THE POWER OF BEING UNDERSTOOD

Agenda

1. GLAM 2020-005: Split holding period and basis in a stockless contribution?
2. Consolidated net operating loss issues
3. Section 382(h) proposed regulations & update

GLAM 2020-005

- Addresses the meaningless gesture doctrine and creation of a split holding period in a stockless contribution of property otherwise qualifying as a section 351 exchange
- Situations in the GLAM appear to be abusive situations (i.e., artificial extension of holding periods beyond the true economic investment)
  - Situation 1: There is an initial and valid section 351 exchange, and the property contributed is of negligible value. After the initial transfer and in the same year, the shareholder contributes cash to the corporation for no consideration. The shareholder, in the following year, sells the stock of the corporation and claims that all of the stock has a holding period exceeding one year.
  - Situation 2: The same facts as situation 1, except that the shareholder contributes in appreciated property to the corporation for no consideration in the transfer subsequent to the initial transfer.

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Section 351

- Holding: After the subsequent transfers in both situations 1 and 2, the shareholder's stock in the corporation has a split basis and split holding period to reflect the initial transfer and subsequent transfer.
  - But the GLAM does not provide for the deemed issuance of stock in the subsequent transfers
  - Situations appear abusive intended to extent holding period beyond actual investment period
- Rev. Rul. 85-164: split holding period created in stock issued in 351 exchange
- Meaningless gesture doctrine may apply to treat stockless contributions to capital as section 351 exchanges

Contributions to Capital

- Capital contribution by a corporation's sole shareholder may still qualify as a section 351 exchange even though no stock is issued
- But does this require a deemed share issuance?
  - Case law does not explicitly provide for deemed issuance
  - Prop. Regs. in 2009 provided for deemed issuance in a section 351 exchange where meaningless gesture doctrine applied, but were withdrawn in 2019
  - If no deemed issuance, is there still a split holding period in the stock in stockless capital contributions?
    - IRS suggests yes in GLAM 2020-005 – but how broadly?

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Implications of GLAM 2020-005

- IRS has recently suggested that GLAM 2020-005 should be applied narrowly
- A broader application of the GLAM could require valuation of the company every time there is a capital contribution if split holding period and basis are created
  - e.g., stockless contribution to capital by a shareholder in a consolidated group or from a foreign corporation to its US subsidiary corporation (or vice versa)
  - Increased burden to taxpayer and valuation issues
- Could also impact other code sections like section 1061
  - Long-term capital gain treatment on the sale of applicable partnership interests held for three or more years
  - Creation of split holding periods could be problematic

Implications of GLAM 2020-005 & Carried Interest

- Example:
  - PE fund invests $200M in a portfolio company (a C corporation) on Jan. 1 of year 1. Due to increased capital needs, PE fund contributes $50M on Jan. 1 of year 2 and year 3, and $20M on Jan. 1 of year 4. No stock is issued to the PE fund upon the contributions in years 2, 3, and 4. On Dec. 31 of year 4, the PE fund sells the portfolio company for $820 million, resulting in a gain of $500 million.
  - If split holding periods in the stock are created for each contribution subsequent to year 1, only the portion of the gain allocable to the stock issued on Jan.1 of year 1 would be eligible for long-term capital gain treatment
  - Company value would need to be determined upon each contribution
- Compare this example to the situations in the GLAM (significant v. not significant economic investment from the beginning)

Consolidated net operating loss issues

CNOL Final Regulations – 80% limitation

- The TCJA enacted a limitation on the amount of NOLs a corporation may deduct in a single tax year equal to the lesser of the available NOL carryover or 80% of the pre-NOL taxable income (the 80% limitation).
- The CARES Act suspends the application of the 80% limitation for taxable years beginning before Jan. 1, 2021.
- Final regulations released in October state that a consolidated group determines its 80% limitation with respect to post-2017 CNOLs based upon consolidated taxable income and the amount of pre-2018 CNOLs carried to such tax year.
  - The corporate group first deducts pre-2018 NOLs without limit.
  - Next, the group deducts post-2017 CNOLs up to 80% of consolidated taxable income (computed without regard to deductions under sections 172, 199A and 250) determined after the deduction of pre-2018 NOLs.

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CNOL Final Regulations – 80% limitation

Example 1: ABC Group, a calendar year consolidated group, generates $100 of taxable income before CNOLs in 2021. ABC Group has $50 of pre-2018 CNOLs and $100 of post-2017 CNOLs carried to the 2021 tax year.

What is the total CNOL deduction for the 2021 tax year?

- The $50 of pre-2018 CNOLs are deductible without limitation
- The deduction of post-2017 CNOLs is equal to the lesser of:
  - $100 (the total post-2017 CNOLs available)
  - $40 ($50 ($100 TI - $50 pre-2018 CNOLs) x 80%)
- Total CNOL deduction for the group is therefore equal to $90 ($50 + $40)

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CNOL Final Regulations – 80% limitation

- Pre-affiliation SRLY-limited NOLs generally are deductible only to the extent such SRLY member contributes to consolidated taxable income. SRLY members net positive or negative contributions to consolidated taxable income are tracked year over year through a cumulative register (SRLY Register).
- Taxpayers must reduce the SRLY Register by 100% of the taxable income of the SRLY member that allowed for the usage of the pre-affiliation SRLY members NOL, not the amount of income offset.

Example 2: T Corp joins in the filing of the consolidated P group on Jan. 1, 2021 with a $200 post-2017 NOL carryforward, subject to the SRLY rules. The P group generates $300 of taxable income in 2021, $100 of which is attributable to T. T's SRLY register is equal to $100.

In determining its CNOL deduction for the 2021 taxable year, the P group includes $80 (80% x $100) of T's SRLY NOL. T's SRLY register is subsequently reduced by the full $100 of T income necessary to support the $80 NOL deduction.

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CNOL Final Regulations – 80% limitation and SRLY

Pre-affiliation SRLY-limited NOLs are deductible only to the extent such SRLY member contributes to consolidated taxable income. SRLY members net positive or negative contributions to consolidated taxable income are tracked year over year through a cumulative register (SRLY Register).

The Final CNOL regulations provide that taxpayers must reduce the SRLY Register by 100% of the taxable income of the SRLY member that allowed for the usage of the pre-affiliation SRLY member's NOL, not the amount of income offset.

Example 2: T Corp joins in the filing of the consolidated P group on Jan. 1, 2021 with a $200 post-2017 NOL carryforward, subject to the SRLY rules. The P group generates $300 of taxable income in 2021, $100 of which is attributable to T. T's SRLY register is equal to $100.

In determining its CNOL deduction for the 2021 taxable year, the P group includes $80 (80% x $100) of T's SRLY NOL. T's SRLY register is subsequently reduced by the full $100 of T income necessary to support the $80 NOL deduction.

Temporary Regulations – Carryback waivers

Split-waiver elections, which generally waive the carryback of losses attributable to an acquired member to years in which the acquired member was a member of a different consolidated group, are generally due with the originally filed federal income tax return of the acquiring consolidated group for the year of the acquisition.

Temporary regulations provide relief for consolidated groups who failed to make timely split-waiver elections due to the then-repealed NOL carrybacks provisions.

Example 3: New Parent corporation (NP) acquired 100% of Target corporation's (T's) stock from Old Parent Corporation (OP) on Oct. 31, 2018. The NP group incurred NOLs attributable to T in its taxable year ended Dec. 31, 2018 (the T NOL). NP did not make a split-waiver election with its originally filed 2018 Federal income tax return.

NP may amend its Federal income tax return for the year ended Dec. 31, 2018 to make an amended statute split-waiver election ensuring the T NOL is not carried back to any tax years in which T was a member of the OP group. This election will not affect the NP group's ability to carry back NOLs attributable to members of the NP group other than T.

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Five-year NOL Carryback Considerations

Example 1:

- To facilitate the acquisition of T (a stand-alone corporate filer), P forms merger subsidiary that merges with and into T with T surviving. To simplify the structure P causes T to merge upstream with and into P. Post-merger, the T business generates NOLs. Though T, prior to the merger, had 5 years of taxable income, P may not carry back those NOLs to T's prior tax years. Instead, P carries the NOLs back to prior P tax years. However, the result differs if T remains in existence as a corporation.

Five-year NOL Carryback Considerations

Example 2:

- Assume a consolidated group organized a new member in 2017 (S). The consolidated group sustained a CNOL in the tax year that ended Dec. 31, 2020. A portion of that CNOL is attributable and apportioned to S. Under the offspring rule described above, the consolidated group may carry back those NOLs attributable to S in 2020 to the 2015 consolidated return year. If the common parent was not filing a consolidated return in the carryback year, the common parent could carry back S's NOLs to the common parent's separate year return assuming the parent was not a member of another consolidated or affiliated group.

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Five-year NOL Carryback Considerations

Example 3:

- P owns all of the stock of S. P and S joined in filing consolidated returns in the tax years ended Dec. 31 of 2016 and 2017. In tax year ended Dec. 31, 2018, S acquired all of the stock of T who was part of another consolidated group. In 2018, the P group generated a CNOL of $100 of which $50 was attributable and apportioned to T. Under the CNOL carryback rules, the P Group cannot carry back T’s $50 loss to any consolidated tax year in which T was not a member of the P group. Therefore, if the P group chooses to take advantage of the five-year carryback rule, the P group can only carry back the NOLs attributable to and apportioned to P and S. The T NOL would be carried back if applicable to a separate return year.

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Five-year NOL Carryback Considerations

Example 4:

- Assuming the same facts as Example 3, but that T converted into an LLC immediately after the acquisition and became disregarded from S for federal income tax purposes. The P Group is able to carry back T's $50 loss because it is a part of S's loss.

SECTION 382: NUBIG/NUBIL & RBIG/RBIL

Proposed Regulations section 1.382-7

§1.382-7 Proposed Regulations

Built-in Gains and Losses

Proposed Regulation on built-in gains

- Proposed regulations, if finalized, would withdraw Notice 2003-65
- Taxpayer unfavorable in virtually all aspects
- Proposed regulations would retain, in large part, the calculation of NUBIG/NUBIL from Notice 2003-65
  - Would adjust treatment of certain liabilities
- Proposed regulation would adopt, in large part, the §1374 approach for determining RBIG/RBIL
  - Would adjust treatment of contingent liabilities
- Proposed regulations would NOT adopt a §338 wasting approach

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Proposed Regulation on built-in gains

Example under the proposed regulations:

- Corporation X has a §382 ownership change on 1/1/20/20 with 2% LTTR and $40M in NOL
- $100M of equity value ($2M annual limitation) & $5B of Liabilities
- $5.01B of tax basis in the Company's assets (no tax basis in goodwill or deposit base)
- $10M limit (compared to $40M) is available in the first 5 years
  - Value $5.1B less tax basis of $5.01B = $90M NUBIG/15 yrs = $6M/yr RBIG
  - Annual limit plus RBIG over first five years = $8M x 5 = $40M
  - 20 years to utilize NOLs under proposed regulations
- Good news – IRS and Treasury seem to be signaling that

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Proposed Regulation on built-in gains

Major changes (beyond elimination of the 338 Method):

- Treatment of liabilities assumed in determining NUBIG/NUBIL
- Treatment of contingent liabilities in NUBIL & RBIL
- Elimination of the 1 year bad-debt safe harbor from the 1374 Method
- Treatment of cancellation of debt income (CODI)

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Proposed Regulation on built-in gains

NUBIG/NUBIL changes: Step 1

1. Include AIP of nonrecourse liabilities if in excess of FMV of property, plus
2. Sold all assets to unrelated third party buyer that assumed no liabilities

- What does this mean? In general we look at equity value paid plus all liabilities assumed to determine FMV of assets (with adjustments)
- Potentially requires taxpayer to get asset valuations to support NUBIG/NUBIL determination
- How does this simplify or decrease complexity?

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Proposed Regulation on built-in gains

NUBIG/NUBIL changes: Step 2

1. Decrease the amount from Step 1 by adjusted basis in assets
2. Decrease by any deductible liabilities
3. Decrease by the value of any contingent deductible liabilities
4. Plus/minus §481 adjustments
5. Plus/minus built in items of income and deduction (think accrual based items)

- Treatment of contingent and deductible liabilities in NUBIG/NUBIL may not have changed but significant – and unfavorable – changes were made to these items for RBIL

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Proposed Regulation on built-in gains

Current Expected Credit Losses (CECL) & RBIL

- FASB rule requires recording of all expected losses as issued
- Will the IRS look to CECL and treat any bad debt on a loan during the recognition period as RBIL?
- How would your audit firm look at this?

Proposed Regulation on built-in gains

RBIL and Liabilities

- Under Notice 2003-65: 1374 Method (which NUBIL companies choose) deductible liabilities (contingent or otherwise) would be an increase to NUBIL – no real change
  - For RBIL only those items that would have been deductible by an accrual method taxpayer would generate RBIL so very few items:
    - Certain liabilities subject to §461(h)(2)(C) & §1.461-4(g), certain §404 items
- Proposed regulations would treat all deductible liabilities and contingent liabilities as RBIL (contingent liabilities to the extent of FMV)
  - Is GAAP value of a contingent liability accurate and appropriate?
  - All contingent liabilities? What about liabilities that are on a GAAP B/S but are simply estimates of future expected costs?
  - Acquire a bank with a plan to shut down a number of branches and GAAP puts a restructuring liability on the books – RBIL?

Proposed Regulation on built-in gains

RBIL and Liabilities

- Seems completely inappropriate to both increase NUBIL for the liability and treat the deduction as RBIL
  - RBIL is a pre-change loss and as such if it is a pre-change loss the liability related to such loss should not increase NUBIL
  - Notice 2003-65 seems more appropriate in that the deductible liability would generally increase NUBIL but the deduction would not result in RBIL

- Prepaid income and associated costs:
  - §1.382-7: Prepaid income recognized post change is generally **<u>not</u>** RBIG
  - Proposed regulations would treat costs associated with performance on the prepaid income as RBIL if incurred post-change

Proposed Regulation on built-in gains

Elimination of one-year bad debt safe harbor

- The 1374 Method applied the rules of §1.1374-4(f) which provides a safe harbor rule that bad debts in the year following a change are treated as RBIL
  - No bad debts after 1 year are RBIL
  - Many banks utilized this safe harbor following an ownership change
- Proposed regulations would eliminate this safe harbor and require 60 month tracking of all bad debt
  - Not only may this provide a worse answer, the record keeping on this could be a massive amount of work
  - Is a bad debt reserve or loan loss reserve specific to each loan or is it a general reserve? Can you identify BIL in each loan at the time of an ownership change?

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