

# Favorable Safe Harbor Rule In Jeopardy For Corporations

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On September 9, 2019, the Treasury Department and the Internal Revenue Service issued proposed regulations under Internal Revenue Code (the “Code”)<sup>1</sup> Section 382(h), REG-125710-18, which address the treatment of unrealized and realized built-in gains and losses in calculating annual loss limitation amounts pursuant to acquisition of a loss corporation, as defined below (“Section 382 limitation”). If adopted in current form as final, the regulations would limit the amount of losses and other tax attributes that corporations may utilize pursuant to an ownership change and would reduce the value of net operating losses and other tax attributes of loss corporations, which may significantly impact certain investment decisions and corporate acquisitions.

For Federal income tax purposes, if a corporation that has net operating losses (“NOLs”) or certain other tax attributes (a “loss corporation”)<sup>2</sup> undergoes an ownership change,<sup>3</sup> the loss corporation will be subject to Section 382 limitation in the use of its pre-change losses with respect to its post-change income.<sup>4</sup> This limitation was designed to prevent acquisitions of loss corporations solely for income tax and not substantive business purposes, in that profitable companies could acquire loss corporations solely for purposes of using their NOLs and reducing their own tax liabilities.

Section 382 limitation consists of the base limitation and adjustments. The base limitation amount equals to the product of the loss corporation’s value before the ownership change and the long-term tax-exempt rate (around 2%).<sup>5</sup> As a general rule, the base limitation amount is small and of insignificant value to the acquiring company. However, the base limitation is subsequently adjusted up or down by various items of income and expense, including built-in gains and losses.<sup>6</sup> For these purposes, built-in gains or losses are items of income and expense, which are attributable to periods before the ownership change, but which are rec-

ognized during the 5-year period after the ownership change (the “Recognition Period”).<sup>7</sup> These built-in gains or losses are determined by comparing the values of the company’s assets to the tax basis of such assets. To the extent value exceeds basis, the company has net unrealized built-in gain (“NUBIG”).<sup>8</sup> To the extent basis exceeds value, the company has net unrealized built-in loss (“NUBIL”).<sup>9</sup>

Thus, if a loss corporation had NUBIG at the time of the ownership change, the Section 382 limitation for any Recognition Period taxable year would be increased by the recognized built-in gains for such taxable year (“RBIG”).<sup>10</sup> On the other hand, if a loss corporation had a NUBIL, the recognized built-in loss (“RBIL”) for any Recognition Period taxable year will be subject to the Section 382 limitation as if such loss were a pre-change loss.<sup>11</sup> Historically, adjustment for NUBIG and RBIG provided for significant increases in the annual Section 382 limitation and made certain acquisitions of loss corporations, especially distressed businesses, more attractive.

Because items of built-in gains and losses involved pre-change and post change periods and were subject to timing and acceleration, they were difficult to identify and compute. Thus, in 2003 the Internal Revenue Service issued Notice 2003-65, which provided two alternative safe harbor approaches for identifying built-in items and calculating RBIG and RBIL: the “1374 Approach” and the “338 Approach.” Both methods utilize a hypothetical sale of assets for determining RBIG and RBIL but vary in calculations.

Under the 1374 Approach, NUBIG and NUBIL are computed by determining the amount realized if a loss corporation sold all its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities subject to other adjustments. This approach utilizes accrual method of accounting and does not treat income from built-in gain assets during the recognition period

as RBIG because “such income did not accrue before the change date.”<sup>12</sup> On the other hand, the 338 Approach identifies RBIG and RBIL by comparing the loss corporation’s actual items of income, gain, deduction and loss with items of income, gain, deduction and loss which would result had a section 338 election been made and treats as RBIG any excess of cost recovery deductions that would be allowable for assets pursuant to section 338 election over the loss corporation’s actual allowable cost recovery deduction.<sup>13</sup> This approach benefits loss corporations with RBIG because it treats certain built-in gain assets as generating RBIG even if such assets were not disposed of during the recognition period. Thus, loss corporations with NUBIL benefit from the 1374 Approach due to its calculation of RBIL, and loss corporations with NUBIG greatly benefit from the 338 Approach, which allows them to increase Section 382 limitation by RBIG based on favorable computation of RBIG as discussed above.

The proposed regulations eliminate the 338 Approach, reversing established guidance and requiring that taxpayers rely exclusively on a modified 1374 Approach. Such change would negatively impact loss corporations with NUBIG in that they will not be able to increase their annual Section 382 limitations as they historically could under the safe harbor provisions of Notice 2003-65. Instead, loss corporations, which would include many distressed businesses, would be significantly limited in the use of their pre-change losses by the Section 382 base limitation amount and would not be able to utilize their NOLs and other beneficial tax attributes, which could reduce the value of these attributes and affect business acquisition and investment decisions.

The regulations are proposed to be effective for ownership changes occurring after they are finalized. Dykema is following these developments and will

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be providing an update regarding the final regulations, if and when they are issued. It should be noted that the calculations of NUBIG/NUBIL and RBIG/RBIL, as well as the application of those calculations to the Section 382 limitation, are fairly complex, and are beyond the scope of this article. For a more detailed explanation of the calculations, the current guidance and the impact of the proposed regulations, please contact the authors of this article or your tax advisor.

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<sup>1</sup>Hereinafter, all Section references are to the Code unless otherwise specified.

<sup>2</sup>Under the statute, a "loss corporation" is defined as a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Such term includes any corporation entitled to use a carryforward of disallowed interest under section 381(c)(20) and any corporation with a net unrealized built-in loss, unless otherwise excepted.

<sup>3</sup>There is an ownership change if, immediately after an owner shift involving a 5% shareholder or any equity structure shift the percentage of the stock of the loss corporation owned by 1 or more 5% shareholders has increased by more than 50 percentage points, over the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period. See Code § 382(g). Technical explanation of what constitutes an "ownership change" for purposes of Section 382 is outside of the scope of this article. For additional information, please see Code § 382 and Treasury Regulations thereunder.

<sup>4</sup>See Code § 382(a).

<sup>5</sup>See Code § 382(b).

<sup>6</sup>See Code § 382(h).

<sup>7</sup>See Code § 382(h)(6).

<sup>8</sup>See Code § 382(h)(3)(A)(i).

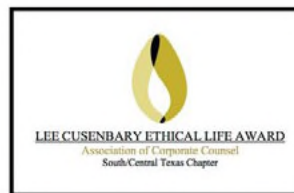
<sup>9</sup>See Code § 382(h)(3)(A)(i).

<sup>10</sup>See Code § 382(h)(1)(A).

<sup>11</sup>See Code § 382(h)(1)(B).

<sup>12</sup>See Notice 2003-65, Section III, The 1374 Approach.

<sup>13</sup>See Notice 2003-65, Section IV, The 338 Approach.



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