of the base limitation when, previously, they would have received a benefit from their NUBIG under the historic calculation of RBIG outlined below. And, in many cases, companies that previously would have had a NUBIG, such that their post-ownership change depreciation, depletion and amortization deductions would not have been subject to limitation at all, will now have a NUBIL, which will cause those deductions to be limited for a five-year period.

### NUBIG and NUBIL Determinations — Less Favorable for Distressed Companies

Under existing guidance,[7] for purposes of calculating NUBIG or NUBIL, the value of the company's assets is calculated by assuming that the company's assets were sold to a third party that assumed the company's liabilities, including liabilities that were discharged in the transaction giving rise to the ownership change.[8] The existing rules essentially establish a valuation "floor" equal to the company's outstanding liabilities and mean that a financially distressed company may be treated as having a NUBIG, even if the encumbered fair market value of the company's assets is less than the tax basis in those assets. The Proposed Regulations, by contrast, provide that recourse liabilities are not taken into account for purposes of the asset value determination. When recourse liabilities are discharged and give rise to cancellation of indebtedness income ("CODI"), the Proposed Regulations provide that the CODI will directly or indirectly affect the company's NUBIG in certain specified circumstances.[9] However, this benefit is significantly limited compared to existing guidance.

Unlike recourse liabilities, “nonrecourse” liabilities are included in the value determination and, as a result, they continue to set a value “floor.” As a result, for purposes of NUBIG and NUBIL determinations, nonrecourse liabilities are treated more favorably than recourse liabilities.

### RBIG and RBIL Determinations — Less Favorable for Companies with NUBIGs, Resulting in Less Benefit for Section 382 Purposes

Regardless of how the Proposed Regulations determine whether a company has a NUBIG or NUBIL, the Regulations fundamentally change the methodology for calculating RBIG and RBIL. In doing so, they are likely to reduce significantly the potential value of NOLs and other tax attributes.

Under existing guidance, companies with a NUBIG could increase their annual limitation under Section 382 by utilizing a “deemed sale” approach. Under this approach, the company would calculate hypothetical depreciation, amortization and depletion deductions that could be claimed in the five years following an ownership change if a third party purchased the company’s assets for fair market value (without a “floor” set by liabilities). This hypothetical depreciation was compared to the company’s actual (and typically lower) existing depreciation, and the difference was treated as RBIG, even if no assets were actually disposed of. This RBIG would, in turn, increase the company’s annual limitation under Section 382, up to a “cap” set by the company’s overall NUBIG. This approach was referred to as the “338 Approach.” The alternative approach, which relies on actual accruals of taxable income or loss, referred to as the “1374 Approach,” was typically utilized by companies with a NUBIL and meaningful contingent liabilities, as the accrual approach typically leads to the recognition of fewer liabilities in the relevant five-year period.

The Proposed Regulations completely eliminate the ability to rely on the comparatively favorable 338 Approach, and instead require reliance on the 1374 Approach. While the Proposed Regulations implement certain welcome “fixes” to the 1374 Approach that make it somewhat less unfavorable to taxpayers, the net effect remains a **dramatic** reduction in the ability of **most** companies — not just financially distressed companies — to utilize NOLs and other tax attributes that are subject to limitation under Section 382.

## Conclusion

The tax attributes of a financially distressed company are frequently among its most valuable assets, and the existing guidance discussed above is one of the primary reasons these companies are able to utilize them after a restructuring. If finalized in their current form, the Proposed Regulations will significantly limit that value. For this reason, we expect that if these Regulations are finalized, transactions structured as taxable asset dispositions (so-called "Bruno's" transactions) to new companies are likely to increase. Additionally, there may be greater appetite by Chapter 11 debtors to rely on the bankruptcy-specific rule under Section 382(l)(5). Where Section 382(l)(5) applies, it avoids the imposition of any annual limitation under Section 382. However, in order for that provision to apply, certain "holding period" requirements with respect to creditor claims must be satisfied, and that is often difficult in light of the frequency that claims against distressed companies are traded. New equityholders must be willing to agree to significant limitations in trading the equity they receive in the chapter 11 plan, and a company must, in many cases, significantly reduce the NOLs that survive the Chapter 11 process. Unfortunately, the "Bruno's" and Section 382(l)(5) alternatives will not make up the value that the Proposed Regulations remove from financially distressed companies.

Although the Proposed Regulations will apply only to ownership changes that occur after the finalization of the Regulations, if finalized, they will affect NOLs and other tax attributes that exist now, even if the ownership change doesn't occur until the future. As a result, decisions that taxpayers must make now, such as the decision to elect bonus depreciation for the 2018 tax year, may be affected by the mere proposal of these Regulations. It is difficult to predict what, if any, changes will be made to the Proposed Regulations prior to their finalization or the actual date upon which they will be finalized. Taxpayers have until November 12, 2019, to comment on these proposals, and the Treasury Department has specifically requested detailed comments regarding the treatment of bankrupt and insolvent taxpayers. In the meantime, taxpayers should take note of the proposals and make sure that they are included in any evaluation of a loss company's tax attributes.

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1. All Section references herein are to the Code, unless otherwise indicated. Section 383 applies to certain kinds of tax credits, but generally follows rules that are similar to Section 382. For ease of reference, the rest of this *Alert* will simply reference Section 382.↩

2. An "ownership change" occurs when there is a 50 percentage point increase in the ownership of "5 percent shareholders" over a rolling three-year period. As a general matter, "ownership changes" almost always occur in debt workout transactions involving significant debt-for-equity components (whether in- or out-of-court), frequently occur in M&A transactions and will often occur even in the absence of any particular transaction.↩

3. For ownership changes occurring pursuant to a plan of reorganization in a bankruptcy case, this test is made somewhat more favorable by looking to the *lesser of* (x) the equity value immediately *after* the transaction and (y) the gross asset value immediately *before* the transaction — essentially, giving credit for the increase in the company's equity value that accrues as a result of the plan of reorganization. Even with this more favorable calculation approach, the base limitation is generally modest.↩

4. The exact amount varies from month to month. For illustration, the rate for ownership changes in September 2019 is 1.89%.↩

5. Significant complexities arise in the application of these rules to consolidated groups that are not discussed here. For the most part, the consolidated return rules were not addressed or changed by the Proposed Regulations except insofar as the basic rules have implications for those rules.↩

6. In addition to the basic question of comparing asset tax basis to value, certain other adjustments are made. In particular, deductible liabilities are subtracted from the calculation (causing a decrease in NUBIL or increase in NUBIG), certain accounting adjustments in connection with a deemed sale are taken into account, and certain amounts related to prior ownership changes are added into the calculation. For the sake of relative simplicity, these adjustments are ignored here. By contrast, if tax basis is more than value, the company has a "net unrealized built-in loss" ("NUBIL"). If a company has a NUBIL, there can be no increase to the base limitation. Additionally, the company's ability to claim tax losses as well as depreciation, depletion and amortization deductions ("RBIL") is also subject to limitation for a five-year period.↩

7. Notice 2003-65, 2003-2 CB 747. Notice 2003-65 will be withdrawn if the Proposed Regulations are finalized. ↩

8. PLR 201051019 (Sept. 14, 2010). While Private Letter Rulings cannot be relied upon by a taxpayer other than the recipient, as a practical matter, taxpayers uniformly followed this interpretation of Notice 2003-65. ↩

9. These cases include: (a) situations where CODI results in an elimination of asset tax basis in assets held on the date of the ownership change; (b) situations where CODI is included in taxable income because the bankruptcy and insolvency exclusions are inapplicable; and (c) situations where CODI results in the elimination of tax attributes generated after an ownership change date. ↩

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