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Report No. 1426
November 11, 2019

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Re: *Report No. 1426 – Report on Proposed Regulations under Section 382(h) Related to Built-in Gain and Loss*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1426 commenting on proposed regulations issued on September 9, 2019 under Internal Revenue Code Section 382(h) addressing the treatment of built-in gain and loss. We suggest certain modifications to the approach of the proposed regulations intended to balance the goals of accuracy and administrability and reflect the "neutrality principle" inherent in Section 382.

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We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
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Report No. 1426

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on
Proposed Regulations under Section 382(h) Related to Built-in Gain and Loss

November 11, 2019

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New York State Bar Association Tax Section

Report on Proposed Regulations under Section 382(h) Related to Built-in Gain and Loss

I. INTRODUCTION

This Report comments on proposed regulations (the "**Proposed Regulations**") issued on September 9, 2019, by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury (collectively with the IRS, "**Treasury**") under Section 382(h) addressing the treatment of built-in gain or loss.[1] Our comments do not address all aspects of the Proposed Regulations, but instead focus on specific issues with respect to which Treasury has requested comments or for which we have recommendations.

Part II of this Report contains a summary of our principal recommendations. Part III provides a summary of current law under Section 382 (including Notice 2003-65[2]) and the Proposed Regulations. Part IV discusses the adoption in the Proposed Regulations of the safe harbor computation provided in Notice 2003-65 based on the principles of Section 1374, with modifications (the "**Modified 1374 Approach**"), and then makes recommendations for changes to the Modified 1374 Approach. Part V comments on the proposed rules for the computation of net unrealized built-in gain ("**NUBIG**") or net unrealized built-in loss ("**NUBIL**"), including the treatment of contingent liabilities, proposed adjustments to account for cancellation of debt ("**COD**") income, and consistency regarding treatment of income and deductions arising on the date of the ownership change (the "**change date**"). Part VI comments on the identification of recognized built-in gain ("**RBIG**") and recognized built-in loss ("**RBIL**") under the Proposed Regulations, including the treatment of income from wasting assets, dividends paid on built-in gain stock, and contingent liabilities. Finally, Part VII comments on certain miscellaneous issues, including potential unintended consequences resulting from the interaction between the Proposed Regulations and Section 163(j), and the need for transition relief.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. Adoption of the Modified 1374 Approach and the elimination of the 338 Approach

1. Section 382(h)(6) does not provide a clear standard for determining whether items of income and deduction taken into account during the five-year period beginning on the change date (the "**recognition period**") are "attributable to" the pre-change period, and therefore properly treated as RBIG or RBIL. The 1374 Approach and the 338 Approach (each defined below in Part III.C) each has advantages and disadvantages. We recognize that there are sound reasons for adopting a single mandatory approach for determining NUBIG and NUBIL and built-in items under Section 382(h). A

[1] The principal author of this report is Shane Kiggen, with substantial contributions from Lulu Ma. Helpful comments were received from Andy Braiterman, Benjamin Brookstone, Robert Cassanos, Peter Connors, James Coss, Larry Garrett, Stuart Goldring, Andrew Herman, Adam Kool, Richard Nugent, Deborah Paul, Amy Sargent, Michael Schler, Linda Swartz, and Joe Toce. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the NYSBA Executive Committee or the House of Delegates.

[2] 2003-2 C.B. 747.

hybrid, which blends elements of the 1374 Approach and the 338 Approach, could serve as a reasonable compromise. However, we believe the Modified 1374 Approach does not achieve an appropriate balance between the goals of accuracy and administrability. Accordingly, we suggest certain modifications to the Modified 1374 Approach targeted at improving accuracy and realizing the "neutrality principle" (defined below in Part III.A.).

B. Computation of NUBIG and NUBIL

1. To avoid the distortion of NUBIG and NUBIL caused by the treatment of deductible liabilities under the Proposed Regulations, we recommend that final regulations reinstate the approach provided under Notice 2003-65 treating the buyer in a hypothetical sale of a loss corporation's assets as assuming all of a loss corporation's liabilities for purposes of computing NUBIG and NUBIL.

2. We recommend that final regulations clarify that a deferred revenue liability is not treated as a deductible liability for purposes of computing NUBIG and NUBIL to the extent the related income is deferred.

3. Final regulations should confirm that liabilities which are not reflected on a taxpayer's financial statement should not be taken into account in determining NUBIG or NUBIL.

4. To achieve consistency regarding the treatment of income and deductions arising on the change date, we propose that Treasury adopt a rule treating an ownership change as occurring at the end of the day on the change date for purposes of Section 382(h). By effectively treating the recognition period as beginning on the day following the ownership change, this approach would avoid certain issues that arise under current law from the inclusion of the change date in both the recognition period and the pre-change period.

5. With respect to adjustments for the treatment of built-in COD income, we recommend that final regulations adopt an approach that (i) includes all liabilities in the computation of NUBIG and NUBIL (consistent with recommendation B.1, above) and (ii) subsequently retroactively adjusts NUBIG or NUBIL (x) to the extent any liability discharged during the recognition period results in COD income that is excluded from income and either does not reduce any attributes or reduces pre-change attributes within a reasonable period (*e.g.*, two to three years) following the change date or (y) to the extent the COD income would have been excludable under Section 108(a) on all dates from and after the change date (*e.g.*, in the case of a multi-year bankruptcy).

C. Identification of RBIG and RBIL under the Modified 1374 Approach

1. We recommend that final regulations permit income from the consumption of wasting assets with a built-in gain on the change date to qualify as RBIG. For this purpose, we believe that the depreciation and amortization rules provide the best guide to Congressional intent in determining which assets waste and to what extent.

Therefore, we recommend final regulations permit income from goodwill to qualify as RBIG. We urge Treasury to adopt the following three-step framework for measuring the amount of income generated from the consumption of a built-in gain asset that qualifies as RBIG: (i) determine the asset's economically useful life; (ii) determine the amount of built-in gain in the asset immediately before the change date; and (iii) amortize the built-in gain over the asset's useful life on a straight-line basis. The economically useful life of an asset should generally be based on the applicable cost recovery period under either the general depreciation system ("**GDS**") of Section 168(c) or the alternative depreciation system ("**ADS**") of Section 168(g), except in the case of an "amortizable Section 197 intangible" as defined in Section 197(f)(9), which should be deemed to have an economically useful life of the lesser of 15 years or the number of year remaining under the taxpayer's amortization method. Further, we urge Treasury to consider permitting a loss corporation that depreciates or amortizes a wasting asset in computing taxable income to determine that asset's useful life by reference to the remaining recovery period under GDS or ADS.

2. Final regulations should provide that dividends that are not eligible for a dividends received deduction ("**DRD**") should constitute RBIG to the extent the loss corporation establishes that the dividend (i) is not offset by a DRD, (ii) does not exceed the amount of built-in gain in the stock of the subsidiary with respect to which the dividend is made, and (iii) is sourced from earnings and profits ("**E&P**") accrued with respect to the stock before the change date.

3. We believe there will often be substantial practical difficulties determining whether and to what extent deductions for contingent liabilities constitute RBIL. Final regulations should provide guidance on how to properly determine what portion of a built-in contingent liability accrues during the recognition period, including whether certain conventions can or must be used.

D. Miscellaneous items

1. We support Treasury's attempts to coordinate the interaction between Sections 163(j) and 382. However, to avoid the potential for double detriment that could arise from the operation of Prop. Reg. §1.382-7(c)(3)(iii)(E), we recommend a rule providing that, in situations in which the actual disposition by a loss corporation of a partnership interest results in the recognition of loss that is already subject to limitation under Section 382 as a result of the operation of Prop. Reg. §1.382-7(c)(3)(iii)(E), taxpayers may elect to either unlock the relevant Section 163(j) business interest expense from the Section 382 limitation or exclude the recognized loss from RBIL.

2. As a transition rule, Treasury should permit taxpayers to rely on Notice 2003-65 to the extent an ownership change results from a transaction or proceeding (i) for which a binding commitment is entered into or (ii) which is described in a public announcement or SEC filing, prior to the date the Proposed Regulations are adopted as final. With respect to an ownership change that occurs pursuant to a confirmed Chapter 11 bankruptcy plan, the relevant testing date should be the earlier of the date (i) the disclosure statement relating to the plan is approved by the bankruptcy court,

unless the economic terms of the plan pertinent to the application of Section 382(h) substantially change thereafter, and (ii) the voting deadline for the plan.

III. BACKGROUND

A. Section 382 generally

Section 382 imposes an annual limitation on a loss corporation's ability to offset taxable income attributable to the period after an ownership change[3] with losses attributable to the period before the change ("**pre-change losses**").[4] The goal of the limitation is to prevent the loss corporation from obtaining a greater benefit from pre-change losses than it would have obtained had the change not occurred, in order to stop trafficking in losses. This is referred to as the "neutrality principle".

In keeping with this principle, Section 382(a) sets the base limitation equal to the product of (i) the value of the loss corporation's stock[5] on the change date, multiplied by (ii) the applicable federal long-term tax-exempt rate.[6] The underlying theory is that, had the ownership change not occurred, the loss corporation would have earned income in an amount equal to a risk-free return on the value of its equity, which would have been freely offset by its pre-change losses.

In addition, Section 382(h) provides special rules addressing the treatment of gains and losses that are built-in at the time of the ownership change and recognized during the recognition

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3 Generally, an "ownership change" occurs if there is a greater-than-50% shift in the ownership of the loss corporation over a three-year period. Section 382(g), (i).

4 More specifically, "pre-change losses" consist of (i) net operating loss ("**NOL**") carryovers, capital loss carryovers, carryovers of disallowed business interest described in Section 163(j)(2), and certain credits from taxable years ending prior to the year in which the ownership change occurred; (ii) the portion of any NOL, capital loss, or disallowed business interest from the year that includes the ownership change to the extent it is allocable to the period on or preceding the date on which the ownership change occurred; and (iii) certain recognized built-in losses. *See* Section 382(d)(1)(A) and (C), Section 383(b), and Reg. §1.382-2(a)(2); Section 382(d)(1)(B) and Section 383(b).

5 Section 382(a) and (b); Reg. §1.382-5. Generally, the value of the loss corporation is the value of the loss corporation's stock immediately before the ownership change. *See* Section 382(e)(1). But adjustments to this value must be made if (i) a redemption or corporate contraction occurs in connection with the ownership change, (ii) the loss corporation is a foreign corporation, (iii) the loss corporation has received a capital contribution as part of a plan a principal purpose of which is to avoid or increase any limitation under section 382, or (iv) the loss corporation has substantial nonbusiness assets. *See* Section 382(e)(2) (corporate contractions), (e)(3) (foreign corporations), (*l*)(1) (asset stuffing), and (*l*)(4) (substantial nonbusiness assets). Additional adjustments to the value of the loss corporation stock may be required to avoid the duplication of value and other items in the case of a controlled or consolidated group. *See* Section 382(m)(5) and Reg. §1.382-8 (controlled groups); Reg. §§1.1502-91(g)(5) (indirect ownership duplication), Reg. 1.1502-93(b)(2)(ii) (anti-duplication of value), 1.1502-93(c)(2) (anti-duplication of limitation adjustments), 1.1502-94(b)(2) (anti-duplication with respect to new loss members), and 1.1502-96(b)(4) (anti-duplication for separate ownership changes).

6 Section 382(b). Reg. §1.382-12 provides rules regarding the determination of the long-term tax-exempt rate for an ownership change.

period. Consistent with the neutrality principle, the purpose of the rules is to treat such gains and losses in the same manner as if they had been recognized before the ownership change.

The treatment of such gains and losses depends on whether the loss corporation has a NUBIG or a NUBIL. A loss corporation cannot have both a NUBIG and a NUBIL, although it can have neither (*e.g.*, if NUBIG and NUBIL are both zero). If a loss corporation has a NUBIG, the Section 382 limitation for any taxable year within the recognition period (a "**recognition period taxable year**") is increased by the amount of its RBIG for that year.[7] The aggregate increase is limited to the NUBIG.[8] "NUBIG" is defined as the amount by which the aggregate fair market value of the loss corporation's assets immediately before the ownership change exceeds the aggregate adjusted basis of its assets at that time.[9] However, if the NUBIG does not exceed a de minimis threshold (the lesser of $10 million or 15% of the fair market value of the loss corporation's assets immediately before the ownership change), the NUBIG is zero.[10] "RBIG" is defined as any gain recognized during the recognition period on the disposition of any asset of the loss corporation, if the loss corporation establishes that (i) the loss corporation held the asset on the change date, and (ii) the gain does not exceed the asset's built-in gain on the change date.

If a loss corporation has a NUBIL, the RBIL for any recognition period taxable year is subject to limitation as if it were a pre-change loss.[11] The aggregate RBIL subject to the Section 382 limitation is limited to the NUBIL.[12] "NUBIL" is defined as the amount by which the aggregate adjusted basis of the loss corporation's assets immediately before the ownership change exceeds the aggregate fair market value of its assets at that time.[13] However, if the NUBIL does not exceed the de minimis threshold, the NUBIL is zero.[14] "RBIL" is defined as any loss recognized during the recognition period on the disposition of any asset of the loss corporation, except to the extent the loss corporation establishes that either (i) the loss corporation did not hold the asset on the change date, or (ii) the loss exceeds the asset's built-in loss on the change date.[15] The statute specifies that any amount allowable as depreciation, amortization, or depletion is treated as RBIL except to the extent the loss corporation establishes that the amount of the deduction is not attributable to the asset's built-in loss on the change date.[16]

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[7] Section 382(h)(1)(A)(i).

[8] Section 382(h)(1)(A)(ii).

[9] Section 382(h)(3)(A)(i).

[10] Section 382(h)(3)(B).

[11] Section 382(h)(1)(B)(i).

[12] Section 382(h)(1)(B)(ii).

[13] Section 382(h)(3)(A)(i).

[14] Section 382(h)(3)(B).

[15] Section 382(h)(2)(B).

[16] Section 382(h)(2)(B).

Section 382(h)(6) treats certain items of income or deduction included or allowed during the recognition period as RBIG and RBIL. Specifically, Section 382(h)(6)(A) provides that any item of income or deduction "which is properly taken into account during the recognition period" is treated as RBIG if it is "attributable to periods before the change date." Similarly, Section 382(h)(6)(B) provides that any item of deduction "which is properly taken into account during the recognition period" is treated as RBIL if it is "attributable to periods before the change date."

Section 382(h)(6)(C) provides that NUBIG or NUBIL is adjusted to reflect amounts that would be treated as RBIG or RBIL under Section 382(h)(6)(A) or (B) if those amounts were taken into account during the recognition period.[17]

B. Legislative history to Section 382(h)

Section 382 was originally enacted in 1954 but was substantially changed by the Tax Reform Act of 1986 (the "**1986 Act**"),[18] including to incorporate the concept of built-in gains and losses, through Section 382(h)(2), for purposes of calculating the Section 382 limitation. Section 382 was further amended through 1989. Although the Congressional intent behind those changes is not always obvious, the relevant legislative history is nonetheless useful in informing policy decisions with respect to Section 382(h).

Most importantly, as the legislative history to the 1986 Act indicates, Congress was heavily guided by the neutrality principle in drafting Section 382(h).[19] The 1986 Act added Section 382(h)(6), which at the time provided that the treatment of amounts "which accrue on or before the change date but which are allowable as a deduction after such date" should be treated as RBIL. The Conference Report to the 1986 Act provided that items of deduction deferred under Section 267 or 465 were examples of items appropriately treated as built-in losses for this purpose; however, depreciation deductions were specifically excluded, and Treasury was required by the Conference Agreement to conduct a study as to whether built-in depreciation deductions should be subject to Section 382.[20] In response, in 1987, Section 382(h)(2)(B) was amended to provide that RBIL generally includes "any amount allowable as depreciation, amortization, or depletion for any period within the recognition period."[21] In this regard, the accompanying Conference Report explained that "preacquisition losses that may not be used to

[17] Section 382(h)(6)(C).

[18] P.L. 99-514, 100 Stat. 85 (1986).

[19] *See* Joint Committee on Tax'n, General Explanation of the Tax Reform Act of 1986 (Pub. L. 99-514) (May 4, 1987), JCS-10-87 (the "**1986 Bluebook**"). Congress believed that "[b]uilt-in losses should be subject to special limitations because they are economically equivalent to pre-acquisition NOL carryforwards," and that special rules subjecting built-in losses to limitations were necessary to prevent taxpayers from engaging in post-ownership change transactions which would essentially circumvent the effect of Section 382. Likewise, relief for built-in gains is appropriate because, "absent a special rule, the use of NOL carryforwards to offset built-in gains recognized after an acquisition would be limited, even though the carryforwards would have been fully available to offset such gains had the gains been recognized before the change in ownership occurred." *Id.* at 298.

[20] H.R. Rep. No. 99-841, at II-191 (1986). *See also* 1986 Bluebook, at 320-21.

[21] The Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, 101 Stat. 1330 (1987) (the "**1987 Act**"), § 10225(b).

shelter built-in gains include built-in losses or items of deduction that have *economically accrued* prior to the deduction."[22]

Section 382(h)(6) was amended by the Technical and Miscellaneous Revenue Act of 1988 (the "**1988 Act**").[23] As discussed above, prior to 1988, Section 382(h)(6) simply referred to items that "accrued" prior to the change date. The 1988 Act updated the provision, now subparagraph 382(h)(6)(B), to authorize items of deduction "attributable to periods before the change date" to be treated as RBIL (in other words, replacing the reference to "accrue" with the phrase "attributable to"), and added subparagraphs 382(h)(6)(A) (regarding the treatment of income items as RBIG) and (C) (regarding adjustments to NUBIG or NUBIL).

The legislative history of the 1988 Act offered the following examples of items that are properly treated as RBIG: (i) accounts receivable of a cash-method taxpayer arising before the change date but collected after the change date, (ii) gain on the completion of a long-term contract recognized under the completed contract method of accounting that is attributable to periods before the change date, and (iii) adjustments under Section 481 resulting in the recognition of income attributable to periods before the change date.[24] However, the legislative history does not provide a specific explanation for the change in language from "accrue" to "attributable to"; thus, the Congressional intent underpinning the amendment to Section 382(h)(6) by the 1988 Act is ambiguous.[25] However, a reasonable interpretation is that Congress intended to broaden the scope of built-in items to include items that are economically accrued as of immediately before an ownership change.

Finally, the Omnibus Budget Reconciliation Act of 1989 (the "**1989 Act**") further amended Section 382(h)(6)(C) to its current form, providing that NUBIG or NUBIL is adjusted for amounts "which would be treated as recognized built-in gains or losses . . . if such amounts were properly taken into account (or allowable as a deduction) during the recognition period."[26] The House Report to the 1989 Act explained that "items of income or loss that would be treated as built-in gain or built-in loss if recognized within the Recognition Period are included in the computation of [NUBIG] or [NUBIL] without regard to when or whether such items are actually recognized within the Recognition Period."[27]

C. Notice 2003-65

In Notice 2003-65, the IRS provided two safe-harbor approaches for determining the treatment of built-in gains and losses under Section 382(h): the "**1374 Approach**" and the "**338**

[22] H.R. Rep. No. 100-495, at 973 (1987) (emphasis added).

[23] P.L. 100-647, 100 Stat. 3342 (1988).

[24] H.R. Rep. No. 100-795, at 46 (1988); S. Rep. No. 100-445, at 48-49 (1988).

[25] Courts have typically interpreted the words "attributable to", consistent with their ordinary meaning, as connoting a causal connection. *See Braunstein v. Commissioner*, 374 U.S. 65, 70 (1963) (construing the words "gain attributable to… property" as limiting "consideration to that gain caused or generated by the property in question."). *See also Schaeffler v. U.S.*, 889 F.3d 298 (5th Cir. 2018).

[26] P.L. No. 101-239, 103 Stat. 2106 (1989), § 7811(c)(5)(A)(i).

[27] H.R. Rep. No. 101-247, at 1406 (1989).

Approach". The key difference between the two approaches concerns the scope of items of income and deduction that are treated as "built-in" for purposes of Section 382(h)(6). The 1374 Approach reflects a narrow interpretation of built-in items, under which such items are generally treated as built-in only if they accrued for *tax* purposes before the change date. By contrast, under the far more expansive 338 Approach, items of income and deduction are generally considered built-in if they *economically* accrued before the change date. In practice, loss corporations with NUBIG tend to apply the 338 Approach because it maximizes RBIG, and loss corporations with NUBIL tend to apply the 1374 Approach because it minimizes RBIL.

1. *The NUBIG/NUBIL safe harbor*

NUBIG and NUBIL are determined in the same manner under both the 1374 Approach and the 338 Approach. First, the loss corporation determines the amount that it would have realized had it sold all of its assets immediately before the ownership change at fair market value to a third party that assumed all of its liabilities (the "**hypothetical amount realized**"). Then, this hypothetical amount realized is—

- decreased by the loss corporation's aggregate asset basis,
- decreased by any deductible liabilities included in the hypothetical amount realized,
- increased or decreased by the loss corporation's Section 481 adjustments that would be taken into account as a result of the sale, and
- increased by any RBIL resulting from the hypothetical sale that would be disallowed as a deduction on the sale under Section 382, 383, or 384.

If the resulting amount is greater than zero, the loss corporation has a NUBIG; if the amount is less than zero, the loss corporation has a NUBIL.

2. *Identification of RBIG and RBIL under the 1374 Approach*

In general, the 1374 Approach relies on the rules of Section 1374(d) (relating to tax on net recognized built-in gain of S corporations previously treated as C corporations) to identify RBIG and RBIL.

Under the 1374 Approach, gain or loss from the sale or exchange of an asset during the recognition period is treated as RBIG or RBIL if the loss corporation establishes that the recognized gain or loss did not exceed the built-in gain or loss in the asset on the change date. In cases other than sales or exchanges, the 1374 Approach generally looks to the accrual method of accounting to identify whether items of income and deduction constitute RBIG and RBIL. Accordingly, items of income or deduction included or allowed during the recognition period generally are considered "attributable to periods before the change date" under Section 382(h)(6)(A) and (B), and therefore treated as RBIG and RBIL, only if an accrual-method

taxpayer would have recognized income or taken a deduction for the item before the change date.[28]

Under this tax accrual rule, income derived from the consumption of a built-in gain asset during the recognition period does not give rise to RBIG under the 1374 Approach because the income did not accrue under tax principles before the change date. To illustrate, suppose a loss corporation undergoes an ownership change, and at the time of the change, the loss corporation owns a patent with a fair market value of $100, a basis of $0, and a remaining life of 10 years. In the first year after the ownership change, the patent produces of $10 of income, and at the end of the year, it is worth $90. Under the 1374 Approach, the $10 of income derived from the patent is not RBIG, even though, as an economic matter, the loss corporation has effectively disposed of part of the patent.

However, the 1374 Approach deviates from the tax accrual rule with respect to cost recovery deductions from the wasting of built-in loss assets. Specifically, in accordance with Section 382(h)(2)(B), the 1374 Approach treats cost recovery deductions during the recognition period deductions as RBIL, even though not accrued for tax purposes before the change date, unless the taxpayer establishes that the deduction is not attributable to the asset's built-in loss on the change date.

Under the 1374 Approach, deductions for contingent liabilities, though included in NUBIG or NUBIL, do not give rise to RBIL because the liabilities did not accrue under tax principles before the change date. In addition, COD income (whether from recourse or non-recourse liabilities) that is included in income under Section 61(a)(12) is treated as RBIG only if recognized within 12 months of the ownership change.[29]

3. *Identification of RBIG and RBIL under the 338 Approach*

Under the 338 Approach, items of RBIG and RBIL are, in significant part, determined by comparing the loss corporation's actual items of income, gain, loss, and deduction with those that would have resulted if all of the loss corporation's stock had been acquired on the change date, and a Section 338 election had been made for the loss corporation as of the change date (the "**hypothetical purchase**"). For purposes of identifying those items that would have resulted from the hypothetical purchase, the loss corporation is treated as using those accounting methods that the loss corporation actually uses.

The 338 Approach identifies RBIG or RBIL from a sale or exchange of an asset by comparing the loss corporation's actual item of gain or loss from that sale or exchange during the recognition period in a recognition period taxable year with the gain or loss that would have resulted had a Section 338 election been made for the hypothetical purchase. For loss

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[28] However, for purposes of determining whether an item is RBIL, Section 461(h)(2)(C) and Reg. §1.461-4(g) (concerning certain liabilities for which payment is economic performance) do not apply.

[29] Any reduction to the tax basis of an asset under Section 108(b)(5) and 1017(a) that occurs as a result of the realization of COD income within 12 months of the ownership change is treated as occurring immediately before the ownership change for purposes of determining whether later gain or loss recognized with respect to the asset is RBIG or RBIL; however, the reduction of tax basis does not impact the loss corporation's NUBIG or NUBIL.

corporations with a NUBIG, the 338 Approach treats certain built-in gain assets of the loss corporation as generating RBIG, even if they are not disposed of during the recognition period. Specifically, the 338 Approach assumes that, for any taxable year, an asset that had a built-in gain on the change date recognizes built-in income equal to the difference between any allowable cost recovery deduction with the cost recovery deduction that would have been allowed for the asset if an election under Section 338 had been made with respect to the hypothetical purchase. The excess of such hypothetical basis recovery over actual basis recovery is RBIG, regardless of the loss corporation's gross income in any particular recognition period taxable year. Thus, even if the built-in gain in built-in gain assets is not actually recognized, the foregone amortization may still result in an increased Section 382 limitation. If unused, such increased Section 382 limitation may be carried forward to later post-change years.

The 338 Approach treats a deduction for the payment of a liability that is contingent on the change date as RBIL to the extent of the estimated liability on the change date. In addition, COD income (whether from recourse or non-recourse liabilities) that is included in income under Section 61(a)(12) is treated as RBIG to the extent attributable to any pre-change liabilities of the loss corporation, in an amount not exceeding the excess, if any, of the adjusted issue price of the discharged liability over the fair market value of the liability on the change date.[30]

D. General overview of the Proposed Regulations

In general, the Proposed Regulations would adopt as mandatory the 1374 Approach, with certain modifications to both the NUBIG/NUBIL safe harbor computation and the identification of built-in items as RBIG/RBIL (*i.e.*, the Modified 1374 Approach). The 338 Approach would be eliminated. The proposed regulatory framework includes significant changes with respect to the treatment of COD income and contingent liabilities. In addition, the elimination of the 338 Approach impacts, in particular, the treatment of wasting assets. A detailed discussion of the proposed modifications is contained in the following sections.

Treasury cites the neutrality principle, discussed above, as the animating principle behind its proposed changes.[31] We agree that the neutrality principle is the appropriate guide for regulations under Section 382(h), properly grounded in Congressional intent. Accordingly, our comments and recommendations likewise aim to evaluate the Proposed Regulations against the backdrop of neutrality.

IV. RECOMMENDATIONS REGARDING THE ADOPTION OF THE MODIFIED 1374 APPROACH AND THE ELIMINATION OF THE 338 APPROACH

As previously noted, the Proposed Regulations would adopt as mandatory the Modified 1374 Approach and eliminate the 338 Approach. Below, we consider the merits and

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[30] Any reduction to the tax basis of an asset under Section 108(b)(5) and 1017(a) that occurs during the recognition period, to the extent of the excess, if any, of the adjusted issue price of the liabilities over the fair market value of the liabilities on the change date, is treated as occurring immediately before the ownership change for purposes of determining whether later gain or loss recognized with respect to the asset is RBIG or RBIL; however, the reduction of tax basis does not impact the loss corporation's NUBIG or NUBIL.

[31] *See* Preamble to the Proposed Regulations (the "**Preamble**"), REG-125710-18, at 18-21, 23, 33-36, 43.

disadvantages of both approaches. Generally, while we acknowledge credible policy reasons for adopting a single approach, we believe certain modifications should be made to improve the Modified 1374 Approach of the Proposed Regulations to implement the policy underlying the neutrality rule.

The Modified 1374 Approach, insofar as it follows a tax accrual model, is highly administrable, as noted in the Preamble. However, strict adherence to an accrual-method model does not always yield results consistent with the neutrality principle. As discussed in greater detail throughout the remainder of this Report, the Modified 1374 Approach's exclusion of certain items from RBIG treatment fails to accurately take into account certain items that are economically built-in at the time of an ownership change.[32]

Treasury argues that the 338 Approach is less grounded in the statutory text of Section 382(h) compared to the 1374 Approach.[33] However, we believe that income derived during the recognition period could be deemed "attributable to" the pre-change period if an event that occurs during the pre-change period caused or generated the income. Section 382(h)(6)(A) defines "RBIG" as any item of income which is properly taken into account during the recognition period, but which is "attributable to" periods before the change date. The phrase "attributable to" suggests a causal connection between the item of income and the pre-change period (*i.e.*, that income caused or brought about by some event in the pre-change period should nonetheless be eligible for RBIG treatment if recognized during the recognition period). In addition, as discussed above, the 1988 Act's change to Section 382(h)(6) suggests that Congress intended to broaden the scope of Section 382(h) from a tax accrual method in the direction of an economic accrual method.

Additionally, from a policy perspective, the 338 Approach is more accurate as compared to the Modified 1374 Approach. The Preamble states that the 338 Approach is made more complex in the context of (i) deemed tiered Section 338 elections, including with respect to controlled foreign corporations, arising when the 338 Approach is applied to a loss corporation that is the parent of other corporations; and (ii) changes under the Tax Cuts and Jobs Acts of 2017 (the "**TCJA**").[34] However, we do not believe that deemed tiered elections or interactions with the TCJA are unduly complex nor that they merit such a profound departure from the system that has developed, and to which taxpayers and Treasury alike have become accustomed, over the past 16 years.[35]

We acknowledge sound policy reasons for adopting a single approach to determining NUBIG and NUBIL and built-in items under Section 382(h)—specifically, Treasury has a valid interest in reducing electivity. Furthermore, the choice of a single approach will inevitably require difficult trade-offs between administrability and accuracy. However, the Modified 1374

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[32] For a detailed explanation of this shortcoming as it relates to the treatment of income from the consumption of wasting assets, see Part VI.A.1.

[33] Preamble, at 13.

[34] Preamble, at 14-16.

[35] For a discussion of proposed solutions which would mitigate the complexities cited in the Preamble, see Part VI.A.2.

Approach as drafted lacks balance in this regard, generally prioritizing accuracy over administrability only when favorable to Treasury (*e.g.*, in its treatment of income from the consumption of wasting assets), and likewise sacrificing accuracy in the name of administrability to the detriment of taxpayers (*e.g.*, in the treatment of contingent liabilities and COD income). As an alternative, we believe that some form of a hybrid approach reflects a reasonable compromise. Accordingly, in the following sections, we suggest certain modifications to the Modified 1374 Approach targeted at improving accuracy and better achieving neutrality.

V. RECOMMENDATIONS FOR THE COMPUTATION OF NUBIG OR NUBIL

A. Treatment of liabilities in the hypothetical sale construct of the Proposed Regulations

1. *Background*

The Proposed Regulations would adopt as mandatory the safe harbor method for computing NUBIG and NUBIL set forth in Notice 2003-65, with significant modifications. The modifications are intended to make the component steps of the computation more explicit, in order to enhance transparency and clarity.[36]

Under the Proposed Regulations, as under Notice 2003-65, the computation of NUBIG and NUBIL would be a two-step process. The first step is to compute the amount that the loss corporation would realize upon a hypothetical sale of its assets (*i.e.*, the hypothetical amount realized). The hypothetical sale construct of the Proposed Regulations, however, would differ from that of Notice 2003-65. Under Notice 2003-65, the hypothetical amount realized is equal to the amount that the loss corporation would realize if, immediately before the ownership change, it sold all its assets at fair market value to a third party that assumed all its liabilities. Under the Proposed Regulations, the hypothetical amount realized would be equal to the amount that the loss corporation would realize if, immediately before the ownership change, it (i) satisfied its inadequately secured non-recourse liabilities by surrendering to the creditor all the assets securing those liabilities,[37] and (ii) sold all its remaining assets at fair market value to an unrelated buyer that assumed none of its liabilities. The change in the hypothetical sale construct is intended to address policy concerns associated with the treatment of built-in COD income of insolvent loss corporations.[38]

The second step in computing NUBIG and NUBIL is to adjust the hypothetical amount realized for certain amounts. Here, again, the Proposed Regulations would differ from Notice 2003-65. As previously discussed, under Notice 2003-65, the hypothetical amount realized is (i) decreased by the loss corporation's aggregate asset basis, (ii) decreased by any deductible liabilities of the loss corporation that would be includible in the loss corporation's hypothetical amount realized, (iii) increased or decreased by the loss corporation's Section 481 adjustments that would be taken into account as a result of the sale, and (iv) increased by any RBIL resulting from the hypothetical sale that would be disallowed as a deduction under Section 382, 383, or

[36] Preamble, at 16-17.

[37] A non-recourse liability is "inadequately secured" for this purpose to the extent the adjusted issue price of the non-recourse liability exceeds the basis of the assets that secure it. Prop. Reg. §1.382-7(c)(3)(i)(A).

[38] *See* Part V.C.

384. The Proposed Regulations clarify that all deductible liabilities (both fixed and contingent) would be subtracted from the hypothetical amount realized in computing NUBIG and NUBIL.[39] Additionally, under the Proposed Regulations, the hypothetical amount realized is increased or decreased by the net amount of the total RBIG and RBIL income and deduction items that could be recognized during the recognition period (excluding COD income), and the adjustment under Notice 2003-65 for RBILs that in a hypothetical sale would be subject to Sections 382, 383 or 384 is removed.[40]

The computation under the Proposed Regulations would be broader than the formula under Notice 2003-65, as the rule that increases or decreases the hypothetical amount realized by the net amount of RBIG and RBIL items that could be recognized during the recognition period means that adjustments are made for any built-in income or deduction items for which an adjustment is not otherwise expressly made or denied. While this approach is more technically accurate, it increases the complexity of the initial evaluation of whether a loss corporation is in a NUBIL or NUBIG position.

2. *Distortion of NUBIG and NUBIL resulting from the treatment of liabilities in the hypothetical sale construct of the Proposed Regulations*

The most significant change to the safe harbor method for computing NUBIG and NUBIL set forth in Notice 2003-65 concerns the hypothetical sale construct used to determine hypothetical amount realized: under Notice 2003-65, the buyer in the hypothetical sale is treated as assuming all the loss corporation's liabilities; under the Proposed Regulations, the buyer would generally be treated as assuming none of them.[41] For the reasons explained below, we believe the approach under Notice 2003-65 should be retained.

In most cases, the different hypothetical sale constructs yield equivalent results.

Example 1 – Base case: Immediately before an ownership change, LossCo has (i) an asset with a fair market value and basis of $100, (ii) a fixed recourse liability of $30, and (iii) a deductible contingent liability of $10. Applying the hypothetical sale construct of Notice 2003-65, LossCo would have a hypothetical amount realized of $100 ($60, the net fair market value of the asset, increased by $40, the sum of the fixed recourse liability of $30 and the contingent liability of $10), and a NUBIL of $10 ($100, the hypothetical amount realized, decreased by $110, the sum of the basis in the asset of $100 and the contingent liability of $10). Likewise, applying the hypothetical sale construct of the Proposed Regulations, LossCo would have a hypothetical amount realized of $100 ($100, the gross fair market value of the asset), and a NUBIL of $10 ($100, the hypothetical amount realized, decreased by $110, the sum of the basis in the asset of $100 and the contingent liability of $10). Thus, while the hypothetical amount realized calculation differs under the two constructs, both accurately reflect the amount of NUBIG or NUBIL.

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[39] Prop. Reg. §1.382-7(c)(3)(i)(C)-(D).

[40] Prop. Reg. §1.382-7(c)(3)(i)(F)-(G).

[41] As mentioned, under the Proposed Regulations, inadequately secured non-recourse liabilities would be reflected in the hypothetical amount realized, which has the same overall effect as treating those liabilities as assumed.

In certain cases involving deductible liabilities, however, the fiction that the buyer in the hypothetical sale assumes none of the loss corporation's liabilities distorts the amount of NUBIG or NUBIL. One such case is where the value of a contingent liability recorded on the loss corporation's applicable financial statement exceeds its true value. Under U.S. GAAP, a contingent liability accrues if it is probable that the liability has been incurred, and the amount of loss can be reasonably estimated.[42] Although the amount of the accrual must reflect management's best estimate of the expenditure required to satisfy the liability (*i.e.*, its fair value), the accrual is not discounted unless the aggregate amount of the loss and the timing of related cash flows is fixed or determinable.[43] And even in such circumstances, discounting is merely permitted, not required.[44] Thus, the true value of a "long-tail" contingent liability—a liability that carries a long settlement period—can be significantly lower than the book value of such a liability. For loss corporations with a significant amount of such liabilities, the hypothetical sale construct of the Proposed Regulations could mismeasure NUBIG or NUBIL, as the following example indicates.

> <u>Example 2 – Overstated contingent liability</u>: Immediately before an ownership change, LossCo has an asset with a fair market value and basis of $100, and a deductible contingent liability. LossCo's management expects to pay $40 to settle that liability, and therefore has recorded a $40 accrual on its applicable financial statement. However, because the liability is expected to be settled over a period of many years, its present value, as of immediately before the ownership change, is only $20. The present value of the contingent liability is reflected in the fair market value of the LossCo stock ($80). Applying the Proposed Regulations, LossCo would have a hypothetical amount realized of $100 ($100, the gross fair market value of LossCo's asset), and a NUBIL of $40 ($100, LossCo's hypothetical amount realized, decreased by $140, the sum of the basis in LossCo's asset of $100 and the book value of LossCo's contingent liability of $40). Thus, LossCo's NUBIL is overstated.

This anomaly is jointly caused by two aspects of the Proposed Regulations: (i) the requirement that the value of a contingent liability be determined based on the loss corporation's most recent applicable financial statement, if the liability is reflected on that statement, and (ii) the fiction that the buyer in the hypothetical sale assumes none of the loss corporation's liabilities. Accordingly, this anomaly could be fixed by allowing the loss corporation to discount contingent liabilities or by treating the buyer in the hypothetical sale as assuming all the loss corporation's liabilities, as under Notice 2003-65. Under the latter approach, deductible

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[42] *See* Financial Accounting Standards Board, Accounting Standards Codification ¶ 450-20-25-2 (2019).

[43] *See* Financial Accounting Standards Board, Accounting Standards Codification ¶ 450-20-30-1 (2019). Moreover, even where discounting is permitted, U.S. GAAP may require the use of a different discount rate than the one a hypothetical buyer may use. For example, the discount rate used to determine the present value of an asset retirement obligation is the "interest rate that equates to a risk-free interest rate adjusted for the effect of its credit standing (a credit-adjusted risk-free rate)." Financial Accounting Standards Board, Accounting Standards Codification ¶ 410-20-55-15 (2019).

[44] *See* Financial Accounting Standards Board, Accounting Standards Codification ¶ 450-20-30-1 (2019).

contingent liabilities—whether accurately measured or not—would have no net effect on NUBIG or NUBIL, because the increase to hypothetical amount realized for the assumption of liabilities would be offset by the reduction to hypothetical amount realized for deductible liabilities. Applying this approach to Example 2, LossCo would have a hypothetical amount realized of $120 ($80, the actual amount LossCo would realize if it sold all its net assets to a buyer, increased by $40, the book value of LossCo's contingent liability of $40), and a NUBIL of $20 ($120, LossCo's hypothetical amount realized, decreased by $140, the sum of the basis in LossCo's asset of $100 and the book value of LossCo's contingent liability of $40). Thus, LossCo's NUBIL would be accurately measured.

Another case in which the hypothetical sale construct of the Proposed Regulations could mismeasure NUBIG or NUBIL is where the loss corporation has deductible liabilities in excess of the assets available to settle them.

> Example 3 – Excess deductible liabilities (simple case):[45] Immediately before an ownership change, LossCo has (i) an asset with a fair market value and basis of $100, and (ii) a deductible contingent liability of $150. Applying the Proposed Regulations, LossCo would have a hypothetical amount realized of $100 (the gross fair market value of LossCo's asset), and a NUBIL of $150 ($100, the hypothetical amount realized, decreased by $250, the sum of the basis in the asset of $100 and the contingent liability of $150).
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> The true amount of LossCo's NUBIL, however, is less. Immediately before the ownership change, the value of LossCo's asset that is available to settle the contingent liability is just $100 (the fair market value of LossCo's asset). Thus, at that time, the maximum deduction that could result from LossCo's settlement of its contingent liability is $100. To be sure, LossCo's assets could appreciate following the ownership change, potentially allowing LossCo to satisfy the entire amount of the contingent liability that is built-in at the time of the ownership change. But in such a case LossCo necessarily would have earned additional income, and so any incremental deduction made possible by post-change appreciation in LossCo's assets would be offset by an equal amount of incremental income.

The general lesson of Example 3 is that the amount of a deduction for a contingent liability that is built-in on the change date should not be greater than the fair market value of the loss corporation's assets available at that time to satisfy the contingent liability. Theoretically, limiting the amount of the contingent liability to this amount could fix this anomalous result that flows from the application of the Proposed Regulations in Example 3. However, where the loss corporation has both non-deductible fixed and deductible contingent liabilities, it would be necessary to allocate between the two categories of liabilities, in order to determine the amount of assets available to satisfy the contingent liabilities.

> Example 4 – Excess contingent liabilities and fixed liabilities: Immediately before an ownership change, LossCo has (i) an asset with a fair market value and basis of $100, (ii)

[45] Although Example 3 involves a deductible contingent liability, the same issue would arise in the case of a deductible fixed liability.

a deductible contingent liability of $60, and (iii) a fixed recourse liability of $60. Applying the Proposed Regulations, LossCo would have a hypothetical amount realized of $100 ($100, the gross fair market value of LossCo's asset), and a NUBIL of $60 ($100, the hypothetical amount realized, decreased by $160, the sum of the basis in the asset of $100 and the contingent liability of $60).

Although the amount of the contingent liability that is built-in at the time of the ownership change is $60, the amount of the potential deduction that is economically built-in as of that time is only $40 ($100, the gross fair market value of LossCo's asset, less $60, the amount of the recourse liability). Any deduction in excess of this amount is arguably not "attributable to" the pre-change period under Section 382(h)(6)(B) because it could not come to pass absent the occurrence of a post-change event that increases the value of LossCo's assets.

A far simpler way of avoiding the anomalies that would result in Examples 3 and 4 would be to treat the buyer in the hypothetical sale as assuming all the loss corporation's liabilities (*i.e.,* by retaining the current approach under Notice 2003-65). Applying this fiction to Example 4, LossCo would have a hypothetical amount realized of $120 (the sum of the contingent liability of $60 and the fixed recourse liability of $60), and a NUBIL of $40 ($120, the hypothetical amount realized, decreased by $160, the sum of the basis in the asset of $100 and the deductible contingent liability of $60).[46]

In summary, given the difficulties in identifying and properly valuing contingent liabilities, we believe the approach taken in the Proposed Regulations for measuring NUBIG and NUBIL will be difficult to implement in a manner that is both administrable and neutral as between the government and taxpayers. The approach taken in Notice 2003-65 largely avoids these issues. Under Notice 2003-65, contingent liabilities essentially result in two offsetting entries in calculating NUBIG or NUBIL, an increase in the amount realized in the hypothetical sale and a decrease as a deductible liability. Accordingly, we recommend that final regulations retain the approach provided under Notice 2003-65 treating the buyer in a hypothetical sale of a loss corporation's assets as assuming all of a loss corporation's liabilities for purposes of computing NUBIG and NUBIL.

3. *Distortions of NUBIG and NUBIL resulting from the treatment of certain deferred revenue liabilities in the hypothetical sale construct of the Proposed Regulations*

The Proposed Regulations would not accurately measure NUBIG or NUBIL where a loss corporation has deferred the recognition of income from the receipt of advance payments for goods, services, or other items.[47]

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[46] We note that the inclusion of excess liabilities in determining NUBIG or NUBIL would not implicate the policy concerns associated with built-in COD income (discussed in Part V.C).

[47] *See* Section 455 (providing deferral for prepaid subscriptions for newspapers and magazines), Section 456 (providing deferral for prepaid dues for membership organizations); Notice 2004-34, 2004-22 I.R.B. 991 (providing deferral for prepayments that are deferred for financial reporting purposes); Reg. §1.451-5 (similar).

Example 5 – Deferral of advance payment: In Year 1, LossCo receives a $100 payment for goods to be provided in Year 2.[48] For tax purposes, LossCo elects to defer the inclusion of that payment in its gross income under Rev. Proc. 2004-34.[49] For book purposes, LossCo records a deferred revenue liability of $90. Later in Year 1, LossCo undergoes an ownership change. Immediately before the ownership change, LossCo has an asset with a fair market value and tax basis of $100, and a deferred revenue liability of $90. Applying the Proposed Regulations, LossCo would have a hypothetical amount realized of $100 ($100, the gross fair market value of LossCo's asset), and a NUBIL of $90 ($100, the hypothetical amount realized, decreased by $190, the sum of the basis in the asset of $100 and the deferred revenue liability of $90). When LossCo provides the goods in Year 2, LossCo has a $90 deduction. Because that deduction is RBIL, and therefore subject to limitation under Section 382, it may not be available to offset fully the deferred income.

This result is doubly illogical: first, the deferred revenue liability arguably should not be treated as a liability to the extent that the income to which the liability relates is deferred; and second, even if the deferred revenue liability is properly treated as a liability, it should not reduce LossCo's hypothetical amount realized because it was never reflected, directly or indirectly, in hypothetical amount realized in the first place. Unlike the anomalies in the previous two examples, though, this anomaly cannot be fixed simply by reverting to the hypothetical sale construct of Notice 2003-65; that construct too would distort NUBIG or NUBIL by failing to reflect the deferred income as a built-in gain. Accordingly, we recommend that final regulations clarify that a deferred revenue liability is not treated as a deductible liability for purposes of computing NUBIG and NUBIL to the extent the related income is deferred.

4. *Clarification regarding determination of estimated value of contingent liabilities*

Under the Modified 1374 Approach, the estimated value of any contingent liability of the loss corporation would be reflected in NUBIG and NUBIL. The Proposed Regulations provide that if a contingent liability is reflected on the face of the loss corporation's most recently issued applicable financial statement (within the meaning of Section 451(b)(3)), then the estimated value of the liability is the amount reflected on the most current applicable financial statement as of the change date.[50]

The Proposed Regulations do not provide guidance as to the treatment of contingent liabilities that are *not* reflected on an applicable financial statement. We recommend that final regulations clarify that such liabilities are not included in the computation of a loss corporation's NUBIG and NUBIL (*i.e.*, that such liabilities should be deemed to have an estimated value of zero). The difficulties involved in identifying and properly valuing contingent liabilities are substantial. As mentioned, under U.S. GAAP, a contingent liability accrues only if the liability

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[48] This prepaid income (*i.e.*, income received prior to the change date that is attributable to performance occurring on or after the change) is not RBIG. Reg. §1.382-7(a), Prop. Reg. §1.382-7(d)(2)(vi).

[49] 2004-22 I.R.B. 991 (the rules of which were largely codified by new Section 451(c), as implemented by the TCJA).

[50] Prop. Reg. §1.382-7(c)(3)(iii)(A)

is both probable and estimable.[51] That a loss corporation has not reflected the amount of a contingent liability on the face of its applicable financial statement is *prima facie* evidence that the liability is either unlikely to materialize or cannot be measured accurately.

B. Consistency regarding treatment of income and deductions arising on the change date

Under current law, the change date is the first day of the recognition period for identifying built-in gains and losses subject to Section 382(h). The change date also is the last day of the pre-change period for determining the amount of taxable income or loss for the year in which the ownership change occurs (the "**change year**") that is free of, or subject to, the Section 382 limitation. Because the change date is included both in the recognition period and the pre-change period, items of income and deduction arising on the change date are sometimes both reflected in the loss corporation's NUBIG or NUBIL and allocated to the pre-change period, duplicating the benefit of change date income and the detriment of change date deductions. The Proposed Regulations would eliminate this duplication by excluding change date items allocated to the pre-change period from the calculation of NUBIG and NUBIL. As discussed below, while we support the objective of preventing the duplication of change date items, we believe this objective is better achieved by effectively redefining the recognition period to begin the day after the change date.

1. *Background: treatment of change date items under current law*

NUBIG or NUBIL is generally calculated as of "immediately before" the ownership change.[52] However, under Section 382(h)(6)(C), NUBIG or NUBIL is adjusted for RBIG or RBIL taken into account during the "recognition period". The recognition period is defined as the five-year period "beginning on the change date."[53] Because the change date is included in the recognition period, change date items can constitute RBIG or RBIL that are reflected in NUBIG or NUBIL.

In the case of an ownership change that does not result in a closing of the loss corporation's taxable year, the loss corporation must allocate its taxable income or loss for the change year between the pre-change period and the post-change period. Subject to certain limitations discussed below, taxable income or loss is allocated according to either a daily proration method or, if the loss corporation elects, a closing-of-the-books method.[54] If the loss corporation has taxable income for the change year, the portion of that income allocated to the pre-change period can be offset by pre-change losses without limitation under Section 382(b)(3)(A). If the loss corporation has a loss for the change year, the portion of that loss allocated to the pre-change period is a pre-change loss subject to the Section 382 limitation under Section 382(d)(1).[55] As mentioned, the change date is included in the last day of the pre-change

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[51] *See* Financial Accounting Standards Board, Accounting Standards Codification ¶ 450-20-25-2 (2019).

[52] *See* Section 382(h)(3)(A)(i).

[53] *See* Section 382(h)(7).

[54] Reg. §1.382-6(a) and (b).

[55] Under a ratable allocation, a portion of the taxable income or loss for the year would be allocated to the post-change portion of the year.

period.[56] Therefore, in the case of a loss corporation with taxable income for the change year, change date income allocable to the pre-change period can be freely offset by pre-change losses, and in the case of a loss corporation with an NOL for the change year, change date deductions allocable to the pre-change period are treated as pre-change losses subject to the Section 382 limitation.

Although the change date falls within both the recognition period and the pre-change period, the statute prevents certain change date items that are included in the computation of NUBIG or NUBIL from being allocated to the pre-change period. Specifically, for purposes of allocating taxable income or loss for the change year, Section 382(h)(5)(A) provides that taxable income or loss is computed without regard to items of (i) RBIG that increased the limitation for the year or (ii) RBIL that are treated as pre-change losses.[57] This rule is intended to implement the neutrality principle. Under this rule, in the case of a loss corporation with a NUBIG, a single item of income arising on the change date is RBIG that increases the Section 382 limitation for the year. It therefore cannot be allocated to the pre-change period and freely offset by pre-change losses. Likewise, in the case of a loss corporation with a NUBIL, a single item of change date deduction is RBIL that is treated as a pre-change loss. However, the deduction must be excluded in determining the taxable income or loss for the change year that is allocated to the pre-change period.

Section 382(h)(5)(A), however, does not mandate that change date items be treated consistently in all circumstances. First, in the case of a loss corporation with a NUBIL, a single item of change date income can be offset by pre-change losses without limitation while also reducing the amount of the NUBIL, as the following example indicates.

> <u>Example 6 – NUBIL and change date income</u>: LossCo undergoes a mid-year ownership change. Immediately before that ownership change, LossCo has an unrealized built-in gain in Asset A of $100; an unrealized built-in loss in Asset B of $500; and an NOL carryover of $200. On the change date, LossCo sells Asset A. LossCo has no other item of income, gain, loss, or deduction for the change year other than from the sale of Asset A.
>
> The built-in gain in Asset A is included in the determination of LossCo's NUBIG or NUBIL. Accordingly, LossCo has a NUBIL of $400 (*i.e.*, built-in loss in Asset B of $500 less built-in gain in Asset A of $100).[58] Because LossCo has a NUBIL, the RBIG from the sale of Asset A does not increase LossCo's Section 382 limitation for the year. Therefore, the gain is included in the determination of LossCo's taxable income that is subject to allocation under Reg. §1.382-6. Assuming LossCo elects to use the closing-of-the-books method, the entire gain recognized on the sale of Asset A will be allocated to

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[56] Section 382(b)(3)(A); Section 382(d)(1)(B); Reg. §1.382-6(g)(2).

[57] *See also* Reg. §1.382-6(c)(1)(ii)(A).

[58] This is similar to the result in PLR 201051019 (Sept. 14, 2010) (holding that, for purposes of calculating NUBIG or NUBIL, the value of the loss corporation should take into account COD income arising on the change date, which is included in the recognition period, notwithstanding that the COD income could be offset by pre-change losses without limitation under Section 382(b)(3)).

the pre-change period, and therefore can be offset by LossCo's pre-change NOL carryover without limitation. Thus, the $100 of built-in gain in Asset A both reduced the NUBIL and was able to be offset by the pre-change NOL without limitation.

Second, in the case of a loss corporation with a NUBIG, a single item of deduction or loss arising on the change date can result in a pre-change loss subject to the Section 382 limitation and reduce the amount of the NUBIG.

Example 7 – NUBIG and change date deduction: The facts are the same as in Example 6, except that LossCo has an unrealized built-in loss in Asset A of $100 and an unrealized built-in gain in Asset B of $500.

The built-in loss in Asset A is included in the determination of LossCo's NUBIG or NUBIL. Accordingly, LossCo has a NUBIG of $400 (*i.e.*, built-in gain in Asset B of $500 less built-in loss in Asset A of $100). Because LossCo has a NUBIG, the RBIL from the sale of Asset A is not treated as a pre-change loss. Therefore, the loss is included in the determination of LossCo's change year NOL that is subject to allocation under Reg. §1.382-6. To the extent that the NOL is allocated to the pre-change period, it will be a pre-change loss subject to limitation under Section 382(d)(1).

Notably, no double benefit or double detriment would have arisen in these examples had the sale of Asset A occurred either the day before or the day after the change date. Treating items more or less favorably depending on whether they arise on the change date conflicts with the neutrality principle underlying Section 382(h).

2. *Proposed consistency rules*

To prevent the duplication of the benefit or detriment associated with change date items, the Proposed Regulations would mandate that change date items be treated consistently. Under the general rule of Prop. Reg. §1.382-7(c)(2)(i), if an amount is properly allocable to the pre-change period and is included in the determination of the loss corporation's taxable income or NOL for the change year, that amount would generally be excluded from the loss corporation's NUBIG or NUBIL calculation. In addition, in the case of a loss corporation that joins or leaves a consolidated group on the change date, change date items would be allocated in accordance with the principles of Reg. §1.1502-76(b).[59] Thus, items allocated under the end-of-day rule to the period prior to the loss corporation joining or leaving the group would not be treated as arising during the recognition period and would not be included in the NUBIG or NUBIL computation.[60] By contrast, items allocated under the next-day rule to the period after the loss

[59] Prop. Reg. §1.382-7(c)(2)(ii). Under Reg. §1.1502-76(b)(1)(ii)(A) (the "**end-of-day rule**"), a corporation is treated as joining or ceasing to be a member of a consolidated group at the end of the day on which its status as a member changes. Under Reg. §1.1502-76(b)(1)(ii)(B) (the "**next-day rule**"), if, on the day of a member's change in status, a transaction occurs that is properly allocable to the portion of the member's day after the event resulting in the change in status, the transaction must be treated as occurring at the beginning of the following day.

[60] Prop. Reg. §1.382-7(c)(2)(ii).

corporation joins or leaves the group would be treated as arising during the recognition period and would be taken into account in the NUBIG or NUBIL computation.[61]

Although the Proposed Regulations, together with Section 382(h)(5)(A), would achieve consistency in the treatment of change date items, precisely how that consistency is achieved would differ depending on whether the loss corporation has a NUBIL or NUBIG and on whether the change date item is income or a deduction. To illustrate, first consider how the Proposed Regulations would deny a double benefit for income or gain recognized on the change date in the context of Example 6, in which LossCo has a NUBIL and recognizes gain on the sale of an asset (Asset A) with built-in gain on the change date. Because LossCo has a NUBIL, the gain does not increase the Section 382 limitation for the year. Therefore, the gain can be allocated to the pre-change period under Reg. §1.382-6. To the extent that the gain is so allocated, the Proposed Regulations would require that it be excluded from the LossCo's NUBIG or NUBIL calculation.

Now compare how Section 382(h)(5)(A) denies a double benefit for change date income or gain in the context of a loss corporation that has a NUBIG.

> Example 8 – NUBIG and change date income: The facts are the same as in Example 6, except that the basis in Asset B is equal to its value. Because the built-in gain in Asset A is recognized within the recognition period, it is RBIG, and therefore included in the calculation of NUBIG or NUBIL under Section 382(h)(6)(C). Accordingly, LossCo has a NUBIG of $100 (*i.e.*, the unrealized built-in gain in Asset A of $100). Accordingly, the RBIG increases the Section 382 limitation for the year. As a result, Section 382(h)(5)(A) prevents the gain from being allocated to the pre-change period and offset by pre-change losses; it must be allocated to the post-change period.

Thus, change date items would be governed by two separate regimes. One would apply in the case of a loss corporation with either (i) a NUBIL and change date income or (ii) a NUBIG and a change date deduction and would achieve consistency in the treatment of change date items by excluding those items from the determination of NUBIG or NUBIL. The other would apply in the case of a loss corporation with either (i) a NUBIG and change date income or (ii) a NUBIL and a change date deduction and would achieve consistency in the opposite way, by preventing the allocation of change date items to the pre-change period. As a practical matter, this bifurcated regime runs counter to Treasury's goals of simplicity and administrability. Moreover, it could end up treating similarly situated taxpayers differently.

3. *Alternative approach*

An alternative way to prevent inappropriate duplication of change date items would be to redefine the recognition period to begin on the date after the ownership change. Mechanically, this could be implemented by treating an ownership change as occurring at the end of the day on the change date for purposes of identifying items of built-in gain and loss under Section 382(h).[62] Under this approach, change date items would be treated as arising before the ownership change,

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[61] *Id.*

[62] Such a rule would conform to the rules for determining whether an ownership change has occurred. *See* Reg. §1.382-2(a)(4)(i) (testing increases in stock ownership percentage at the end of the day on the change date).

and so would not be RBIG or RBIL and would not be taken into account in computing NUBIG or NUBIL. Because change date items would be treated as arising in the pre-change period, change date income could be offset by pre-change losses without limitation, while change date deductions that contribute to losses would be treated as pre-change losses.[63] Like the Proposed Regulations, this approach would prevent the inconsistent treatment of change date items; but unlike the Proposed Regulations, it would do so in a uniform way.

This approach is consistent with the approach previously taken by the IRS in private letter rulings addressing the treatment of change date deductions and losses. In PLR 200442011,[64] the taxpayer, a subsidiary member of a consolidated group, filed for bankruptcy to resolve its liability for personal injury claims related to the taxpayer's products. Under the plan of reorganization filed with the Bankruptcy Court, the taxpayer agreed to fund a qualified settlement fund with, among other things, cash and newly issued shares of its common stock. Upon transferring its stock to the fund, the taxpayer underwent an ownership change. The IRS ruled that the deduction attributable to the transfer of cash and stock to the fund would be allocated to the pre-change period. Furthermore, the IRS ruled, that deduction would not be treated as a recognized built-in loss under Section 382(h)(6)(B) and would not be taken into account in determining NUBIG or NUBIL.

The IRS reached similar conclusions on similar facts in PLR 200751007.[65] There, as in the earlier ruling, the taxpayer underwent an ownership change when it transferred shares of its stock to a qualified settlement fund formed to resolve the taxpayer's product liability obligations. However, unlike in the earlier ruling, the taxpayer's taxable year did not close on the change date, implicating the question of how to allocate the taxable income or loss for the change year between the pre-change and post-change periods. The IRS ruled that assuming the taxpayer did not make the closing-of-the-books election under Reg. §1.382-6(b), any NOL for the change year would be allocated between the pre-change period and the post-change period ratably by day, consistent with the general operation of Reg. §1.382-6. Furthermore, the IRS ruled that the deduction was not RBIL and was not reflected in determining NUBIG or NUBIL.

One potential disadvantage of allocating change date items to the pre-change period is that it could create an incentive for persons who acquire stock in the loss corporation in the ownership change to cause the loss corporation to enter into a transaction (*e.g.*, an asset sale) outside the ordinary course of business on the acquisition date, but after the event resulting in the ownership change, in order to accelerate income into the pre-change period. To counter this incentive, Treasury could provide a special rule for extraordinary items, similar to the special rule in the next-day rule of Reg. §1.338-1(d) that allocates extraordinary items to the post-change period. Treasury considered and rejected such an approach when it promulgated Reg. §1.382-6

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[63] We note that the adoption of this recommendation may alleviate some of the practical concerns regarding the treatment of built-in COD income, discussed in greater detail in Part V.C below.

[64] (Oct. 14, 2004).

[65] (Dec. 21, 2007).

in 1994.[66] But a special rule for extraordinary change date items might be considered appropriate in the context of changes to the definition of the recognition period.

4. *Recommendation*

Based on the foregoing, we recommend that final regulations treat an ownership change as occurring at the end of the day on the change date for purposes of Section 382(h).

C. Proposed adjustments to account for built-in COD income

Under current law, the treatment of built-in COD income can result in a double benefit in certain cases. As discussed below, we agree that this potential for double benefit presents a valid policy concern that should be addressed. Below, we recommend an alternative approach that we believe is preferable to the approach taken by the Proposed Regulations.

1. *Background: potential double benefit for built-in COD income under current law*

Under Notice 2003-65, liabilities are included in the calculation of NUBIG and NUBIL, regardless of whether the COD income that arises from the discharge of the liabilities is included or excluded from the loss corporation's gross income.[67] The Preamble rightly notes that the failure under current law to distinguish between the eventual excluded or included nature of COD income actually recognized by the loss corporation during the recognition period can result in the overstatement of RBIG (or understatement of RBIL) in contravention of Section 382(h)(6)(C).[68] Consider the following example, which illustrates the potential for a double benefit in certain cases.

> Example 9: LossCo has a $100x NOL carryforward in Year 1. On July 1 of Year 2, LossCo undergoes an ownership change. At the time of the ownership change, LossCo has a NUBIG of $200x, including $50x from outstanding recourse liabilities. On October 1 of Year 2, LossCo generates COD income in the amount of $50x which is excludable under Section 108(a) and which reduces LossCo's Year 2 NOL carryover of $100x under Section 108(b). LossCo is in the same position as if it had recognized includable COD income offset by its pre-change NOL. Thus, there is no need to increase RBIG (or NUBIG) upon LossCo's recognition of its $50x of COD income.

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[66] See T.D. 8564 (June 6, 1994).

[67] As previously discussed, under Notice 2003-65, the calculation of NUBIG and NUBIL under both the 1374 Approach and the 338 Approach is determined by deeming a hypothetical sale by the loss corporation of all of its assets at fair market value to a third party that assumes all of its liabilities. *See also* PLR 201051019, *supra* n. 57 (ruling that "[l]iabilities immediately before the ownership change should be taken into account at their adjusted issue price *regardless of whether they were subsequently discharged in whole or in part during the recognition period* (which includes the change date) or thereafter" (emphasis added), even where the facts of the ruling indicated that COD income recognized on the change date would have been excluded under Section 108(a)(1)).

[68] Preamble, at 19-20.

2. *The Proposed Regulations*

Under the Proposed Regulations, non-recourse liabilities generally would be reflected in NUBIG and NUBIL to the extent that the non-recourse liabilities are inadequately secured (*i.e.*, the adjusted issue price of a non-recourse liability exceeds the fair market value of the assets that secure it).[69] In contrast, for recourse liabilities, the Proposed Regulations adopt a "wait-and-see" approach, under which recourse liabilities generally would not be reflected in NUBIG and NUBIL unless and until a liability gives rise to COD income that is treated as RBIG/RBIL, at which time the loss corporation could elect to make a retroactive adjustment to the NUBIG or NUBIL calculation.[70] COD income that is built-in as of the ownership change would be treated as RBIG only if (i) it is recognized within 12 months of the ownership change and (ii) it is either (x) includable in gross income or (y) excludable from income and applied to reduce post-change attributes or basis in assets not held on the change date.[71] If excluded COD income reduces basis in assets held immediately before the ownership change, that asset basis reduction would be retroactively taken into account in NUBIG or NUBIL and could become RBIG upon disposition of the asset during the recognition period.

We agree that treatment of built-in COD income under current law raises significant policy concerns that merit a regulatory response. However, we have concerns regarding the approach taken by the Proposed Regulations—primarily, that it would require distinguishing between recourse and non-recourse liabilities.

First, the differential treatment of recourse and non-recourse liabilities will result in inaccuracies. Specifically, the premise underlying the distinction between recourse and non-recourse liabilities is that non-recourse liabilities will be satisfied with the property securing the liabilities, and thus built-in COD income arising from the liabilities will be treated as amount realized under Reg. §1.1001-2(a). However, non-recourse liabilities may be, and often are, satisfied with cash, rather than the property securing the liabilities. In such a case, the debtor would recognize COD income, rather than amount realized. In such a case, built-in COD income on the non-recourse liabilities could be both (i) excluded and applied to reduce pre-change losses and (ii) treated as RBIG, and so increase the Section 382 limitation. Thus, non-recourse liabilities may give rise to a double benefit. This highlights the difficulty in determining, at the time of an ownership change, whether built-in COD income (on recourse and non-recourse liabilities alike) will result in NUBIG or NUBIL.[72] Furthermore, this approach will lead to questions about what types of liabilities should be considered non-recourse. For example, should liabilities of a disregarded limited liability company formed for the sole purpose of holding a single asset be considered "non-recourse", even though, under the terms of the debt agreement, the creditor has recourse to the company's assets generally?

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69 Prop. Reg. §1.382-7(c)(3)(i)(A)(i).

70 Prop. Reg. §1.382-7(c)(3)(ii)(A) and (B).

71 Prop. Reg. §1.382-7(c)(3)(ii)(B) and (d)(2)(iii).

72 As a practical matter, the requirement to distinguish between recourse and non-recourse liabilities would also increase the compliance enforcement burden on the IRS.

In addition, a "wait-and-see" approach is overbroad insofar as it can exclude liabilities from the calculation of NUBIG and NUBIL even when the policy concerns identified by Treasury—a double benefit—are not present. Consider the case of a non-bankruptcy debt workout, where COD income that is built-in as of the change date is recognized more than 12 months after the ownership change.

> <u>Example 10 – non-bankruptcy debt workout</u>: Assume the same facts as Example 9, except that LossCo recognizes excludable COD income on August 1 of Year 3 (13 months after the ownership change), which is applied to reduce post-change attributes. In this case, LossCo is not receiving the double benefit present in Example 9 and truly has an item of income that was economically built-in as of the change date. However, contrary to prior law, under the Proposed Regulations, the COD income does not give rise to RBIG and thus is not included in the calculation of NUBIG and NUBIL.

Similarly, the Proposed Regulations would exclude so-called "black hole" COD income—excludable COD income in excess of attributes which are available for reduction under Section 108(b).

> <u>Example 11 – "black hole" COD income</u>: Assume the same facts as Example 9, except that LossCo recognizes "black hole" COD income on October 1 of Year 2. To the extent that LossCo's attributes are not reduced, the COD income does not give rise to a double benefit. Nonetheless, the Proposed Regulations would not treat the "black hole" COD income as giving rise to RBIG.

However, the exclusion of liabilities that, when eventually discharged give rise to black hole COD income is arguably appropriate because COD income which is neither includible nor gives rise to attribute reduction has not been "properly taken into account", because such income escapes tax altogether. In other words, this type of income is not deferred but is permanently excluded.[73] Accordingly, we agree with the result achieved by the Proposed Regulations with respect to "black hole" COD income.

Finally, retroactive adjustments to NUBIG or NUBIL could lead to unintended consequences and increased complexity. As the text of Prop. Reg. §1.382-7(c)(3)(ii)(B) indicates, such adjustments may cause a loss corporation that would otherwise have a NUBIL to have a NUBIG. In many cases, retroactive adjustments may not be necessary. Typically, COD income is triggered on the date the loss corporation emerges from bankruptcy (which is commonly the change date). Further, in such a case, the loss corporation will usually know (i) whether it will realize COD income, (ii) how much COD income it will realize, and (iii) what attributes will be reduced. Nonetheless, in certain cases, the retroactive redetermination of a loss corporation's NUBIG or NUBIL may be necessary and require the loss corporation to amend its tax return (*e.g.*, to reflect that depreciation deductions that were treated as RBIL are not, which,

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[73] *See* Los Angeles County Bar Association Tax Section Corporate Tax Committee, *Recommendations for Regulations to be Promulgated under Section 382(h)(6)* (May 15, 2003), at 17-18.

in turn, could force the re-computation of the corporation's BEAT limitation and Section 163(j) computations).[74]

3. *Alternative approaches*

Alternative 1

One alternative would be to include both recourse and non-recourse liabilities in the NUBIG and NUBIL computation; however, if any such liabilities are discharged during the recognition period, any built-in COD income that either does not reduce any attributes or is applied to reduce pre-change attributes would be treated as RBIG that absorbs a corresponding portion of the Section 382 limitation. The effect would be to prevent the loss corporation from increasing the Section 382 limitation for RBIG from other sources. Furthermore, to prevent any subsequent double benefit, NUBIG would be reduced by any COD income that is not otherwise treated as RBIG. This adjustment would be solely for the purpose of reducing the loss corporation's NUBIG, and not to create a NUBIL.

This approach has advantages. First, like the Proposed Regulations, it generally would prevent the overstatement of RBIG in cases where the loss corporation has a NUBIG (determined without regard to liabilities that would give rise to COD income). For example, applied to Example 9, the COD income recognized in Year 2 would not be inappropriately treated as RBIG. Second, it would allow liabilities to be reflected in NUBIG or NUBIL in cases such as Example 10 that do not implicate the policy concern identified in the Preamble. Third, the approach would avoid the complexity attending a retroactive redetermination of NUBIG or NUBIL under the Proposed Regulations' "wait-and-see" approach. Finally, unlike the "wait-and-see" approach of the Proposed Regulations, it does not require distinguishing between recourse and non-recourse liabilities. Thus, this approach would be more administrable as compared to the Proposed Regulations.

However, this approach also has certain disadvantages compared to the Proposed Regulations. Most significantly, it would do nothing to prevent the understatement of RBIL in cases where the loss corporation has a NUBIL (determined without regard to liabilities that would give rise to COD income). To illustrate, consider the following example:

> Example 12: LossCo emerges from bankruptcy in Year 1, and undergoes an ownership change as a result. At the time of the ownership change, LossCo has (i) assets with an aggregate fair market value of \$50 and an aggregate basis of \$100 and (ii) a recourse liability with an adjusted issue price of \$150. Thus, LossCo has built-in COD income of \$100. The built-in COD income is recognized when the loss corporation emerges from bankruptcy and is applied against pre-change losses. Under Alternative 1, the recourse liabilities that give rise to the built-in COD income would be reflected in NUBIG and

[74] This complexity could be exacerbated in the context of a consolidated group, in which case the redetermination of NUBIG or NUBIL may necessitate that amounts of NUBIG or NUBIL previously allocated to the departing member under Reg. §§1.1502-95(c) or (e)(2) be redetermined as well. For a detailed discussion of the potential knock-on effects of NUBIG or NUBIL redetermination in the context of consolidated groups, *see* NYSBA Tax Section Report No. 1269, *Report on Prop. Reg. §1.1.1502-91(g)(7): Determining Section 382 Net Unrealized Built-in Gain and Loss of a Consolidated Group* (July 13, 2012).

NUBIL, even though, when the COD income is later taken into account, it is excluded from income and applied against pre-change losses. Therefore, LossCo would have a hypothetical amount realized of $150 (the recourse liability of $150) and a NUBIG of $50 ($150, the hypothetical amount realized, decreased by $100, the basis in the assets). As a result, LossCo can sell the built-in loss assets during the recognition period and use the resulting losses without limitation.

If Treasury were to issue guidance treating an ownership change as occurring at the end of the day on the change date for purposes of computing NUBIG and NUBIL, that would have the side effect of resolving many of the practical concerns noted above, while simultaneously addressing Treasury's policy concern. Specifically, in the context of COD income, if the ownership change is treated as occurring at the end of the day, the COD income arising on the change date would be allocated to the pre-change period. If that COD income is taxable, it would be offset by pre-change NOLs without limitation. However, it would not be included in NUBIG or NUBIL or treated as RBIG. Hence, no double benefit will arise. We believe this solution would address a significant number of fact patterns in which the treatment of COD income is relevant and double counting arises (*i.e.*, in the context of bankruptcy workouts where COD income arising on the change date is treated inconsistently under current law).

Alternative 2

Another alternative would be to (i) include all liabilities in the computation of NUBIG and NUBIL and (ii) retroactively adjust NUBIG or NUBIL (x) to the extent any liability discharged during the recognition period results in COD income that is excluded from income and either does not reduce any attributes or reduces pre-change attributes within a reasonable period (*e.g.*, two to three years) following the change date or (y) to the extent the COD income would have been excludable under Section 108(a) on all dates from and after the change date (as is common with bankruptcy proceedings). This alternative essentially adopts the opposite presumption taken by the Proposed Regulations but would achieve a similar—and likely more accurate—result. The look-back period would serve to increase administrability and reduce the complexities, noted above, associated with a retroactive approach.

By eliminating the disadvantages noted with respect to Alternative 1, this approach would more fully address the potential for double benefit present under current law. In addition, similar to Alternative 1, it does not require distinguishing between recourse and non-recourse liabilities and would allow liabilities to be reflected in NUBIG or NUBIL in cases such as Example 10.

Furthermore, we believe this alternative is preferable to the Proposed Regulations, notwithstanding that it is still a "wait-and-see" approach, because it is likely to be less distortive as a practical matter. We believe that, in general, any presumption with respect to Section 382(h) should be to include, rather than exclude, a built-in item in order to avoid distortive effects and better effect neutrality. As it relates to COD income, in practice, the further in time from an ownership change, the more likely it is that built-in COD income will be used to reduce post-change attributes. Additionally, as noted above, COD income is typically triggered on the date the loss corporation emerges from bankruptcy (commonly the change date), and in such cases, the loss corporation will likely know with relative certainty the amount of COD income

and attribute reduction that will result from the discharge of its liabilities. Thus, a look-back period of two to three years would adequately capture most situations in which a double benefit could arise.[75]

4. *Recommendation*

Based on the foregoing, we recommend that final regulations implement Alternative 2 above.[76]

VI. RECOMMENDATIONS REGARDING THE IDENTIFICATION OF RBIG AND RBIL UNDER THE MODIFIED 1374 APPROACH

We make the following recommendations regarding the identification of RBIG and RBIL under the Modified 1374 Approach. In general, these recommendations are intended to effectuate the neutrality principle by capturing items that have economically accrued as of the change date and are taken into account in the recognition period.

A. Treatment of income from the consumption of wasting assets as RBIG[77]

Under the Modified 1374 Approach, built-in gain recognized on the disposition of an asset can constitute RBIG.[78] Yet built-in income derived from wasting assets cannot.[79] Although the Preamble does not disclose the rationale for this distinction *per se*, it does express two concerns with the manner in which built-in income derived from wasting assets is identified under the 338 Approach. First, according to the Preamble, the 338 Approach is inconsistent with the text of Section 382(h) because cost recovery deductions on certain built-in gain assets may give rise to RBIG, even though no gain or income has actually been recognized. Second, the 338 Approach tends to overstate the amount of income created by wasting assets during the recognition period.

Below, we first address the question whether treating built-in income derived from the consumption of wasting assets as RBIG is compatible with the statute. Although the statute itself does not unambiguously resolve the question, we believe that Treasury should resolve that ambiguity by determining that such income does so qualify. Below, we also offer additional rationales for treating built-in income derived from wasting assets as RBIG. Lastly, we consider methods for measuring the income from the consumption of wasting assets, in light of Treasury's concerns regarding the 338 Approach.

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[75] As a collateral benefit, this approach aligns with our recommendations, *supra*, regarding modifications to the computation of NUBIG and NUBIL and the treatment of contingent liabilities.

[76] We note that both Alternatives 1 and 2 are consistent with our prior recommendation that all of a loss corporation's liabilities should be treated as assumed for purposes of computing NUBIG and NUBIL (discussed in Part V.A.2).

[77] We address the treatment of built-in income from goodwill and similar intangible assets, which have historically been viewed as non-wasting assets separately, in Part VI.B.

[78] Prop. Reg. § 1.382-7(d)(2)(ii).

[79] Prop. Reg. § 1.382-7(d)(2)(i).

1. *Income from the consumption of wasting assets should be eligible for RBIG treatment*

As discussed above, a loss corporation may offset pre-change losses with both (i) built-in gain that is recognized on the disposition of an asset during the recognition period under Section 382(h)(3)(A) and (ii) built-in income that is taken into account during the recognition period, but which is "attributable to" the recognition period under Section 382(h)(6)(A). Thus, the overall structure of the statute demonstrates that Congress did not intend to limit RBIG to gain on the disposition of an asset.

However, the statute does not specify whether income from the consumption of wasting assets can qualify as RBIG. By contrast, with respect to deductions, the flush language of Section 382(h)(2)(B) defines "RBIL" to include any amount allowable as a cost recovery deduction during the recognition period, except to the extent the loss corporation establishes that the deduction is not attributable to the asset's built-in loss on the change date. Congress did not add similar flush language to the definition of "RBIG" under Section 382(h)(2)(A).

Precisely what this asymmetry implies is not clear. It could imply Congress specifically intended to preclude income from the consumption of wasting assets from qualifying as RBIG.

However, the legislative record surrounding the amendments to Section 382(h)(2)(B) and (h)(6) casts doubt on this interpretation and supports an alternative interpretation, namely, that income from the consumption of built-in gain wasting assets can be considered to be RBIG. As originally enacted in the 1986 Act, Section 382(h)(6) authorized regulations treating certain items "which accrue on or before the change date but which are allowable as a deduction after such date" as RBIL. Depreciation deductions were not among such items.[80] In 1987, Congress amended Section 382(h)(2)(B), adding the flush language providing for the treatment of certain cost recovery deductions as RBIL. And one year later, Congress amended Section 382(h)(6), adding paragraphs (A) and (B), treating income and deductions "attributable to" the period prior to the ownership change as RBIG and RBIL, respectively. Notably, the legislative history to the 1988 Act indicates that Congress intended that Section 382(h)(6)(B)—not Section 382(h)(2)(B)—apply to cost recovery deductions described in the flush language to Section 382(h)(2)(B).[81] It is therefore plain that Congress considered deductions from the consumption of wasting built-in loss assets to be "attributable to" the pre-change period within the meaning of Section 382(h)(6)(B). Given that the language of Sections 382(h)(6)(A) parallels that of Section 382(h)(6)(B), it could be reasonably inferred that Congress intended income from the consumption of wasting built-in gain assets during the recognition period to be treated as "attributable to" the pre-change period within the meaning of Section 382(h)(6)(A), and intended

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[80] H.R. Rep. No. 99-841, at 191 (1986). *See also* 1986 Bluebook, at 320-21. In its discussion of the exclusion of depreciation deductions from RBIL, the Bluebook noted its view at the time that Section 382 similarly "does not provide relief for built-in income other than gain on disposition of an asset." *Id*. at 320, n. 36. However, as mentioned, a year later, Congress reversed its earlier position on the treatment of depreciation deductions as RBIL.

[81] *See* H.R. Rep. No. 100-795, at 46-47 (1988); S. Rep. No. 100-445, at 48-49 (1988) (each indicating that Section 382(h)(6)(B) is intended to be effective "with respect to amounts allowable as depreciation, amortization, or depletion only to the extent consistent with the special effective date provided in the Revenue Act of 1987 for such items" (*i.e.*, December 15, 1987)).

that Treasury develop rules for this purpose under the authority it was previously granted to prescribe regulations necessary and appropriate to carry out the purposes of Section 382.

IRS administrative guidance has taken inconsistent positions on the implication of the flush language of Section 382(h)(2). In 1993 FSA Lexis 200,[82] the IRS ruled that built-in income earned by a loss corporation from the license of software, the costs of which had been fully expensed prior to the ownership change, constituted RBIG. After recounting the legislative history behind Section 382(h), the IRS asserted that the "flip side" to treating post-change depreciation that is attributable to pre-change loss as RBIL is that "post-change income attributable to post-change depreciation, which generated the built-in gain, should be treated as recognized built-in gain."[83] In FSA 200217009,[84] however, the IRS distinguished 1993 FSA Lexis 200, characterizing the legislative history as highly ambiguous. Although Notice 2003-65 does not address the point directly, the 338 Approach permits income and deductions from wasting assets to qualify as RBIG and RBIL, respectively.

Although the statute does not resolve whether built-in income derived from the consumption of wasting assets qualifies as RBIG, treating such income as so qualifying would further the underlying purpose of Section 382(h). As the Preamble notes, the purpose of section 382(h) is to "treat built-in gains and losses that are recognized after the ownership change the same as if they had been recognized before the ownership change."[85] In the case of a loss corporation with a NUBIG, the neutrality principle dictates that RBIG increase a loss corporation's Section 382 limitation, because, if the gain had been recognized before the ownership change, it could have been offset by pre-change losses without limitation. In keeping with this principle, Prop. Reg. §1.382-7(d)(2)(ii) provides that built-in gain from the disposition of an asset during the recognition period is RBIG, and therefore increases the Section 382 limitation, if the loss corporation establishes that the gain was built-in on the change date.

By the same token, the neutrality principle also implies that built-in income from the consumption of wasting assets should qualify as RBIG. If the idea is to treat a loss corporation as if it had sold its assets before the ownership change, then it should make no difference whether the loss corporation recognizes the built-in gain in an asset by disposing of it or by consuming it. Indeed, Section 382(h)(2)(B) and Section 382(h)(6)(B), treating cost recovery deductions as RBIL, treat sales and consumption the same in the case of deductions and RBIL.

In analogous contexts, Treasury has acknowledged that gain recognized on the disposition of assets and income derived from the consumption of wasting assets should be treated similarly. For example, the former loss disallowance rules under Reg. §1.1502-20(c)(1)(iii), which aimed to prevent positive investment adjustments attributable to the recognition of built-in gain from creating non-economic losses in consolidated subsidiary stock, treated income from wasting assets the same as gain from sales. In drafting this rule, Treasury disagreed with the notion that the consumption of wasting assets should be treated differently

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82 (July 8, 1993). *See also* 1998 FSA Lexis 508 (July 2, 1998).

83 1993 FSA Lexis 200 (July 8, 1993).

84 (April 9, 2002).

85 Preamble, at 33.

from the actual sale of built-in gain assets, noting that distinguishing the two would result in disparate treatment of taxpayers in similar economic circumstances.[86]

Another analogy is Section 704(c), which generally prevents the shifting of tax consequences among partners in cases where the basis of property contributed to a partnership differs from its fair market value (*i.e.*, a partner contributes built-in gain or loss property). This is accomplished through the allocation of items of income, gain, loss, and deduction among the partners using one of three methods prescribed under Reg. §1.704-3. The rules pertaining to the "traditional method" note that, for property subject to amortization, depletion, depreciation, or other cost recovery, "the allocation of deductions attributable to these items takes into account built-in gain or loss on the property."[87] Accordingly, items attributable to depreciation or amortization are allocated to eliminate built-in gain or loss in the property.

The importance of treating income from wasting assets as RBIG is even more pressing in the wake of the TCJA, which increased the allowance for bonus depreciation under Section 168(k) for qualified property—generally, tangible personal property with a useful life of 15 years or less. With the increased allowance for bonus depreciation, taxpayers making sizable purchases of qualified property may have both ample built-in gains and an NOL. If that NOL is subject to limitation upon a future ownership change, but the income from the consumption of the qualified property cannot be RBIG, the taxpayer's income will not be clearly reflected.

Finally, denying RBIG treatment for built-in income from wasting assets will encourage wasteful planning. If gain from the sale of an asset can qualify as RBIG, but income from the consumption of an asset cannot, taxpayers will inevitably seek to accelerate the recognition of built-in gain either before an ownership change or during the recognition period, perhaps through related-party transactions. This result runs counter to the neutrality principle.

> <u>Example 13 – Acceleration of built-in gain</u>: LossCo has a NUBIG that is attributable to a patent with a remaining useful life of five years. If the income from the consumption of the patent is not RBIG, LossCo can sell the patent to a partnership that is owned by LossCo and its affiliates.[88] LossCo recognizes gain, which is treated as RBIG, thus

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[86] *See* Preamble to former Temp. Reg. §1.1502-20T, T.D. 8294, 55 Fed. Reg 9,426, 9,427 (March 14, 1990), Examples 2 and 3 (disallowing a loss from an investment adjustment caused by consolidated subsidiary's recognition of built-in gain, "whether from dispositions or operations"); Preamble to former Prop. Reg. §1.1502-20, 55 Fed. Reg. 49,075, 49,078 (Nov. 26, 1990) (noting that the "[c]onsumption of wasting assets is not outside the scope of *General Utilities* repeal because dispositions and consumption may produce identical investment adjustments" and "[f]ailing to take wasting assets into account would treat taxpayers in similar economic circumstances differently"); Preamble to former final Reg. §1.1502-20, 56 Fed. Reg. 47,379, 47,383 (Sept. 19, 1991) (noting that "[i]f an asset is amortizable or depreciable, its built-in gain may be recognized through consumption as well as disposition. . . . If E&P depreciation and amortization are not taken into account, the group that consumes assets through production would be in a better position than the group that sells assets.").

[87] Reg. §1.704-3(b)(1).

[88] Alternatively, if LossCo is a member of a consolidated group, LossCo achieve the same result by selling the patent to another group member, which, in turn, contributes the patent to a partnership that is wholly owned by members of the LossCo consolidated group.

increasing LossCo's Section 382 limitation. Further, the partnership takes a stepped-up basis in the patent, which can be amortized over the remaining useful life of the patent.

In some cases, taxpayers will not be able or willing to accelerate the recognition of income prior to an ownership change or during the recognition period, either because of non-tax frictions or because of the potential application of anti-abuse provisions. However, some taxpayers will be able to do so, creating a situation in which similarly situated taxpayers are treated differently.

Based on the foregoing, we believe that, consistent with the neutrality principle, built-in income derived from the consumption of wasting assets should be treated as RBIG.

2. *Income from the consumption of wasting assets should be calculated by amortizing the built-in gain over its useful life*

As mentioned, the Preamble expresses concern that the 338 Approach may be inconsistent with the text of Section 382(h). The root of this concern is apparently that the 338 Approach relies on certain presumptions to determine what amount of post-change income is attributable to particular Section 382 assets with unrealized built-in gain on the change date. Specifically, the 338 Approach assumes that the income generated by a wasting asset for a taxable year is equal to the excess of (i) the hypothetical cost recovery deduction on the asset for the year had a Section 338 election been made for a hypothetical purchase of all the loss corporation's stock, over (ii) the actual cost recovery deduction for the period. In some cases, this presumption is false, resulting in RBIG, even though no income has in fact been generated.

To begin with, the only alternative to a presumptive approach is a tracing approach, which would require the loss corporation to trace items of post-change income to particular Section 382 assets with unrealized built-in gain on the change date. A tracing approach is unworkable except in the relatively rare case of assets that produce an identifiable income stream, and therefore would impose undue administrative burdens on taxpayers and on Treasury alike.

In our view, a presumptive approach is a logical, practical solution to the inherently difficult problem of identifying the precise amount of income generated by wasting assets that is attributable to the pre-change period. Indeed, for purposes of determining items of RBIL, the Proposed Regulations would use a presumptive approach in determining the extent to which a post-change cost recovery deduction with respect to a wasting asset with a built-in loss constitutes RBIL. The Proposed Regulations do not require tracing the cost recovery deduction to an actual decline in the value of the asset. Thus, a presumptive approach should also be a permissible method for determining items of RBIG.

As the Preamble suggests, the second anomaly in the 338 Approach is that, in computing the hypothetical cost recovery deduction, the useful life of each wasting asset starts anew. As the Preamble notes, the "schedules for cost recovery deductions were never intended to match the production of income for each asset; rather they were intended to accelerate cost recovery to

stimulate investment."[89] Consequently, the 338 Approach tends to overstate the amount of income created by wasting assets during the recognition period.

However, we believe that this anomaly could be avoided simply by adopting a different methodological approach. Specifically, we urge Treasury to adopt the following three-step framework for measuring the amount of income generated from the consumption of a built-in gain asset that qualifies as RBIG: (i) determine the economically useful life of the asset, (ii) determine the amount of built-in gain in the asset immediately before the change date, and (iii) amortize the built-in gain over the asset's useful life on a straight-line basis. Below, we explain each step in greater detail.

The first step would be to determine the asset's economically useful life. In general, we recommend determining an asset's useful life based on the applicable cost recovery period under either the general depreciation system (GDS) of Section 168(c) or the alternative depreciation system (ADS) of Section 168(g). The difference between GDS and ADS is that the latter provides for longer recovery periods for certain assets, and so would tend to produce less RBIG than the former. In any case, we recommend that any "amortizable Section 197 intangible" as defined in Section 197(f)(9) be deemed to have an economically useful life of the lesser of 15 years or the number of years remaining under the taxpayer's amortization method, to avert potential disputes concerning the identification and valuation of intangible assets. Further, we urge Treasury to consider permitting a loss corporation that depreciates or amortizes a wasting asset in computing taxable income to determine that asset's useful life by reference to the remaining recovery period under GDS or ADS. Under this approach, 10-year property with a remaining recovery period of eight years would have a useful life of eight years. This approach would mirror the approach for determining the amount of RBIL attributable to wasting assets under the Proposed Regulations.

The second step would be to determine the amount of built-in gain in the asset immediately before the change date. To avoid valuation disputes, we recommend that the built-in gain in particular assets be determined in accordance with the residual method of Section 1060.

The third and final step would be to amortize the built-in gain over the asset's useful life on a straight-line basis. This step reflects two reasonable assumptions: first, that the built-in gain in a wasting asset represents the future income that the asset is expected to generate; and second, that the value of a wasting asset is consumed on a straight-line basis. Indeed, this second assumption could be viewed as methodologically conservative. If the greater part of the value of a wasting asset is consumed during the earlier years of its useful life, the assumption that a wasting asset is consumed on a straight-line basis will effectively defer the inclusion of RBIG items. However, we believe that a straight-line method is a reasonable proxy for identifying RBIG, and moreover, we believe that allowing taxpayers to establish an accelerated recovery schedule would create undue complexity.

Example 14 – proposed framework for identifying RBIG: Immediately before undergoing an ownership change, LossCo has a NUBIG of $65 that is attributable to (i) a tangible

[89] Preamble, at 41.

asset with a fair market value of $100 and a basis of $70, and (ii) a patent with a fair market value of $100 and a basis of $65. The fixed asset has a useful life of 10 years under both GDS and ADS, and a remaining useful life of six years. The patent is an "amortizable Section 197 intangible" as defined in Section 197(f)(9) with a remaining useful life of seven years. In the first year of the recognition period, LossCo has taxable income of $400. In Year 1, $5 of LossCo's income is RBIG attributable to the fixed asset ($30, the built-in gain in the fixed asset on the change date, divided by six, the number of years in the remaining useful life of the fixed asset). Additionally, $5 of LossCo's income is RBIG attributable to the patent ($35, the built-in gain in the patent on the change date, divided by seven, the number of years in the remaining useful life of the patent).

This simple, objective framework for identifying RBIG from wasting assets would address many of the policy concerns associated with the 338 Approach identified by the Preamble. First, unlike the 338 Approach, it would not systematically inflate the amount of income generated by wasting assets during the recognition period. Second, it would avoid the complexity associated with respect to applying the 338 Approach in the case of a loss corporation that owns lower-tier controlled foreign corporations. Third, this framework would largely avoid the complexities that would arise from the interaction of the 338 Approach and provisions of the TCJA, such as Sections 168(k), 163(j), and 172.

B. Treatment of income from goodwill and similar intangible assets as RBIG

The view that income from the consumption of conventional wasting assets should qualify as RBIG is premised on the assumption that such assets do in fact waste. This assumption is uncontroversial in the case of tangible assets and most kinds of intangible assets, which plainly have both separate and distinct identities and determinable useful lives. Not so, however, with goodwill and similar intangibles. Below we discuss whether income from goodwill should qualify as RBIG.

1. *Is goodwill really a wasting asset?*

As an economic matter, whether goodwill is a wasting asset is debatable. The Tax Section discussed this question in 1993, in a report on proposed legislation on the amortization of acquired intangibles that would ultimately evolve into Section 197.[90] There, we stated:

> Goodwill is plainly a wasting asset, although without a determinable useful life. Goodwill associated with an acquired business would generally disappear if the business did not continue to produce satisfactory projects or services for its customers. It has to be maintained by continuing effort and expense.[91]

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[90] *See* NYSBA Tax Section Report No. 700, *Report on Proposed Legislation on Amortization of Intangibles (H.R. 3035)* (September 30, 1991), at 21.

[91] *Id.* at 21.

Our view then was informed not only by practical experience, but also by the fact that amortization of goodwill was then required under U.S. GAAP and was permitted or required under the tax systems of our major international trading partners. The U.S. General Accounting Office, in a 1991 report issued on tax policy issues concerning the treatment of intangible assets, echoed this opinion, stating: "[t]he [then] current tax treatment of goodwill and similar intangible assets fails to recognize the economic benefits that wasting intangible assets contribute over time. These assets are consumed over time even if a precise period cannot be determined."[92]

On the other hand, it could be argued that the wasting of goodwill is illusory. According to this view, the principal element of goodwill—the value of the expectancy of continued patronage—is self-regenerating. That is, goodwill is not consumed; rather it is the essential foundation for a taxpayer to spend additional (deductible) funds in the future, which preserve and enhance its overall value. On this theory, treating income from goodwill as RBIG would produce a windfall to certain loss corporations.

It also bears mention that the Tax Section's and the Government Accounting Office's historical view that goodwill is a wasting asset was grounded in part on the fact that goodwill was then amortizable for book purposes under U.S. GAAP.[93] The book treatment of acquired goodwill has since changed. Now, goodwill is effectively presumed to have an indefinite useful life, and so cannot be amortized under either U.S. GAAP or international financial reporting standards, as promulgated by the International Accounting Standards Board.[94] Instead, goodwill must be regularly tested for impairment.

2. *Treatment of costs incurred to maintain goodwill*

A second factor to consider in respect of the question whether income from goodwill should qualify as RBIG is the treatment of costs incurred to maintain the value of goodwill. It could be argued that even if goodwill loses value over time, the lost value is continually replenished through the payment of costs relating to advertising, research and the like. Theoretically, these costs, insofar as they enhance goodwill, should be capitalized and amortized over the life of the goodwill. Yet they are currently deductible. Accordingly, since built-in income from goodwill is already matched by currently deductible expenses, the argument goes, there is no policy reason to increase the Section 382 limitation for income derived from the consumption of goodwill.[95]

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[92] U.S. GENERAL ACCOUNTING OFFICE, TAX POLICY: ISSUES AND POLICY PROPOSALS REGARDING THE TAX TREATMENT OF INTANGIBLE ASSETS 10 (1991).

[93] *See* Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 142*, at 5-6 (June 2001).

[95] A theoretically appealing way of eliminating this perceived double benefit would be to permit income from goodwill to qualify as RBIG but to make remedial adjustments to the extent of deductible payments made to preserve or enhance goodwill. The practical challenges associated with identifying whether and to what extent deductible payments preserve or enhance goodwill are likely to be insuperable. However, Treasury could

However, it could be argued that the treatment of costs incurred to replenish wasting goodwill is beside the point. It may not be correct as a policy matter to allow a current deduction for these expenses. But, if so, this reflects a more general defect in the tax treatment of costs incurred to maintain the value of intangible assets, which should be addressed systematically, rather than solely in the narrow context of Section 382(h)(6). On this view, the scope of the relevant inquiry should be limited to whether and to what extent income from the consumption of goodwill is "attributable to" the pre-change period. If one accepts that goodwill is a wasting asset, then it follows that, over time, the value of goodwill attributable to built-in gain on the ownership date declines while the value attributable to the post-change activities (*e.g.*, from expenditures for advertising and research and development) increases. Even if the overall value of goodwill remains constant, income has been derived from the consumption of built-in gain in the goodwill.

3. *Symmetry between RBIG and RBIL*

A third consideration is the desirability of symmetry in the treatment of income and deductions attributable to goodwill as RBIG or RBIL.

The statute presupposes that goodwill is a wasting asset for purposes of determining RBIL. Consider the following example:

<u>Example 15</u>: In Year 1, LossCo acquires all the stock of TargetCo in a "qualified stock purchase" within the meaning of Section 338(d)(3) and makes a Section 338 election. Immediately after the acquisition, Target has goodwill with a basis of $150 that is amortizable over 15 years under Section 197. In Year 3, LossCo undergoes an ownership change. At the time of the change, LossCo has a NUBIL, and the goodwill has a fair market value of $50 and a basis of $130 ($150, initial basis, less $20, the sum of the amortization deductions in Year 1 and 2). Section 382(h)(2)(B) states that RBIL includes any amount allowable as a cost recovery deduction during the recognition period, except to the extent the loss corporation establishes that the deduction is not attributable to the asset's built-in loss on the change date. Thus, a portion of LossCo's amortization deductions for the goodwill are treated as RBIL.

In addition, the Proposed Regulations treat deductions for contingent liabilities occurring in the recognition period as RBIL. The requirement that the loss corporation determine its contingent liabilities by reference to its applicable financial statements has the effect of treating as RBIL certain deductions (*e.g.*, contributions to fund "past service liabilities" under a defined benefit plan) which are not liabilities for tax purposes. Such costs could be considered a form of "negative" goodwill. If such items are capable of giving rise to RBIL, then items of income attributable to goodwill with a built-in gain on the change date arguably should be capable of giving rise to RBIG.

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consider reducing RBIG from goodwill by a specified percentage (*e.g.*, 25%) of advertising or similar expense recognized during the recognition period.

4. *Difficulties distinguishing goodwill from related intangibles*

The final factor bearing on the treatment of income from goodwill is the practical and conceptual challenges associated with distinguishing goodwill from its cognates that inarguably *do* waste.

Historically, treating goodwill differently than other similar intangible assets has created considerable problems. The quintessential example is the tax treatment of acquired intangible assets before the enactment of Section 197.[96] Before Section 197, the cost of an acquired intangible was depreciable only if the taxpayer could show that the intangible had a limited and readily ascertainable useful life. Goodwill was considered to lack such a life, and so was not depreciable. By contrast, customer-based intangibles—assets such as customer lists, core deposits, and client base, which, though not labeled goodwill, nonetheless derived their value from the expectancy of continued customer patronage—*were* depreciable, if the taxpayer could show the intangibles had both (i) limited and readily ascertainable useful life and (ii) an ascertainable value separate and distinct from goodwill. Predictably, this disparity encouraged taxpayers acquiring a business to establish useful lives and separate values for purchased intangible assets other than goodwill, leading to frequent, costly disputes between taxpayers and the IRS. To quell these disputes, Congress enacted Section 197, which generally provides for uniform treatment of intangibles acquired as part of the acquisition of a business. Under Section 197, virtually all such intangibles are amortizable over a 15-year period—even goodwill, its lack of a readily ascertainable useful life notwithstanding.

The decision to enact Section 197 and avoid distinctions among intangibles supports refraining from resurrecting these distinctions in other contexts. Even if goodwill is not technically a wasting asset, it is arguably so intimately related to other customer-based intangibles that are bona fide wasting assets that it should be treated as such.

5. *Recommendation*

As discussed in Part VI.A, we believe there is a compelling case under the neutrality principle for allowing income from the consumption of wasting intangibles as RBIG. We acknowledge credible arguments that, unlike tangible and intangible assets with a readily ascertainable useful life, goodwill is not a wasting asset that is consumed in the operation of business. However, the boundary separating goodwill from certain other kinds of wasting intangibles is not clearly marked. And as the pre-Section 197 case law demonstrates,

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[96] In addition, before the issuance of final regulations under Section 367(d) in 2016, outbound transfers of foreign goodwill in nonrecognition transactions were treated more favorably than outbound transfers of related intangibles—specifically, the former arguably were not subject to Section 367(a)(3) or Section 367(d), while the latter were subject to Section 367(d). This led U.S. companies to inflate the value of foreign goodwill transferred in connection with the transfers of business assets to foreign subsidiaries. *See* T.D. 9803 (Dec. 16, 2016) (eliminating the exception under Reg. §1.367(d)-1T(b) for outbound transfers of foreign goodwill and limiting the application of the active foreign trade or business exception under Section 367(a)(3) to certain specified property (not including foreign goodwill).

determining on a case-by-case basis whether a particular customer-based intangible asset is more properly treated as a distinct wasting asset or rather as a component of goodwill is impractical and expensive. We believe that the status of an asset as depreciable or amortizable is the best guide to Congressional intent in determining which assets should be treated as wasting assets for purposes of Section 382(h). Accordingly, we recommend that final regulations permit income from goodwill to qualify as RBIG.

C. Treatment of dividends paid on built-in gain stock as RBIG

The Proposed Regulations would provide that dividends paid on stock during the recognition period do not constitute RBIG, even if the loss corporation has a NUBIG and the loss corporation has built-in gain in the relevant stock immediately before the ownership change.[97] This treatment would extend to gain recognized on the disposition of stock in a foreign corporation that is taxable as a dividend under Section 1248. As the Preamble notes, although gain recognized on the disposition of stock generally would be treated as RBIG, Section 1248 gain generally would give rise to an offsetting DRD under Section 245A.[98] Therefore, the Proposed Regulations would provide that the gain taxable as a dividend under Section 1248 should not give rise to RBIG.[99] As a further point, however, Section 1248 gain would not be RBIG even if the Section 245A DRD were not available. We believe the latter result is inappropriate.

We agree with Treasury's reasoning that, as a matter of policy, DRD-eligible dividends should not give rise to RBIG. Granted, the statute says that RBIG is tested on a gross (rather than a net) basis.[100] If, in a single year during the recognition period, a loss corporation's sole items of income, gain, loss, or deduction are (i) gain from the sale of a built-in gain asset and (ii) loss from the sale of a built-in loss asset, the gain can still be RBIG, even if the loss corporation has no net income for the year. With respect to a DRD, however, there is an essential link between the items of income and deduction (*i.e.*, the items relate to the same asset and are taken into account by virtue of the same event). Accordingly, we believe it is appropriate to offset the income and the deduction for purposes of determining RBIG. Therefore, a dividend should not give rise to RBIG to the extent a loss corporation claims a DRD (whether under Section 245A or 243) for a dividend it receives from its subsidiary.

This should be so even if the loss corporation is required under Section 1059(a) to reduce its basis in its subsidiary stock by the non-taxed portion of the dividend received. Because any such basis reduction would preserve the unrealized built-in gain in the subsidiary stock, the dividend should not constitute RBIG.

However, not all dividends received by a loss corporation are eligible for a DRD. For example, in the case of a loss corporation that receives a dividend from a controlled foreign

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[97] Prop. Reg. §1.382-7(d)(2)(ii).

[98] Preamble, at 23.

[99] *Id.*

[100] Specifically, Section 382(h)(6)(A) refers to "any item of income" as potentially giving rise to RBIG, without any reference to netting of the income against items of deduction.

corporation ("**CFC**"), the dividend may not qualify for a DRD under Section 245A because the dividend holding period is not met, or by reason of the application of Section 245A(e) (relating to hybrid dividends) or Reg. §1.245A-5T (relating to dividends that are either attributable to E&P created in transactions perceived to violate the purposes of the transition tax and GILTI provisions of the Code or that have the effect of reducing another person's GILTI or subpart F inclusion). In addition, a loss corporation may receive dividends from non-consolidated domestic subsidiary that is only partially sheltered by a DRD under Section 243.

We believe that dividends that are not eligible for a DRD should constitute RBIG in certain circumstances, for the same reasons discussed above in connection with wasting assets. The statute does not mandate an actual disposition of stock. Furthermore, as a matter of policy, we see no basis for treating an actual disposition of built-in gain stock more favorably than a dividend that reduces the value of built-in gain stock.

Specifically, we believe that a dividend should qualify as RBIG to the extent the loss corporation establishes that the dividend (i) is not offset by a DRD, (ii) does not exceed the amount of built-in gain in the subsidiary's stock and (iii) is sourced from E&P accrued with respect to the stock prior to the change date. The latter limitation serves to ensure that dividends paid out of E&P attributable to post-change date activity do not qualify as RBIG.

> Example 16: Suppose LossCo undergoes an ownership change in Year 1. At the time of the ownership change, LossCo has two assets: (i) stock of CFC with a fair market value and basis each equal to $100 and no E&P, and (ii) land with a fair market value of $150 and basis of $50 (*i.e.*, LossCo's NUBIG of $100 is solely attributable to the unrealized built-in gain in the land). In Year 2, CFC generates $100 of untaxed earnings and increases in value to $200 as a result. On January 1 of Year 3, LossCo sells the stock of CFC for gain of $100, which is recharacterized as a dividend under Section 1248. In this case, the deemed dividend received by LossCo is attributable solely to post-ownership change activity, rather than gain that was built-in at the time of the ownership change, and thus should not be treated as RBIG.

D. Determining whether and to what extent payments for contingent liabilities constitute RBIL

Under the Modified 1374 Approach, amounts paid or accrued with respect to contingent liabilities during the recognition period would be treated as RBIL to the extent of the estimated value of those liabilities on the change date. As mentioned, the estimated value of a contingent liability is the amount reflected on the most current applicable financial statement as of the change date, if the contingent liability is reflected thereon.

As a practical matter, there will often be substantial difficulties in tracing particular deductions for liabilities that are paid or accrued during the recognition period to the value of those liabilities estimated on a taxpayer's financial statements. To illustrate these difficulties, consider the case of warranty liabilities—a common kind of contingent liability.

> Example 17: LossCo sells washing machines to customers under a three-year warranty contract. At the beginning of Year 1, LossCo undergoes an ownership change. At the

beginning of Year 1, LossCo's applicable financial statement reflects an aggregate warranty liability of $200 (*i.e.*, the estimated amount of future warranty claims).

During Year 1, LossCo enters into new warranty contracts for which it expects to incur additional costs of $130. In addition, LossCo pays $30 of warranty claims from pre-existing warranty liabilities. Thus, at the beginning of Year 2, LossCo's applicable financial statement reflects an aggregate warranty liability of $300. The statement provides the following tabular reconciliation of the changes in the aggregate warranty liability for the year:

	Year 1
Warranty liability at beginning of year	$ 200
Costs accrued for new warranty contracts	130
Warranty claims paid	(30)
Warranty liability at end of year	**$ 300**

During Year 2, LossCo pays warranty claims of $50.

LossCo's accounting system may not differentiate between payments made with respect to warranty contracts executed before the ownership change (which would give rise to RBIL) and payments with respect to warranty contracts executed after the ownership change (which would not). As a result, it may be burdensome (if not impossible) for LossCo to identify what portion of the warranty claims paid in Year 2 relate to warranty contracts executed before January 1, Year 1. Thus, LossCo may be unable to determine whether and to what extent the deductions for the warranty claims paid in Year 2 constitute RBIL.

In light of these difficulties, we recommend that final regulations clarify how to determine the portion of a built-in contingent liability that actually accrues during the recognition period, including whether certain conventions can or must be used in lieu of a tracing approach. For example, where tracing is impractical, Treasury could permit taxpayers to presume that a certain percentage of its contingent liabilities become fixed and determinable and are economically performed within a given year based on historical averages.

VII. RECOMMENDATIONS REGARDING MISCELLANEOUS ITEMS

A. Interaction between Sections 163(j) and 382 – excess business interest expense of a partnership

Under the Proposed Regulations, for purposes of computing NUBIG and NUBIL and RBIL, a loss corporation's adjusted basis in a partnership interest would be adjusted as if the loss corporation disposed of all or substantially all of its partnership interests immediately before the ownership change.[101] This rule was drafted in light of Section 163(j)(4)(B)(iii) and Prop. Reg.

[101] Prop. Reg. §1.382-7(c)(3)(iii)(E).

§1.163-6(h)(3)(i), which provide that if a partner disposes of all or substantially all of its interest in a partnership, the adjusted basis of the partner in the partnership interest is increased immediately before the disposition to reflect the partner's Section 382 excess business interest expense from the partnership, if any. We agree that the interaction between Sections 163(j) and 382 must be considered. However, as drafted, this particular rule may give rise to a double detriment in certain cases, as illustrated by the following example:

> Example 18: Assume, for simplicity, that LossCo owns 100% of a partnership interest. LossCo's basis in the partnership interest is $100, and the value of the partnership interest is also $100. In Year 1, the partnership pays $20 of interest expense which is disallowed under Section 163(j), thereby reducing the value of the partnership interest to $80. In addition, under Section 163(j)(4)(B)(iii), LossCo's adjusted basis in the partnership interest is reduced by $20.
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> In Year 2, LossCo undergoes an ownership change. Under Prop. Reg. §1.382-7(c)(3)(iii)(E), for purposes of calculating NUBIG and NUBIL, LossCo's adjusted basis in the partnership interest is increased to $100. Thus, LossCo has a NUBIL of $20.Additionally, in Year 3, the partnership earns $20 of income, and the value of the partnership interest and LossCo's basis are actually adjusted to $100. Although the interest expense is no longer limited under Section 163(j), it now becomes subject to limitation under Section 382. Finally, assume that, in Year 4, the partnership interest has declined in value to $50, and LossCo sells its partnership interest for a loss of $50. $20 of that loss is treated as RBIL (up to the amount of LossCo's NUBIL). However, the treatment of that loss as RBIL seems to result in the loss being double counted (*i.e.,* to the extent the loss (in the form of the deferred interest expense deduction is already limited under Section 382, it should not again be limited by virtue of being treated as a RBIL).

To avoid this potential for double detriment, we recommend that final regulations provide that, in situations in which the actual disposition by a loss corporation of a partnership interest results in the recognition of loss that is already subject to limitation under Section 382 as a result of the operation of Prop. Reg. §1.382-7(c)(3)(iii)(E), a taxpayer may elect either to unlock the relevant Section 163(j) business interest expense from the Section 382 limitation or exclude the recognized loss from RBIL.

B. Transition relief

The Proposed Regulations would apply to any ownership change occurring after the date the Proposed Regulations are adopted as final regulations. However, in certain instances, while the transaction pursuant to which an ownership change occurs will close after such date, the transaction may be agreed upon prior to that date. For instance, suppose that before the Proposed Regulations are finalized, a buyer signs a binding agreement to purchase a loss corporation that has a NUBIG, and the purchase price reflects the benefit from the use of the loss corporation's NOLs, assuming Notice 2003-65 is applicable and thus that the 338 Approach is available. After signing but before closing, the Proposed Regulations are adopted as final. Similarly, suppose that a loss corporation is undergoing a bankruptcy proceeding. Prior to the date the Proposed Regulations are finalized, some or all of the loss corporation's creditors accept a plan of reorganization, but the bankruptcy court does not confirm the plan until after the Proposed

Regulations are finalized. The creditors' acceptance of the reorganization plan is premised on the assumption that the Section 338 Approach will be available to allow for a certain threshold of NOL utilization.

Taxpayers and their advisors have been relying on Notice 2003-65, including the 338 Approach, to determine the treatment of built-in gains and losses under Section 382(h) for over 16 years. The Proposed Regulations would constitute a significant change. Furthermore, there is significant uncertainty about the extent to which the Proposed Regulations will be reflected in final regulations. Allowing taxpayers to rely on Notice 2003-65 during the interim would provide taxpayers certainty, so that transactions can be negotiated against the background of shared expectations about their tax consequences.

Based on the foregoing, we believe a transition rule is necessary to reduce uncertainty in the interim period. Accordingly, we recommend that Treasury adopt a rule permitting taxpayers to rely on Notice 2003-65 to the extent an ownership change results from a transaction or proceeding (i) for which a binding commitment is entered into or (ii) which is described in a public announcement or SEC filing, prior to the date the Proposed Regulations are adopted as final. With respect to an ownership change that occurs pursuant to a confirmed Chapter 11 bankruptcy plan, the relevant testing date should be the earlier of the date (i) the disclosure statement relating to the plan is approved by the bankruptcy court, unless the economic terms of the plan pertinent to the application of Section 382(h) substantially change thereafter, and (ii) the voting deadline for the plan.