

It's a BIG, BIG World Out There

How to effectively use technology to preserve tax benefits in this challenging economic environment.

We all know that the current economic environment is less than ideal. Many corporations face the possibility of mergers, bankruptcy or fire sale. Many of these corporations will have incurred large net operating losses in years leading up to such events. A significant number of these acquired companies have built-in losses and gains, as a result of recent declining value. The “value” of these losses will depend in large part upon the tax law’s limitation with regard to offsetting these losses against income.

This area of law dealing with corporate net operating losses (NOLs), built-in gains (BIG) and built-in losses (BIL) is one of the more complex sections of the Internal Revenue Code. It is essential that corporations in this situation be fully aware of the traps that can reduce their NOL value.



The complexities of Section 382 provide specific rules with regard to the following:

➤ **Bankruptcy**

The “bankruptcy exception” allows qualified entities to avoid Section 382 limitations with respect to the amount of income that can be offset by a NOL. However, this exception imposes a “toll charge” which disallows certain interest deductions. Furthermore, subsequent “ownership changes” will result in wiping out the entire NOL altogether. Therefore, corporations must carefully evaluate whether they should use this exception or elect out of it.

➤ **Business Continuity**

If the corporation is not qualified or elects out of the bankruptcy exception, Section 382 imposes a continuity of business requirement. The failure to meet this business continuity test will result in Section 382 limitation becoming zero and none of the pre-change losses can be utilized. There is a partial exception to this rule, in that carryovers of recognized built-in gains (RBIG) will increase the Section 382 limitation to the extent of these gains.

➤ **Ownership Changes**

Section 382 provides a limit to a corporation’s ability to use NOLs incurred before the change in ownership in the periods after the ownership change. Ownership change is triggered when the percentage of stock of a loss corporation held by a 5% shareholder increases by more than 50 percentage points during a three year period. Section 382 imposes restrictions on the use of a corporation’s NOLs and other carryovers after an ownership change occurs.

➤ **Built-in Gains and Losses**

Section 382 provides an important exception to the general loss limitation rules when a built-in gain or loss is recognized following an ownership change. This exception only applies if the loss company has a net unrealized built-in gain or loss (NUBIG or NUBIL). A NUBIG or NUBIL is defined as “the amount by which the fair market value of the asset of such (loss) corporation is more or less, respectively, than the aggregate adjusted tax basis of such assets at such time.”

If the loss company has a NUBIG and a RBIG during the five year (sixty month) recognition period, the Section 382 limitation is increased by the amount of that RBIG for the year. On the other hand, if the loss company with a NUBIL has a realized built-in loss (RBIL) during the five year (sixty month) recognition period, the loss will be subject to the limitation as if it were a pre-change loss. Under Sec. 382(h)(6)(A), any item of income properly taken into account during the recognition period is treated as RBIG if the item is attributable to periods before the change date. Likewise, Sec. 382(h)(6)(B) provides that any item of deduction allowable as a deduction during the recognition period is treated as RBIL if the item is attributable to periods before the change date. Also, allowable depreciation, amortization or depletion deductions are treated as RBIL except to the extent the loss corporation establishes that the amount of the deduction is not attributable to the assets built-in loss on the change date.

Notice 2003-65 provides two safe harbor methods for computing gains and losses. These are referred to as the Section 1374 approach and the Section 338 approach. The selection of the most advantageous approach and the proper implementation of that method could have a significant impact on maximizing the utilization of the taxpayer's NOLs. Both of these methods require that the company calculate a hypothetical sale of all of their company's assets for fair market value (FMV). This can be an extremely challenging endeavor. In general:

- **The IRC Section 1374 approach** is a direct asset sale approach and would typically be the preferred method for a loss company with a NUBIL. NUBIG or NUBIL is calculated by determining the amount that would be realized if immediately before the ownership change date the loss corporation sold all of its assets, including goodwill, at fair market value. This sale would be to a third party that assumed all of its liabilities, decreased by the sum of any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale and the loss corporation's aggregate adjusted basis in all of its assets. These are increased or decreased by the corporation's section 481 adjustments that would be taken into account on a hypothetical sale, and increased by any RBIL that would not be allowed as a deduction under section 382, 383, or 384. This amount results in a NUBIG where the amount is greater than zero and a NUBIL when the amount is less than zero.
- **The IRC Section 338 approach** identifies items of RBIG and RBIL generally by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if a section 338 election had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date (the “hypothetical purchase”). As a result, unlike under the 1374 approach, under the 338 approach, BIG assets may be treated as generating RBIG even if they are not disposed of at a gain during the recognition period; and deductions for liabilities, in particular contingent liabilities that exist on the change date, may be treated as RBIL. This approach will likely be preferred for loss corporations with a NUBIG.

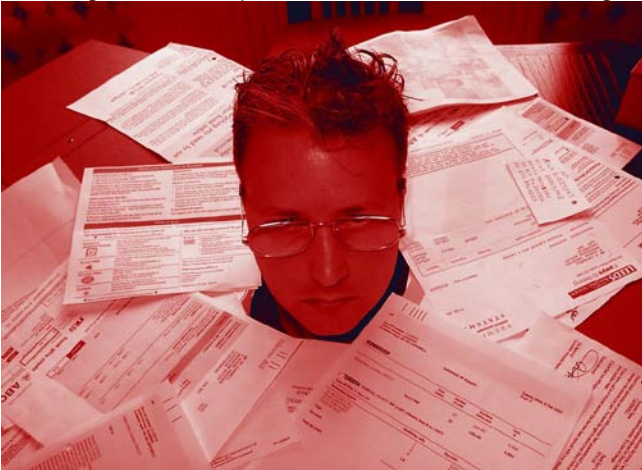
Maximizing and Preserving the Value of Your NOLs

The value of a NOL is limited by the complex rules of Section 382. Therefore, you need both a top notch tax strategy and a lot of help from technology to deal with the intricate details of the NUBIG and NUBIL asset by asset calculations.

Don't Get Buried in Complexity and Details....How Technology Can Reduce the Complexity of NUBIG and RBIG!

When considering NUBIG and RBIG as a part of corporate tax strategy, you might ask the question, "How do I even begin to implement something so detailed, large and complex?" The answer to this question is no surprise and something you already do...*look to technology*. The complexity of NUBIG and RBIG can be reduced like many other difficult tax processes through the use of technology. While there are no specific NUBIG and RBIG software solutions per se, consider working with a fixed asset management software provider to accommodate your needs. That is what a major airline, in one of the most public mergers of today, did. Together with their fixed asset management software provider, *Red Moon Solutions*, they devised a successful solution to meet their needs.

Their Corporate Tax Department stated, "We knew going into this merger that we wanted to take advantage of the safe harbor provisions of Notice 2003-65; but we knew that manual calculations and tracking would be onerous, time consuming, and error prone. We realized there weren't great technology options out there, and we were challenged to find a provider that was flexible enough to meet our needs. We now have our "customized" solution in



place to deal with the tremendous number of assets and the complexity of the calculations required. Working with Red Moon allowed us to fully automate this process as well as provide an auditable and archivable solution that met our organization's needs."

At a glance, the solution looks similar to how your asset depreciation/gains and losses are tracked. Assets are imported from their ERP system. The NUBIG and NUBIL amounts are calculated and tracked per asset detail in Red Moon Solutions's Fixed Assets Manager™ (FAM). All assets are tagged specifically as of the "effective date of ownership change" with appropriate new FMVs. All FMVs were imported (automated into the system), and are used to recalculate depreciation across the "NUBIG set of books." Those amounts are then compared to the Federal

Tax books to assess the appropriate BIG/BILs. When you look within FAM, you therefore see a separate BIG/BIL book (similar to MACRS and ACRS books). They were also able to run the initial 60 month (five year) set of projection reports which include the NUBIG/NUBIL reports across all entities, RBIG/RBIL reports used in determining the limitation, as well as a set of Gain/Loss reports for actual retirements. This set of reports facilitates and allows them to deal with the requirements of Section 382. All books and calculations are preserved as of the change date and for each subsequent year calculation in which the retirements will be added, calculations re-run and reports generated.

"We really enjoyed working with this major airline in devising a solution that would meet their unique needs. This is our sweet spot, coming up with solutions to meet the specific and unique needs of our clients. It is always rewarding for us to work side by side to meet our clients' challenges and see how our technology simplifies the complex world of tax," said Kelley Lear, Red Moon Solutions Managing Director.



Summary

If your corporation has NOLs, preserve their value through the benefits of BIG and reduce the burden of complex tax rules through the use of technology.

Reference Materials

Internal Revenue Bulletin: 2003-40, October 6, 2003, Notice 2003-65, Built-in Gains and Losses Under Section 382(h), http://www.irs.gov/irb/2003-40_IRB/ar17.html

About the author

Kelley Lear is a Managing Director with Red Moon Solutions LLC. Kelley has extensive experience in project management product management, and consulting with Fortune 500 and Global 1000 clients.

About Red Moon Solutions

Red Moon Solutions takes pride in solving unique challenges for today's tax department professionals. Founded by the former CIO and head of Tax Technology Enterprises for Andersen, LLP, RED MOON SOLUTIONS provides specialty tax products and services. Its solutions, Like-Kind Exchange Matching™ (LKEM), WorldPro™, and Fixed Assets Manager™ (FAM), were built to support the tax practice of Arthur Andersen. FAM offers a way to track high volumes of assets, improve control, and ensure that financial and tax depreciation are up to date. PowerOLAP™, a cost-effective business intelligence tool, is an exciting new addition to the RED MOON SOLUTIONS portfolio. RED MOON SOLUTIONS is an SAP® -certified integration partner.

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