

SECTION 382: BUILT-IN GAIN AND LOSS RULES

INTRODUCTION

With U.S. corporate bankruptcies poised to hit a decade-long high as a result of the economic impact of COVID-19, we have prepared these materials that detail the key bankruptcy tax issues and guidance offered by Linda Swartz, the chair of Cadwalader's Tax Group, in old and new speeches and panels. We hope you find this presentation to be both useful and informative.

For additional information, contact [Linda Swartz](mailto:linda.swartz@cwt.com) (linda.swartz@cwt.com).

Upcoming speaking engagements:

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| October 14, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" at PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2020 |
| November 5, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy" at The University of Chicago Tax Conference |
| January 25, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the 2021 University of Southern California Federal Tax Institute |
| February 8, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Workouts and Debt Restructurings" at PLI's 23rd Annual Real Estate Tax Forum |
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Linda Swartz, the longtime chair of Cadwalader's Tax Group and member of the Firm's Management Committee, focuses her practice on structuring complex restructurings, bankruptcies, mergers and acquisitions, spin-offs, joint ventures, and foreign tax planning strategies. She also regularly advises clients on fund structures, financings and derivative transactions.

Linda is consistently recognized as one of the leading tax lawyers in the country. She was recently named one of 14 "Influential Women In Tax Law" by *Law360*, noted for her role as "a key architect on billion-dollar transactions involving major multinational companies" with clients describing her tax structuring expertise as "so strong that we don't even go to the IRS to get a blessing from them. We go to Linda to get a blessing from her." She has been described by *Chambers USA* as "acclaimed for her vast reservoir of practical knowledge of the U.S. tax code" and "an expert on the law of today but cognizant of where the law might go in the future, allowing clients to make decisions which last for the next ten years." Clients quoted by *The Best Lawyers in America* have described Linda as "the foremost U.S. tax advisor on structured acquisition and divestiture deals" and "a professional force of nature" with "extraordinary technical ability, coupled with fiercest and most trenchant deal negotiation skills of any transactional tax lawyer." She was also recognized as "2017 Foreign Tax Planning Lawyer of the Year" by *Finance Monthly*, and *Dow Jones*, reporting on Procter & Gamble's Reverse Morris Trust transaction with Coty, noted that "it isn't often you see a tax adviser credited on a deal, but that's exactly what happened for Cadwalader, Wickersham & Taft in P&G's complicated \$12.5 billion unloading of its beauty business to Coty."

Linda is widely regarded as a thought leader in the industry and is a prolific speaker and writer on a wide range of transactional tax issues, with articles that include "Partnership Bankruptcy Tax issues," "Debt Exchanges," "Bankruptcy Tax Issues," and "Bankruptcy Tax 101." She also authors the chapters on Debt Exchanges in *Collier on Bankruptcy Taxation* (Matthew Bender) and Securities Lending Transactions in *Taxation of Financial Institutions* (Clark Boardman Callaghan). In addition to writing, she speaks on a broad range of topics, including each year on workout and bankruptcy tax issues at the corporate and real estate tax PLI conferences.

Linda is a member of the Executive Committee of the New York State Bar Association Tax Section and has chaired its Tax-Free Reorganizations; Corporations; Bankruptcy; Consolidated Returns; Real Property; and Tax Accounting and Basis Committees.

Linda received her J.D. from University of Pennsylvania Law School, and her B.A. from Bucknell University, where she graduated *magna cum laude* and was elected to Phi Beta Kappa.

SECTION 382

BIGs and BILs recognized within five years after ownership change are subject to special rules if the loss corporation has a NUBIG or NUBIL, respectively, on an ownership change date.

NUBIG/NUBIL generally equals the difference between aggregate FMV of assets and adjusted basis immediately before an ownership change, with adjustments for pre-change built-in items.

- Threshold: Lesser of 15% of FMV of corporation's assets or \$10,000,000.
- Recognized BIGs for five years after an ownership change increase annual section 382 limitation of a loss corporation with a NUBIG.
- Utilization of a NUBIL loss corporation's built-in losses is subject to section 382 limitation for five years after ownership change.

Two primary questions: what constitutes BIG, and how are BIG assets valued in determining whether corporation has a NUBIG?

- Should built-in income items be included, and if so, at what value in determining whether the loss company satisfies the NUBIG threshold?
- How should income be traced to particular assets and accrued for purposes of increasing NOL limit?
- Should tax or economic accrual models be used, or should income and cost recovery be matched?

NOTICE 2003-65

Pending the issuance of final regulations, taxpayers can continue to rely on the two safe harbors in Notice 2003-65 to identify recognized built-in items

Section 338 Approach

Loss corporations may treat all income and liability items (using estimated values for contingent items) that would trigger gain on a deemed asset sale on ownership change date as built-in items.

- RBIG in five-year postchange period includes additional deemed depreciation and amortization deductions based on the FMV of the loss corporation's assets on the ownership change date ("wasting" built-in gain assets).
- This approach generally assumes that BIG assets generate income equal to cost recovery deductions that would have been allowed if the loss corporation had made a section 338 election on the ownership change date.

Section 1374 Approach

Loss corporations may alternatively elect to treat as built-in items only those items that would satisfy the all-events test on the ownership change date but for a lack of economic performance.

- The portion of depreciation and amortization deductions attributable to basis that exceeds an asset's FMV during the five-year post-change period will be treated as RBIL.

NUBIG / NUBIL



The net amount of income or loss the loss corporation would have realized on a third-party sale, immediately before ownership change, of all of its assets at FMV subject to all of its liabilities, including contingent liabilities at their estimated amount



The amount of any deductible liabilities

EXAMPLE OF SECTION 338 APPROACH

FMV of Intangible Asset	\$90
Tax Basis of Intangible Asset	\$15
Mark-to-Market Amortization ($\$90 \text{ FMV} / 15 \text{ years}$)	\$6
Actual Amortization ($\$15 \text{ basis} / 15 \text{ years}$)	<\$1>
Annual Benefit from Notice	\$5
Total 5 Year Benefit from Notice	\$25

NOTE: These results may vary significantly based on a loss corporation's current amortization and depreciation deductions.

PROPOSED BUILT IN GAIN AND LOSS REGULATIONS – PRIMARY CHANGES

Regulations proposed in 2019 would jettison the more taxpayer-favorable parts of Notice 2003-65.

- Would create a single set of rules based generally on the section 1374 approach of the Notice in the name of “simplicity, objectivity and administrability.”
 - Curiously, the proposed regulations would nonetheless treat the accrual or payment of a previous contingent liability as RBIL to the extent of the estimated value of the liability at the time of the ownership change.
- Would eliminate the section 338 approach and the “wasting asset” rule of the Notice.
 - Thus, an actual disposition of built-in gain assets during the recognition period would be required to create RBIG and so benefit from the net built-in gain rule.
- Would eliminate the “double benefit” of including pre-discharge recourse liabilities, regardless of impact.
- Effective 30 days after the regulations are published as final, with transition relief for certain ownership changes planned at that time.
- NOTE: Taxpayers can elect to apply proposed regulation to a current or past ownership change (if taxable year is still open), provided the taxpayer and its related parties consistently apply the proposed rules to the particular ownership change and to all subsequent ownership changes.

NEW PROPOSED NUBIG / NUBIL REGULATIONS (cont'd)

Transition Relief

Ownership changes qualifying for transition relief must occur immediately after a transaction:

- pursuant to a binding agreement in effect on or before the effective date;
- described in a public announcement made on or before the effective date;
- described in an SEC filing submitted on or before the effective date;
- described in a PLR request submitted to the IRS on or before the effective date; or
- by order of a court in a Title 11 or similar case (or pursuant to a plan confirmed, or a sale approved, by order of the court), if the taxpayer was a debtor in a case before that court on or before the effective date.

Computing NUBIG or NUBIL

The Proposed Regulations define NUBIG/NUBIL as:

- the net amount of income or loss that loss corporation would have realized if, **immediately before** the ownership change, loss corporation had sold all of its “section 382 assets” (*i.e.*, assets other than certain cash equivalents and non-ordinary course receivables) at fair market value to a third party that assumed all of its **non-recourse (but not recourse) liabilities**,
- *decreased by* the amount of any fixed deductible liabilities and the “estimated” value of any contingent deductible liabilities,
- *increased or decreased* for any other built-in income or deduction items based on an accrual method of accounting not otherwise taken into account (unless specifically excluded),
- *adjusted* for any section 481 amount that would be taken into account on a hypothetical sale, and
- *increased after the fact*, if the taxpayer so elects, for certain COD recognized upon the cancellation of recourse debt within 12 months after the ownership change date.

CHANGES IN COMPUTATION OF NUBIG / NUBIL

Recourse Debt

Recourse debt is excluded from the calculation **unless**:

- the taxpayer realizes the COD **within 12 months** (subject to cap);
- the COD is actually includable in income; **or**
- the COD is excluded under section 108(a) (generally under the bankruptcy or insolvency exceptions to COD income) and reduces the borrower's post-change tax attributes (including tax basis in any new post-change assets) or reduces the tax basis of assets taken into account in determining net built-in gain or loss (*i.e.*, section 382 assets); **and**
- the taxpayer elects on its tax return or any amended return to take the COD into account in determining its NUBIG / NUBIL.

In contrast, the full amount of any non-recourse debt is included.

RBIL

No adjustment for RBIL previously limited under section 382, 383, or 384.

Section 382(h)(8) Limitation

Section 382(h)(8) limitation on value applies for determining net built-in loss.

CHANGES IN COMPUTATION OF NUBIG / NUBIL (cont'd)

General Consistency Rule

- No amount is included in computing NUBIG / NUBIL that is properly included in a Loss Co's taxable income or loss for the pre-change period.
- This avoids the so-called "double detriment" that might otherwise exist for companies with substantial economic performance-type liabilities: the risk that the NUBIL / NUBIG is decreased by the payment of substantial economic performance-type liabilities on the change date, yet the deduction is within the pre-change period.

Coordination between Section 382 and Reg. §1.1502-76(b)

- If an ownership change date is also the date Loss Co enters or leaves a consolidated group, Regulation -76(b) would apply with respect to the calculation of built-in gain and loss.
- Thus, for example, if Loss Co realizes but excludes COD income on an ownership change date that is also the date Loss Co joins a new consolidated group, Loss Co's COD is allocable to the pre-consolidation period. See Treas. Reg. §1.1502-28(b)(11). Accordingly, the excluded COD would not be taken into account in determining NUBIG / NUBIL.
 - This rule has been in proposed form in Regulation -76 since 2015.