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Proposed Regulations May Significantly Impact Tax Assets in M&A Transactions

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On September 9, 2019, the Treasury Department and Internal Revenue Service (the "IRS" or “Service”) issued proposed regulations under Sections 382 and 383 of the Internal Revenue Code (the “Code” and, such regulations, the “Proposed Regulations” or “Regulations”).[1] While these Proposed Regulations would only apply to “ownership changes” occurring after the publication of final Regulations, taxpayers should be aware that these Proposed Regulations 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 Proposed Regulations are likely to have a substantial and adverse impact in the distressed debt context (discussed in greater detail in a separate *Alert*), but the Proposed Regulations may significantly affect the economics of certain traditional M&A transactions. As discussed in greater detail below:

1. **Decreased Value of Transaction Tax Deductions.** The Proposed Regulations could in many cases reduce the present value of tax attributes arising from deductible expenses associated with an M&A transaction (“Transaction Tax Deductions”).
2. **Decreased Value of Target’s Historic Tax Attributes.** The Proposed Regulations could significantly limit a buyer’s ability to use historic tax attributes of a target corporation, including NOLs and interest deductions deferred under new Section 163(j).

The Regulations cause these adverse outcomes 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 follow the enactment less than two years ago of the Tax Cuts and Jobs Act of 2017 ("TCJA"), which eliminated a taxpayer's 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 to deduct interest expense. These Proposed Regulations would reverse 16 years of guidance from the Service, settled practice and taxpayer expectations regarding the value of tax attributes in connection with ownership changes.

Existing Guidance Under Section 382

When a Section 382 ownership change occurs, unless a special bankruptcy 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 with 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 published IRS rate (which has been around 2% for many years),[4] which means that the base limitation is generally quite low in most cases.[5]

The second component of the annual limitation is based on a calculation that 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.[6] If tax basis is lower than value or liabilities, the company has a "net unrealized built-in gain" ("NUBIG") and 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. 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. This NUBIG/RBIG calculation has for many companies resulted in significant increases in the annual limitation and thus increased their ability to utilize pre-closing tax attributes following the ownership change.[7]

Changes Under Proposed Regulations

Unfortunately, as discussed below, the Proposed Regulations make unfavorable changes to the calculation of the second component of the annual limitation by effectively capping the use of tax attributes at the base limitation. Thus, although Pre-Change Tax Losses generated after December 31, 2017,[8] generally may be carried forward indefinitely, the present value of the tax benefit of such losses will be dramatically reduced.

The Proposed Regulations are particularly likely to impact the valuation of Transaction Tax Deductions in M&A transactions. Helpfully, the Proposed Regulations would not restrict a target corporation's ability to utilize Transaction Tax Deductions to offset taxable income accrued from the beginning of the target's taxable year through the closing date of the transaction, but they will limit the use of Transaction Tax Deductions remaining after offsetting current year income.

Similarly, any historic tax attributes of a target corporation, including historic NOLs and any interest deductions deferred under Section 163(j), may be subject to Section 382 generally, and accordingly may be subject to the Proposed Regulations.

Conclusion

If finalized in their current form, the Proposed Regulations will significantly limit the value ascribed to tax attributes in M&A transactions. For this reason, we expect that buyers will focus more on the ability to accomplish taxable asset transactions where possible (including by trying to avoid purchasing blocker corporations) and will ascribe diminished value to tax attribute carryforwards in valuations. Although the Proposed Regulations will apply only to ownership changes that occur after the finalization of the Regulations, if finalized, they will affect NOLs that exist now, even if the ownership change doesn't occur until the future. 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 *KirklandPEN* 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. Depending on the precise facts and circumstances of a given transaction, it is possible that the base limitation may be large enough to permit immediate use of pre-closing tax attributes. For example, if an M&A transaction occurs at a time when a target corporation's equity value is $1 billion and the applicable rate is 2%, the base limitation would generally permit $20 million per year of pre-closing tax attributes to be used to offset post-closing taxable income, subject to the 80% taxable income for NOL deductions.↩

6. 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.↩

7. 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 relatively 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.↩

8. For calendar year taxpayers.↩

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