Section 382 proposed rules impact troubled business transactions

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In brief

PwC's Washington National Tax Services on October 16 hosted the live webcast "Tax Readiness: Recession or not, how troubled businesses will be affected by the Section 382 proposed regulations", featuring PwC Tax and Deals specialists. They discussed economic risk factors for US companies, and the tax impact that the proposed regulations under Section 382(h) (the Proposed Regulations), released by Treasury on September 9, may have on troubled businesses. In addition, the panelists addressed common M&A strategies in the context of distressed companies.

In this context, buyers and sellers of loss corporations must prepare for finalization of the Proposed Regulations. Moreover, the proposed rules could reduce the value of tax attributes in M&A transactions even before they become effective. Generally, Section 382 limits a corporation's ability to offset income with losses arising before an ownership change, with adjustments for certain recognized built-in gains or losses (RBIG or RBIL) recognized by the loss corporation.

Prior to the Proposed Regulations, Notice 2003-65 (the Notice) provided two alternative safe harbor approaches for calculating RBIG and RBIL: the "1374 approach" and the "338 approach". The Proposed Regulations would make mandatory the safe harbor provided in the Notice, generally following the 1374 approach and eliminating the so called "wasting asset" or 338 approach. Further, the Proposed Regulations address the treatment of numerous specific items accounted for in the Section 382(h) computations, including the treatment of cancellation of indebtedness income and excess business interest expense allocated from a partnership. The effective date of the Proposed Regulations is discussed below.

In detail

Proposed Regulations

Background

Section 382 generally restricts a corporation's utilization of its net operating losses (NOLs) after the corporation undergoes an ownership change, by limiting the amount of income earned by the corporation after the change that may be offset by NOLs incurred prior to the change.

An ownership change occurs if one or more “5% Shareholders” increase their ownership in the corporation’s stock, in the aggregate, by more than 50 percent during a testing period, generally the three-year period preceding a testing date.

Prior to the Proposed Regulations, the Notice provided safe harbor settlement guidelines regarding the determination of net unrealized built-in gain (NUBIG) and net unrealized built-in loss (NUBIL) as well as the identification of RBIG/RBIL. The Notice described two approaches for determining when items of income, gain, deduction, and loss are treated as RBIG and RBIL: the “1374 approach” and the so-called “wasting asset” or “338 approach.” While both approaches yield similar results for dispositions, they yield different results with respect to items of income and deductions, as the 1374 approach is narrower, including fewer items as RBIG and RBIL. The Proposed Regulations follow a modified version of the 1374 approach and would eliminate the 338 approach.

Significant modifications of the 1374 approach include (i) the inclusion as RBIL of the amount of contingent deductible liabilities paid or accrued during the recognition period and (ii) the treatment as RBIL of bad debt deductions recognized at any point during the recognition period. The Proposed Regulations also provide a methodology for calculating NUBIG/NUBIL that likely would result in taxpayers having lower NUBIGs or larger NUBILs.

COD, RBIG/RBIL, and other adjustments

The Proposed Regulations, unlike the Notice, generally do not integrate the insolvency amount of a loss corporation into the NUBIL or NUBIG calculation by excluding liability assumption from the hypothetical sale. Instead, includible cancellation of debt (COD) income of the loss corporation that is recognized on recourse debt during the 12-month period following an ownership change is eligible for inclusion in the NUBIG or NUBIL computation. COD income that is excluded from a taxpayer’s taxable income generally does not generate RBIG and thus does not impact NUBIG or NUBIL. There are exceptions for excluded COD income recognized by a loss corporation during the first 12 months of its post-change period.

RBIG from recourse debt is capped at the amount of recourse liabilities discharged by the federal bankruptcy court when the loss corporation is in bankruptcy. In other cases, RBIG from recourse debt is capped to the extent to which the adjusted issue price of the recourse liabilities taken into account in determining insolvency exceeds the sum of (i) the fair market value of assets of the corporation that are not securing nonrecourse debt and (ii) the excess value of assets securing nonrecourse debt over the amount of debt they secure immediately before the ownership change.

RBIG from nonrecourse debt is capped at the amount by which the adjusted issue price of the nonrecourse debt exceeds the fair market value of the property securing the debt immediately before the ownership change.

Inclusions and exclusions of items recognized during the five-year recognition period under the Proposed Regulations

RBIG includes the following items recognized during the five-year recognition period	RBIG does not include the following items recognized during the five-year recognition period	RBIL includes the following items
Gain on the disposition of built-in gain assets (to the extent the assets had an unrealized built-in gain on the change date)	Income from wasting assets	Loss on the disposition of built-in loss assets (to the extent the assets had an unrealized built-in loss on the change date)
Income if the item would have been properly included in gross income before the change date by an accrual-method taxpayer	Income from licensing or leasing property	Deductions if the item would have been properly allowed as a deduction before the change date by an accrual method taxpayer
Certain COD income (as described above)	Prepaid income	Depreciation of built-in loss assets (equal to the excess of the corporation’s actual depreciation or amortization of a built-in loss asset over the amount

		allowable if the adjusted basis of the asset on the change date equaled its FMV)
	Dividends	Deductions of items not yet incurred at the time of the ownership change that would be deductible on payment
	Gain from the sale or exchange of controlled foreign corporation (CFC) stock characterized as a dividend under Section 124	Bad debt deductions recognized during the recognition period
	Sections 951(a) and 951A income inclusions	Section 382 excess business interest expense

Notably, the Proposed Regulations also seek to eliminate the distortion of RBIL and NUBIL through Section 163(j), which was amended by the 2017 tax reform legislation. In order to do so, the Proposed Regulations provide that disallowed interest carryforwards would not be treated as RBIL if such amounts were allowable as a deduction during the recognition period. In addition, the Proposed Regulations contain rules addressing necessary adjustments for excess business interest expense allocated from partnerships.

Effective date

The Proposed Regulations are prospective and would apply to determinations of NUBIG/NUBIL and of RBIG/RBIL for Section 382 ownership changes occurring after the date final regulations are published. The regulations state that taxpayers may apply the proposed regulations to any ownership change in an open year so long as taxpayers and all of their related parties consistently apply the rules to that ownership change and all subsequent ownership changes. Comments on the Proposed Regulations are due by November 12, 2019.

Observation: If finalized in their current form, the Proposed Regulations are expected to significantly impact the ability of loss corporations to use their attributes. A resulting reduction in the value of tax attributes in M&A transactions could negatively impact deal consideration even before the Proposed Regulations become effective. Once finalized, the changes for insolvent and bankrupt companies will likely be dramatic, particularly for companies with tax losses and high-value, low-basis depreciable or amortizable assets, such as substantially depreciated equipment and self-generated intangibles. These are often found among technology and life sciences companies. **Note:** The life sciences sector, including pharma companies, has recently seen an uptick in distressed activity due to economic factors.

Impact of reduced deal consideration and common distressed M&A strategies

In distressed transactions, reduced value of tax attributes likely would result in an increase in asset sales as opposed to stock sales. Companies that are stressed and/or distressed may find it difficult to effectuate an asset sale outside of a formal bankruptcy proceeding due to the risk of fraudulent transfer litigation. A constructive fraudulent transfer occurs when a debtor transfers property without receiving "reasonably equivalent value" in exchange for the transfer if the debtor is insolvent at the time of the transfer or becomes insolvent or is left with unreasonably small capital to continue in business as a result of the transfer.

Overview of common distressed M&A strategies

	Out of Court	(Bankruptcy Code) Section 363 Sale	Plan sale	Claims purchase/ conversion
Advantages	No court oversight	Relatively quick process	More flexibility in terms of form and timing of consideration	Capitalize on discount between fair market value and trading price of claims
	Exclusivity	Assets can be acquired free and clear of claims, liens, and encumbrances	Assets can be acquired free and clear of claims, liens, and encumbrances	Ability to block competing plans
	Potentially a longer diligence process	Transaction can be consummated over creditor objections	Ability to deal with complex, multi-jurisdictional issues	
Disadvantages	Greater risk of liabilities attaching	Stalking Horse bid subject to higher and better offers	More costly and time-consuming	Claims may not be converted into equity
	High risk of fraudulent transfer, especially when Debtor is distressed	Auction procedures will be imposed	Buyer may become embroiled in plan formulation process	Investment may be illiquid
	Difficult to shed unfavorable contracts or liabilities	Cannot influence structure of the plan of reorganization	Ability to consummate sale depends on broad creditor acceptance	Purchases may attract attention, thereby increasing total acquisition cost

Section 363 of the US Bankruptcy Code allows for the sale of substantially all of the target's assets outside the ordinary course of business with the approval of the Bankruptcy Court (Section 363 Sale). In a Section 363 Sale, the buyer can identify certain assets for acquisition, and the sale is free and clear of all liens, claims, and encumbrances. Further, it typically is subject to an auction process resulting in the "higher and best" offer, and there is no formal ability for a dissatisfied creditor class to "block" a deal; however, note that any deal still could be subject to creditor objections.

Section 363 Sales also offer the opportunity for a potential buyer to acquire select assets of the target company under the protection of a court order barring most creditors from asserting any of their claims against the purchase. This avoids the aforementioned risk of fraudulent transfer liability, which often can be a risk when acquiring troubled companies prior to a bankruptcy filing. Moreover, unfavorable assets can be excluded from the transaction while shedding a majority of legacy liabilities.

In addition, Section 363 Sales give debtors the ability to assume and assign certain favorable unexpired leases and executory contracts while eliminating undesirable ones. Further, buyers in a Section 363 Sale are not responsible for making distributions to creditors – the debtor receives consideration and is responsible for distributions and estate administration.

Observation: Given these comparative advantages over the other approaches shown in the above overview chart, the Section 363 Sale process is the most commonly utilized acquisition method in a bankruptcy scenario.

The takeaway

If economic downturn indicators rise, so will the risks for US companies' finances going forward. The ability to use tax attributes of loss corporations will decrease significantly compared to the currently available method, if the Proposed Regulations are finalized in their current form. Anticipation of the potential finalization could reduce overall deal

consideration. In distressed transactions, such reduction might result in an increase in asset sales as opposed to stock sales.

Buyers and sellers of companies should analyze the Proposed Regulations in the context of contemplated transactions and consider strategies designed to reduce any negative impact. Given that the Proposed Regulations also address the further complexity of having Section 163(j) applied at the partnership level with regard to determining the basis of partnership interests, additional attention should be paid to structures involving partnerships.

See also:

For an in-depth discussion of the provisions in the Proposed Regulations, see our Tax Insight, Treasury issues comprehensive proposed regulations under Section 382(h).

For a deal-focused discussion of the Proposed Regulations, see our Tax Insight, Proposed Regulations under Section 382 reduce tax attributes' value in M&A transactions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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