Simpson Thacher

Memorandum

IRS Proposed Regulations Significantly Reduce the Annual Limitation Imposed on NOLs Following an Ownership Change

September 12, 2019

On September 9, 2019, the Treasury Department and the IRS issued proposed regulations (the "Proposed Regulations") under Section 382 of the Internal Revenue Code of 1986 (the "Code"). If finalized, the Proposed Regulations will impose stricter limitations on the ability of a corporation with net operating losses ("NOLs") to utilize such NOLs following an ownership change.

The Proposed Regulations are expected to adversely affect the valuation of the tax attributes of certain corporations.

Current Law

Under Section 382 of the Code, when a corporation with a net operating loss carryover (or a corporation having a net operating loss for the taxable year in which the ownership change occurs) undergoes an ownership change[1], an annual limitation generally applies on the corporation's ability to use pre-change tax attributes to offset taxable income in a post-change year (the "Section 382 Limitation").

The Section 382 Limitation is calculated, in general, by multiplying the value of the loss corporation prior to the ownership change by the long-term tax-exempt rate (known as the "base limitation"). The Section 382 Limitation may be further increased if the corporation is in a net unrealized built-in gain ("NUBIG") position (generally, if the fair market value of its assets exceeds the aggregate adjusted basis of its assets) or reduced if the corporation is in a net unrealized built-in loss ("NUBIL") position (generally, if the aggregate adjusted basis of its assets exceeds the fair market value of its assets). The amount of such increase or decrease of the Section 382 Limitation is determined by taking into account the extent of the recognized built-in gain ("RBIG") or the recognized built-in loss ("RBIL"), respectively, for the five-year period after the change of ownership. Under IRS Notice 2003-65, in computing their Section 382 Limitation taxpayers are permitted to determine their recognized RBIG on a hypothetical basis as if all of the assets of the corporation were sold

[1] The determination whether an ownership change under Section 382 of the Code has occurred is a complex test.

for fair market value and the new corporation has deductions attributable to such hypothetical stepped up basis, (such an approach, the "Section 338 Approach"). For NUBIG corporations the Section 338 Approach generally created significant additional Section 382 Limitation in each of the first five years following the ownership change (generally an amount equal to approximately 6.67% of the value attributable to intangible assets of the corporation at the time of the ownership change). This additional Section 382 Limitation often allows an acquirer to place additional value on NOLs of a target corporation.

The Proposed Regulations

The Proposed Regulations change unfavorably the method of determining whether a corporation is in a NUBIG or NUBIL position, and the amounts of RBIG and RBIL which increases or decreases the base limitation, and therefore reduced the amount of the Section 382 Limitation.

Most importantly, the Proposed Regulations eliminate the ability of a taxpayer to elect the Section 338 Approach and instead mandates the use of the "Section 1374 approach" outlined in the Notice (with certain modifications). Although certain taxpayers have historically elected to use the Section 1374 Approach, that approach generally only provided material benefits for loss corporations which were in an overall NUBIL position. One modification requires that recourse liabilities not be taken into account for determining the value of assets (whereas nonrecourse liabilities are taken into account). The Proposed Regulations also clarify that income from the cancellation of indebtedness ("CODI") that was excluded from the loss corporation's income under Section 108 of the Code should not be included in the computation of NUBIG or NUBIL (on the contrary, CODI which is not excluded under Section 108 should be taken into account in most circumstances).

Effective Date

The Proposed Regulations will apply only to ownership changes after the date of publication of the final regulations in the Federal Register. Taxpayers may elect to apply the Proposed Regulations so long as the taxpayers and any of their related parties consistently apply these rules also to all subsequent changes of ownership which will occur before the applicability date of the final regulations.

Practical Implications

As the Section 382 Limitation is expected to become more limited, the value attributed to the NOLs and other tax attributes of a target corporation is expected to reduce significantly, possibly even prior to the enactment of final regulations due to the uncertainty as to when the regulations will be finalized.

For further information, please contact one of the following members of the Firm's Tax Department.

NEW YORK CITY

John J. Creed
+1-212-455-3485
jcreed@stblaw.com

Marcy G. Geller
+1-212-455-3543
mgeller@stblaw.com

Jonathan Goldstein
+1-212-455-2048
jgoldstein@stblaw.com

Robert E. Holo
+1-212-455-2514
rholo@stblaw.com

Nancy L. Mehlman
+1-212-455-2328
nmehlman@stblaw.com

Andrew B. Purcell
+1-212-455-3064
apurcell@stblaw.com

PALO ALTO

Katharine P. Moir
+1-650-251-5035
kmoir@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000