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Report No. 1429
December 4, 2019

The Honorable David J. Kautter
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Re: *Report No. 1429 – Report on Select Issues under Sections 382 and 108 involving Carryforwards of Recognized Built-in Losses and Business Interest*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1429 commenting on the carryforward of disallowed recognized built-in losses under Internal Revenue Code Section 382(h)(4) and on the application of Sections 382 and 108(b) with respect to the carryforward of business interest expense under Section 163(j). This Report also responds to the request of the Department of the Treasury and the Internal Revenue Service in the preamble to the proposed regulations under Section 163(j) in connection with the application of 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,

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Report No. 1429

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON SELECT ISSUES UNDER SECTIONS 382 AND 108 INVOLVING CARRYFORWARDS OF RECOGNIZED BUILT-IN LOSSES AND BUSINESS INTEREST

DECEMBER 4, 2019

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This Report comments on (i) the carryforward rule in Section 382(h)(4)[1] for disallowed recognized built-in loss ("**RBILs**"), particularly in relation to other provisions of the Code, including the attribute reduction rules in Section 108(b), and (ii) Section 382 and rules relating to cancellation of debt ("**COD**") attribute reduction in Section 108(b) with respect to the carryforward of business interest under Section 163(j).[2] This Report also responds to the request of the Department of the Treasury and the Internal Revenue Service (the "**IRS**") in the preamble to the proposed regulations under Section 163(j) (the "**Proposed Regulations**"),[3] as amended by the Tax Cuts and Jobs Act of 2017, P.L. 115-97 (the "**Act**"), in connection with the application of Section 382.[4]

Part I of this Report contains a summary of our recommendations. Part II includes a summary of the relevant statutory framework. Part III discusses the application and scope of the carryforward rule in Section 382(h)(4) for disallowed RBILs, and Part IV discusses the carryforward of business interest under Section 382 and the attribute reduction rule in Section 108(b), including, as applicable, the Proposed Regulations.

I. Summary of Recommendations

The following is a summary of our recommendations:

- Clarify how current year disallowed RBILs are determined: In addition to the portion of the RBIL that exceeds the Section 382 annual limitation, is the amount of the RBIL within the 382 limitation but in excess of current income also disallowed and carried forward under Section 382(h)(4)? We believe that it is.

- Confirm that the carryforward periods (*e.g.*, 20 years for pre-Act net operating losses ("**NOLs**"), indefinite for post-Act NOLs, and 5-years for net capital losses

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[1] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "**Code**"), and all "Reg. §" and "Prop. Reg. §" references are to the Treasury regulations promulgated or proposed to be promulgated thereunder.

[2] This Report was written by Stuart J. Goldring and Daniel Dunn with the substantial assistance of Benjamin Brookstone and George Davis. Helpful comments were received from Kimberly Blanchard, Andy Braiterman, Robert Cassanos, Peter Connors, David Hardy, Andrew Herman, Robert Kantowitz, Jeffrey Maddrey, Richard Nugent, Deborah Paul, Michael Schler, David Sicular, Linda Swartz, Joseph Toce, Shun Tosaka, and Sara Zablotney. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[3] Notice of Proposed Rulemaking, REG-106089-18, 83 F.R. 67490, November 26, 2018.

[4] During the consideration of this Report, the Treasury Department and the IRS released proposed regulations regarding, among other things, the determination of net unrealized built-in gain and loss and the treatment of built-in income and deduction items under Section 382(h)(6). *See* Notice of Proposed Rulemaking, REG-125710-18, 84 F.R. 47455, September 10, 2019. These proposed regulations do not affect the discussion herein, and are the subject of a recent report by the Tax Section. *See* 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), *reprinted at* 2019 TNTF 220-12.

("**NCLs**") apply to ordinary loss and capital loss RBIL carryforwards, as applicable, under Section 382(h)(4).

- Clarify whether RBIL carryforwards under Section 382(h)(4) generally are treated as an equivalent deduction in subsequent years, or instead are treated as NOLs or NCLs for some or all purposes of the Code (beyond the application of the carryforward period). For example:
    - Whether the 80% limitation under post-Act Section 172 applies to RBIL carryforwards.
    - Whether RBIL carryforwards are subject to attribute reduction under Section 108(b).
    - Whether short-term or long-term character of a capital RBIL depends on the timing of when the loss is actually recognized, or whether capital RBIL carryforwards are treated as NCL carryforwards and treated as short-term capital losses in the absorption year.
    - The extent to which other Code sections are affected.

Although Section 382(h)(4) could reasonably be interpreted narrowly (to incorporate only the carryforward period applicable to NOLs and NCLs), we believe that an intermediate or broad interpretation that treats RBIL carryforwards as NOLs or NCLs for some or all purposes of the Code (beyond the application of the carryforward period) is more appropriate.

The following chart summarizes certain implied consequences of adopting a Narrow, Intermediate or Broad Approach (each as defined in Part III.B below):

	Narrow	**Intermediate**	**Broad**
Incorporate Carryforward Periods?	Yes, the carryforward period of Section 172 or 1212, as applicable, is incorporated.	Yes (same as Narrow).	Yes (same as Narrow).
Does 80% Limitation under Post-Act Section 172(a) apply?	No. The deductibility of an RBIL carryforward is implicitly authorized by Section 382(h)(4), and not based on Section 172(a).	Yes, since Section 172(a) needed to allow deduction and the 80% limitation is within the four corners of Section 172(a).	Yes, since ordinary RBIL carryforwards are treated as NOLs for all purposes of the Code.
Attribute Reduction under Section 108(b)?	No, since RBIL carryforwards are not a specified attribute subject to reduction.	No (same as Narrow).	Yes, since RBILs are treated like NOLs/NCLs for all purposes of the Code.

	Narrow	Intermediate	Broad
Treatment of Holding Period in NCL Absorption Year	A capital RBIL carryforward is either short-term or long-term, depending on its holding period when it was actually recognized.	Capital RBIL carryforwards are treated as short-term capital loss regardless of actual holding period, since Section 1212(a) is needed to allow deduction of capital RBIL carryforwards and NCLs are treated as short-term capital loss under Section 1212(a).	Capital RBIL carryforwards are treated as short-term capital loss regardless of actual holding period, since capital RBIL carryforwards are treated like NCLs for all purposes of the Code.
Offset excess inclusion income under Section 860E(a)?	Yes.	Yes (same as Narrow).	No, since NOL carryforwards cannot offset excess inclusion income.

- Determine whether disallowed RBIL resulting from the disposition of a Section 1231 asset that, if taken into account in the year recognized would have offset in part Section 1231 gains, should carry forward entirely as an ordinary loss or, instead, as part ordinary loss and part capital loss.

  Such determination then would interact with the Narrow, Intermediate or Broad Approach adopted with respect to Section 382(h)(4). Under the Narrow Approach, the disallowed RBIL resulting from a Section 1231 asset would carry forward into a subsequent taxable year as an ordinary deduction or regular capital loss, as applicable. Under the Intermediate or Broad Approach, the amount of disallowed RBIL would carry forward as an NOL or NCL as discussed above.

- Provide in final regulations that the closing-of-the-books election applies to Section 163(j) carryforwards that are allocated between pre-change and post-change periods (as in the case of other pre-change losses and credits), and that the ratable allocation approach set forth in Proposed Regulations is not mandatory for Section 163(j) carryforwards.

- Adopt the Proposed Regulations' ordering of the absorption of Section 163(j) carryforwards (after pre-change losses and RBILs but before NOLs).

- Confirm that the interest chargeback rule under Section 382(l)(5)(B) applies to the carryforward of disallowed business interest expense.

- If Treasury and the IRS believe they have regulatory authority, subject Section 163(j) carryforwards to attribute reduction under Section 108(b). If Treasury and the IRS do not believe they have regulatory authority, consider seeking legislation.

- Consider mitigating the distortion caused by the cancellation of business interest expense that gave rise to business interest expense carryforwards, either by treating cancellation of business interest expense (i) as excluded from income and correspondingly reducing the carryforward, or (ii) potentially as business interest income for Section 163(j) purposes.

II. Background – Statutory Framework and Proposed Regulations

A. Section 382: Limitations on Use of Tax Attributes After an Ownership Change

Section 382(h)(4) was enacted in 1986 as part of the enactment of present day Section 382.[5] Section 382 (together with Section 383) generally imposes an annual limitation on the amount of a loss corporation's taxable income that may be offset by pre-change losses following an ownership change of the loss corporation.[6] In general, the annual limitation is equal to the product of (i) the value of the old loss corporation *times* (ii) the long-term tax exempt rate.[7] As such, the annual limitation limits the use of pre-change losses to income resulting from pre-change capital of the loss corporation based on a return comparable to an investment in treasury bonds. The annual limitation is increased for any built-in gains recognized during the five-year recognition period (which begins on the change date) if and to the extent that the loss corporation has a "net unrealized built-in gain" at the time of the ownership change.[8]

A "loss corporation" is generally defined as a corporation that has (i) an NOL or capital loss carryforward or certain credit carryforwards, (ii) a current year NOL, NCL, or certain current year credits, or (iii) a "net unrealized built-in loss" (treating the date of determination as the change date).[9] The Act added to this a corporation entitled to use a business interest carryforward.

"Pre-change losses" to which Section 382 applies generally means (i) any NOL or capital loss carryforward of the old loss corporation to the taxable year ending with the ownership change or in which the change date occurs to the extent allocable to the pre-change period, (ii) any RBIL (in respect of a net unrealized built-in loss), and (iii) certain credit carryforwards to or from the year of change.[10] Here also, the Act added as a pre-change loss any business interest

[5] P.L. 99-514 (1986), Section 621(a).

[6] Section 382(a).

[7] Section 382(b)(1). The "value of the loss corporation" is generally the value of the stock of the loss corporation immediately before the ownership change, subject to certain adjustments. Where the ownership change occurs pursuant to a bankruptcy court order or confirmed bankruptcy plan, Section 382(l)(6) as implemented by Reg. §1.382-9(j) generally utilizes the value of the reorganized loss corporation, but not in excess of pre-change gross asset value.

[8] Section 382(h)(1)(A)(i), (h)(7); Reg. §1.382-2(a)(2); *see also* Reg. §1.383-1(c)(4).

[9] Section 382(l)(1); Reg. §1.382-2(a)(1)(i).

[10] Section 382(d)(1); Reg. §1.382-2(a)(2).

carryforward “under rules similar to the rules” for NOLs.[11] The Proposed Regulations interpret this as meaning that any disallowed business interest actually incurred in the year of the ownership change to the extent allocable to the pre-change period is treated as a pre-change loss.[12] RBIL is any built-in loss recognized during the five-year recognition period if and to the extent that the loss corporation has a “net unrealized built-in loss” at the time of the ownership change, reduced by any built-in losses previously recognized during such period.[13] Such loss, like any other pre-change loss, is subject to the annual limitation.

In the event that any portion of an RBIL is disallowed for any post-change period, for example due to insufficient taxable income or annual limitation available to utilize the RBIL, Section 382(h)(4) provides for the carryforward of the disallowed portion of such loss to subsequent taxable years under rules similar to the rules for the carrying forward of NOLs and NCLs, as applicable. The meaning and application of this provision is the subject of Part III below.

The enhancement of the annual limitation for recognized built-in gains (in the event of a net unrealized built-in gain), and subjecting to limitation RBILs (in the event of a net unrealized built-in loss) furthers the neutrality principle underlying Section 382, namely, that the loss corporation should be in a similar position to that which it would have been in had the net unrealized built-in gain or loss been recognized on or before the date of the ownership change.[14] In general, whether a loss corporation has a “net unrealized built-in gain” or a “net unrealized built-in loss” at the time of an ownership change is determined by taking the aggregate value of the loss corporation’s assets over the aggregate tax basis of its assets, subject to adjustment for built-in income and deduction items.[15] As a *de minimis* threshold, if the amount of the net unrealized built-in gain or loss does not exceed the lesser of $10 million or 15% of the fair market value of the loss corporation’s assets immediately before the ownership change, excluding cash items (including receivables) and certain marketable securities, the amount of the net unrealized built-in gain or loss is deemed to be zero.[16]

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[11] Section 382(d)(3).

[12] *See* Prop. Reg. §1.382-2(a)(7), and §1.382-6(b)(4). The Proposed Regulations also treat any deferred interest under old Section 163(j) as a pre-change loss. *See* Prop. Reg. §1.382-2(a)(7), and §1.163(j)-1(b)(10).

[13] Section 382(h)(1)(B)(i), (h)(7).

[14] *See* H.R. Rep. No. 99-426, at 260–61 (Dec. 7, 1985); S. Rep. No. 99-313, at 235 (May 29, 1986).

[15] Section 382(h)(3)(A)(i), (6)(C).

[16] Section 382(h)(3); H.R. Rep. No. 99-841, at II-190-91 (Sept. 18, 1986).

B. Section 108: Exceptions to Cancellation of Debt Income

In general, the cancellation or discharge of a taxpayer's indebtedness is includable in the taxpayer's gross income. [17] This generally includes the cancellation of interest on the debt, in the case of an accrual basis taxpayer.[18] Section 108 contains certain exclusions from gross income including if the cancellation or discharge occurs in a title 11 case (the "**Bankruptcy Exception**") or when the taxpayer is insolvent to the extent of the insolvency (the "**Insolvency Exception**").[19] Also, COD income is not realized from the cancellation or discharge of a liability that would have given rise to a deduction if paid.[20]

For purposes of the Bankruptcy Exception, a "title 11 case" is a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the court grants the discharge of indebtedness or the discharge occurs pursuant to a plan approved by the court.[21] The Bankruptcy Exception applies regardless of, and takes precedence over, the Insolvency Exception.[22] For purposes of the Insolvency Exception, a taxpayer is insolvent to the extent its liabilities exceed the fair market value of its assets, as determined immediately before the relevant discharge.[23]

Congress exacted a cost for excluding COD income from gross income under the Bankruptcy and Insolvency Exceptions. A taxpayer must reduce certain specified tax attributes in the order and manner set forth in Section 108(b) and Reg. §1.108-7. The tax attributes subject to reduction are (1) NOLs, (2) general business credits, (3) minimum tax credits, (4) capital losses, (5) tax basis, (6) passive activity losses and (7) foreign tax credits.[24] Under regulations, a

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[17] Section 61(a)(11); Reg. §1.61-12(a); s*ee also, e.g.*, *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); Rev. Rul. 77-437, 1977-2 C.B. 28. COD income generally equals the adjusted issue price of the cancelled indebtedness over the sum of the cash, the issue price of any debt instrument and the fair market value of any other property delivered in exchange therefor. *See* Section 108(e)(10)(A); Reg. §1.61-12(c)(2)(ii).

[18] *See* Rev. Rul. 67-200, 1967-1 C.B. 16 (COD rules override tax benefit rules if interest deduction has not expired, in which event Section 111 applies), *clarified by* Rev. Rul. 70-406, 1970-2 C.B. 16; Rev. Rul. 58-546, 1958-2 C.B. 143 (same). *But see* IRS Chief Counsel Advice 200801039, September 24, 2007 (erroneously stating that, in the case of accruing, deductible postpetition interest in a bankruptcy case, the tax benefit rule would require current inclusion in income when such interest is not payable under the confirmed plan).

[19] Section 108(a)(1)(A), (a)(1)(B).

[20] Section 108(e)(2).

[21] Section 108(d)(2).

[22] Section 108(a)(2).

[23] Section 108(d)(3).

[24] Section 108(b). For the application of attribute reduction rules if the debtor is a member of an affiliated group, see Reg. §1.1502-28.

deferred loss under Section 267(f) (controlled groups) or Reg. §1.1502-13 (consolidated groups) is treated as tax basis that the transferor retains in the asset.[25] According to the legislative history, Congress essentially intended to exchange a current income tax liability for deferred income tax liability in an effort to support a "fresh start" for the taxpayer.[26]

C. Section 163(j): Limitations on the Deductibility of Business Interest

Section 163(j), as amended by the Act, places new restrictions on the deductibility of business interest, with exceptions for certain businesses.[27] Under Section 163(j), the deduction for business interest for each taxable year is limited to the sum of (i) business interest income for the taxable year,[28] (ii) 30% of the adjusted taxable income of the taxpayer for the taxable year, and (iii) floor plan financing interest for the taxable year.[29] The amount of any business interest not allowed as a deduction by reason of the limitation is carried forward and treated as business interest paid or accrued in the succeeding taxable year.[30] The preamble to the Proposed Regulations indicates that Section 163(j) reflects an annual accounting approach.[31] Accordingly, the Section 163(j) limitation is calculated anew each year based on a taxpayer's income for the year, and unlike under former Section 163(j), no excess limitation from a prior taxable year may be carried forward.

Under Section 163(j)(8), the computation of "adjusted taxable income" depends on the applicable tax year. For taxable years beginning before January 1, 2022, adjusted taxable income is the taxable income of the taxpayer computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any NOL deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) any deduction allowable for depreciation, amortization, or depletion. For taxable years beginning on and after January 1, 2022, depreciation, amortization and depletion would be taken into account,

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[25] Reg. §1.108-3(a).

[26] *See* S. Rep. No. 96-1035, at 10 (Nov. 20, 1980); H.R. Rep. No. 96-833 at 9 (Mar. 19, 1980).

[27] Section 163(j)(1), (j)(3) (excepting taxpayers if the average annual gross receipts for the 3-taxable-year period ending with the taxable year which precedes the current taxable year does not exceed $25 million), (j)(7) (excluding certain businesses such as electing real property trade or businesses, regulated utilities, and electing farming businesses).

[28] "Business interest income" means the amount of interest (excluding investment income) includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Section 163(j)(6).

[29] Section 163(j)(1).

[30] Section 163(j)(2).

[31] *See* Preamble to Proposed Regulations, Part 5(A).

further limiting the deductibility of business interest expense. A general discussion of and commentary on new Section 163(j) is beyond the scope of this Report.[32]

III. Carryforward of Disallowed RBILs: Section 382(h)(4)

As discussed above, if a loss corporation that undergoes an ownership change has a net unrealized built-in loss, any built-in losses recognized during the five-year recognition period (up to the amount of the net unrealized built-in loss) are subject to the Section 382 annual limitation. The legislative history explains that:

> [Built-in losses] should be subject to special limitations[, *i.e.*, the section 382 annual limitation,] because they are economically equivalent to pre-acquisition NOL carryforwards. If built-in losses were not subject to limitations, taxpayers could reduce or eliminate the impact of the general rules by causing a loss corporation (following an ownership change) to recognize its built-in losses free of the special limitations (and then invest the proceeds in assets similar to the assets sold).[33]

Where the absorption of all or part of an RBIL is disallowed under Section 382, the disallowed portion is carried forward under Section 382(h)(4):

> (h) Special Rules For Built-In Gains And Losses And Section 338 Gains.—For purposes of this section—
>
> . . .
>
> (4) DISALLOWED LOSS ALLOWED AS A CARRYFORWARD.—If a deduction for any portion of a recognized built-in loss is disallowed for any post-change year, such portion—
>
> > (A) shall be carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of net operating losses (or to the extent the amount so disallowed is attributable to capital losses, under rules similar to the rules for the carrying forward of net capital losses), but
> >
> > (B) shall be subject to limitation under this section in the same manner as a pre-change loss.

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[32] For prior reports on Section 163(j) by the Tax Section, *see* New York State Bar Association, Tax Section, Report on Proposed Section 163(j) Regulations (February 26, 2019), *reprinted at* 2019 TNT 39-12; New York State Bar Association, Tax Section, Report on Section 163(j) (March 28, 2018), *reprinted at* 2018 TNT 61-11.

[33] H.R. Rep. No. 99-426, at 260-61 (Dec. 7, 1985); S. Rep. No. 99-313, at 235 (May 29, 1986) (same); General Explanation of the Tax Reform Act of 1986, May 4, 1987 ("**1986 Bluebook**") at 298 (same).

The existing regulations under Section 382 do not address the application of the carryforward rule in Section 382(h)(4)(A). The regulations do provide that the term "pre-change loss" includes "any recognized built-in loss for any recognition period taxable year."[34] In addition, Reg. §1.383-1(d)(2) provides an ordering rule for the absorption of pre-change losses, including RBILs, against taxable income to the extent permitted by the Section 382 annual limitation.

Preliminarily, as to what constitutes a "disallowed" RBIL under Section 382(h)(4), certainly, the portion of the RBIL that is disallowed under Section 382 because it exceeds the Section 382 limit is an RBIL carryforward under Section 382(h)(4). We believe that the portion of the RBIL that is within the Section 382 limit but exceeds the taxable income of the corporation (or, in the case of a capital loss, exceeds the capital gain of the corporation) in the year of recognition is also a disallowed RBIL subject to the carryforward rule of Section 382(h)(4).[35] The existing regulations lead to this result since the RBIL is one component of a pre-change loss. If and to the extent not currently absorbed against taxable income, there is nothing otherwise "allowing" it.[36] Also, Section 382(b)(2) presupposes that any excess pre-change loss (whether comprised of NOLs or otherwise) would be carried forward since it provides for the Section 382 annual limitation for a subsequent year to be increased by the excess amount in a prior year. Regulations should clarify this accordingly.

> <u>Example 1 – RBIL in Excess of Income</u>: Corp A, a domestic loss corporation and a calendar year taxpayer, experienced an ownership change on January 1st, resulting in a Section 382 annual limitation of $125. For the taxable year, Corp A has gross income of $100, RBIL for the year of $140 (inclusive of depreciation and other loss and deduction items), other depreciation of $200, and no other items of deduction. Under Reg. §1.382-2(a)(2)(iii), an RBIL is treated as a pre-

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[34] Reg. §1.382-2(a)(2)(iii). *See also* Section 382(h)(1)(B)(i): "If the old loss corporation has a net unrealized built-in loss, the recognized built-in loss for any recognition period taxable year shall be subject to limitation under this section in the same manner as if such loss were a pre-change loss."

[35] How that excess is computed is a separate question as to which there can be disagreement. The IRS in a Chief Counsel Advice has taken the position that RBILs allowed under the Section 382 limitation initially factor into the regular annual tax computation alongside other losses or deductions to the full extent permitted by the Section 382 limitation, rather than taxable income or loss first being determined without regard to the RBIL. IRS Chief Counsel Advice 201309013, November 21, 2012, discussed further in Parts III.B-C below. That approach, combined with Section 382 limited losses being used before unlimited losses from the same year, see Section 382(l)(2)(B), has the practical effect that, if there is an NOL for the taxable year, the NOL generally results from non-RBIL deductions exceeding the net remaining income (after having offset the available RBILs) and thus is free of any Section 382 limitation. The Advice did not address what would happen if the RBILs themselves exceed the available income, *e.g.*, whether such excess RBIL should be disallowed rather than creating an NOL since, as discussed in the text, a pre-change loss can only be used to offset taxable income.

[36] *See* IRS Chief Counsel Advice 201309013, November 21, 2012 ("Section 382(h)(4) also provides that the disallowed deduction will be carried to the next tax year in the same manner as an NOL carryforward. Such a provision would be unnecessary if something had already made the RBIL a separately determined NOL. . . . [T]he answer is nothing has made the RBIL a separately determined NOL.").

change loss, and thus may be used to offset taxable income to the extent of the Section 382 annual limitation. *See* Section 382(a). Any excess is disallowed and treated as an RBIL carryforward under Section 382(h)(4). Accordingly, at a minimum, the $15 of RBIL in excess of the Section 382 limitation is disallowed and carried forward under Section 382(h)(4). $125 of the RBIL (the amount equal to the available Section 382 limitation) is available to reduce taxable income to zero. Under Section 382(l)(2)(B), where there are some deductions that are limited by Section 382 and others that are not limited by Section 382 that arise in the same year, the Section 382 limited deductions are used first. Accordingly, it appears, and an IRS Chief Counsel Advice concludes,[37] that the $125 of current year RBIL will be used before the $200 of other deductions. Since Corp A only has $100 of income, the $125 of RBIL exceeds current year income by $25. Accordingly, the excess $25 would also be disallowed and carried forward under Section 382(h)(4), and under Section 382(b)(2), the $25 of unused limitation will increase the Section 382 limitation in the following year. The $200 of other (non-Section 382 limited) depreciation deductions will result in a $200 NOL for the taxable year, which is a post-change NOL.

This brings us to the question of carrying forward any disallowed RBIL. Notably, no separate provision provides, as a general matter, that pre-change losses carry forward to the extent unused. Rather, each component of a pre-change loss is subject to its own carryforward rules. For example, pre-2018 NOLs and general business credits are subject to a 20-year carryforward period, post-2017 NOLs have an indefinite carryforward period, capital loss carryforwards have a 5-year carryforward period, and foreign tax credits have a 10-year carryforward period. Section 382(h)(4) provides the carryforward rule for RBILs.

In addition, post-2017 NOLs can only be used to offset up to 80% of taxable income in the year to which such NOLs are carried forward. Section 172 as amended by the Act provides, in relevant part:

> (a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the lesser of —
>
> (1) the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, or
>
> (2) 80 percent of taxable income computed without regard to the deduction allowable under this section.
>
> For purposes of this subtitle, the term “net operating loss deduction” means the deduction allowed by this subsection.

[37] *See* IRS Chief Counsel Advice 201309013, November 21, 2012, *supra* note 35.

(b) NET OPERATING LOSS CARRYBACKS AND CARRYOVERS —

(1) YEAR TO WHICH LOSS MAY BE CARRIED —

(A) GENERAL RULE.—Except as otherwise provided in this paragraph, a net operating loss for any taxable year —

(i) except as otherwise provided in this paragraph, shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss, and

(ii) shall be a net operating loss carryover to each taxable year following the taxable year of the loss.

A. Rules "Similar To" Rules for Carrying Forward NOLs and NCLs

Section 382(h)(4)(A) provides that any disallowed RBILs shall be carried forward "under rules similar to" the rules for NOL carryforwards or, to the extent the amount so disallowed is attributable to capital losses, "under rules similar to" the rules for capital loss carryforwards. So what is meant by "rules similar to"? There is a continuum of possibilities.

Several provisions of the Code govern the treatment of NOLs and NCLs, but the statute is not explicit as to which rules governing NOLs also apply to RBIL carryforwards.[38] First is the carryforward period. NOLs that arose in taxable years ending on or before December 31, 2017 may be carried forward a maximum of 20 taxable years, but NOLs that arise in taxable years beginning on or after January 1, 2018 may be carried forward indefinitely. Therefore, when ordinary loss RBILs are carried forward under Section 382(h)(4), should ordinary loss RBILs recognized but disallowed prior to 2018 be limited to a 20-year carryforward period? And should those recognized after 2017 have an indefinite carryforward period? Further, for post-2017 recognized ordinary loss RBILs, does the 80% limitation in Section 172(a) apply? And, beyond that, should provisions of the Code having less to do with Section 382 but that could

[38] The question whether RBILs may be carried back under rules applicable to NOLs is beyond the scope of this Report. The 1986 Bluebook indicates that RBILs may not be carried back. 1986 Bluebook at 302 ("The amount of any recognized built-in loss that exceeds the section 382 limitation for any post-change year must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations in the same manner as a pre-change loss."); IRS Chief Counsel Advice 201132022, April 28, 2011 ("Under section 382(h)(4), to the extent that a deduction for an RBIL is 'disallowed,' that portion of the RBIL becomes part of a special attribute that may be carried forward only, subject to section 382 limitations on use. The loss is not included in any NOL for the year, and thus cannot be carried back to preceding years."); IRS Chief Counsel Advice 200926027, March 9, 2009 (denying the carryback of RBILs in excess of the Section 382 limitation). *But consider* IRS Chief Counsel Advice 201309013, November 21, 2012, discussed *supra* notes 35-37, and in Part III.B. below (demonstrating that, although an RBIL cannot itself be carried back, it can have the effect, to the extent of the Section 382 limitation, of allowing other losses to be carried back); Debra J. Bennett, Corporate Tax Watch – Code Sec. 382(h)(4): A Need for Clarification, 87 Tax Mag. 7 (2009). Given that NOLs that arise in taxable periods beginning on or after January 1, 2018 may not be carried back, this question may have reduced practical importance in the future.

affect the carryforward of an NOL apply? As such, for Section 382(h)(4) purposes, are they "rules similar to" the carrying forward of NOLs, such as the reduction of NOLs under Section 108(b) or the prohibition against using NOLs to offset excess inclusion income under Section 860E(a)? We will individually discuss these situations below.

Neither the legislative history nor regulatory guidance provides clarity on these issues. The only change to Section 382(h)(4) since its enactment in 1986 was the addition of the portion relating to NCLs, as part of the Technical and Miscellaneous Revenue Act of 1988 ("**TAMRA**").[39] The legislative history to TAMRA briefly explains the reason for the addition:

> Finally, the bill clarifies that a recognized built-in loss that is disallowed retains its character as a capital loss or ordinary loss and is carried forward under the rules applicable to a loss of that character.

B. Narrow, Intermediate and Broad Approaches to Applying "Similar Rules"

Conceptually, does or should the carryforward rule in Section 382(h)(4)(A) apply narrowly or broadly? The lead-in to all of Section 382(h) says "[f]or purposes of this section," which, given its plain reading, would mean for purposes of Section 382 only. But Section 382(h)(4)(A) incorporates into Section 382 for purposes of carrying forward any disallowed RBILs rules "similar to" those for NOL carryforwards and capital loss carryforwards. This presents a natural tension.

As indicated above, Section 382(h)(4)(A) serves a clear purpose in ensuring that disallowed RBILs can be carried forward. There is no other provision that does this. However, under what authority does a taxpayer deduct an RBIL carryforward? Is this simply assumed as part of Section 382(h)(4), that the RBIL can be deducted under the ordinary recognition rule that gave rise to the recognized loss? So viewed, Section 382(h)(4) is self-operative, with no intention or need to incorporate provisions of the Code other than the carryforward periods that are applicable to NOL and NCL carryforwards. We refer to this as the "**Narrow Approach**" – only those provisions applicable to NOLs and NCLs that are necessary to the operation of Section 382 (*i.e.*, Sections 172(b) and 1212(a)) are incorporated into Section 382(h)(4). Proponents of the Narrow Approach emphasize the restrictive lead-in language to Section 382(h) and general principles of statutory construction. Canons of statutory interpretation generally prescribe that words not included in the statute should not be read into the statute.[40] Where a

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[39] Pub. L. 100-647 (1988); S. Rep. No. 445 (1988), at p. 50.

[40] *See*, *e.g.*, *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. . . . When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'") (citations omitted); *Lamie v. United States Tr.*, 540 U.S. 526, 537 (2004) (deciding against the construction of a statute that would read an absent word into the statute).

provision is intended to apply "for all purposes of the Code," particularly when there are indications to the contrary, it should say so expressly.[41]

Alternatively, do rules "similar to" the rules for NOL carryforwards effectively require the incorporation of Section 172(a) and the other aspects of Section 1212(a), and not only the carryforward period rule in Section 172(b) and Section 1212(a), since Sections 172(a) and 1212(a) are the authority for deducting NOL and capital loss carryforwards in subsequent years? Given that the purpose of Section 382 is to limit otherwise allowable deductions, an alternative approach reasons that a plain reading of the statute requires the application of similar rules to Section 172(a) and the other aspects of Section 1212(a), but need not be read as applying other provisions beyond Section 172 and Section 1212 applicable to NOL and capital loss carryforwards. We refer to this as the "**Intermediate Approach**."

Or more broadly, do rules "similar to" the rules for NOL carryforwards and capital loss carryforwards include Code provisions beyond Sections 172 and 1212 that govern the deductibility and other treatment of NOL and capital loss carryforwards? We refer to this as the "**Broad Approach**." Under the Broad Approach, Section 382(h)(4) potentially could be read as treating an RBIL carryforward equivalent to an NOL or capital loss carryforward for all purposes of the Code. Proponents of the Broad Approach argue that the Broad Approach is consistent with the neutrality principle underlying Section 382 and the legislative intent to treat RBILs as "economically equivalent to pre-acquisition NOL carryforwards."[42] Applying Section 382(h)(4) in a manner that creates neutrality between an NOL and an RBIL reduces the inevitable strategizing by loss corporations relating to acceleration or deferral of the recognition of built-in losses based on the timing of an ownership change.[43] In addition, the Broad Approach avoids divining the line between those NOL carryforward rules necessary to effectuate the purpose of Section 382 and those arguably not, at least if interpreted as treating RBIL carryforwards in the same manner as NOL carryforwards for all purposes of the Code.[44] It has also been suggested that the Broad Approach is more administrable since it dispenses with the need for a differing

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[41] There are numerous examples of Congress expressly prescribing rules for the entire Code or for specific parts of the Code. *See, e.g.*, Section 78 (treating taxes deemed to be paid as a dividend "for purposes of this title" other than in two enumerated cases); Section 7701(a) (providing definitions "[w]hen used in this title"); Section 761(a) ("For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization . . . ."); Section 306(c)(1) ("For purposes of this subchapter, the term 'section 306 stock' means stock which meets the requirements of subparagraph (A), (B), or (C) of this paragraph.").

[42] 1986 Bluebook, at 298. The legislative history makes this statement in the context of subjecting an RBIL to the Section 382 annual limitation.

[43] Some strategizing is inevitable given, for example, that the recognition period for RBIGs and RBILs is five years and that Section 382 limits an RBIL regardless of whether a partial or equal offsetting built-in gain (that was taken into account in computing the net unrealized built-in loss) is recognized during the same post-change taxable year.

[44] This argument raises the question why Congress chose to apply "rules similar to" rules applicable to NOLs, rather than simply treat RBIL carryforwards as NOL carryforwards.

carryforward regime for RBIL carryforwards. Instead, RBIL carryforwards effectively can be rolled into the equivalent NOL carryforwards from the same recognition year.[45]

Although each approach is a reasonable interpretation of Section 382(h)(4) under current law, we believe that the Intermediate or Broad Approach is more appropriate than the Narrow Approach.

We are not aware of the IRS having issued any guidance addressing the manner in which Section 382(h)(4) operates to carryforward a disallowed RBIL. However, the IRS in a 2012 Chief Counsel Advice considered the extent to which RBILs can offset a loss corporation's taxable income in the year of recognition (in contrast to a carryforward year). In question was the meaning of the general rule in Section 382(h)(1)(B)(i), which provides that "the recognized built-in loss for any recognition period taxable year shall be subject to limitation under this section in the same manner as if such loss were a pre-change loss." [46] The taxpayer in that instance asserted that this meant that the current year RBIL is taken into account in determining taxable income in the same manner as an NOL, *i.e.*, only after the taxable income (or loss) for the year has otherwise been computed. As explained by the taxpayer, if the loss corporation had positive taxable income for the year as determined without regard to the RBIL, the RBIL (to the extent permitted by the Section 382 limitation) would offset such income and any excess would carry forward to the next year in the same manner as an NOL. The taxpayer also indicated that its position was consistent Section 382(h)(4). Moreover, the taxpayer asserted that, in the event the loss corporation otherwise had a taxable loss for the year, Section 172 would govern the carrying back or forward of the RBIL, since the RBIL is meant to be treated the same as an NOL. Indeed, this was the main thrust of the taxpayer's position, since the taxpayer was attempting to carryback the RBIL. The IRS Chief Counsel's office disagreed that the effect of treating an RBIL "in the same manner as if such loss were a pre-change loss" meant treating it as a separately determined NOL. Rather, the IRS concluded:

> Nothing in section 382 takes an RBIL to the extent of the section 382 limitation (that is, to the extent of an allowed deduction) out of the loss corporation's annual tax computation for the year. Section 382(h)(4) clearly describes the Excess RBIL as a disallowed deduction making the portion of the RBIL within the limitation an allowed deduction. Section 382(h)(4) also provides that the disallowed deduction will be carried to the next tax year in the same manner as an NOL carryforward. Such a provision would be unnecessary if something had already made the RBIL a separately determined NOL. If something had made the RBIL a separately determined NOL, why can it not be carried back. Of course, the answer is nothing has made the RBIL a separately determined NOL. It

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[45] Proponents of the Broad Approach concede that some tracing is required because (i) RBILs are treated as pre-change losses despite having been recognized in a post-change period, and (ii) not all built-in losses will become RBILs subject to limitation under Section 382, since built-in losses recognized outside the Section 382(h)(7) five-year recognition period are not subject to limitation.

[46] IRS Chief Counsel Advice 201309013, November 21, 2012, discussed in earlier sections of this Part III.

remains an item of deduction to which the section 382 limitation applies in the loss corporation's annual tax computation.

Although the Chief Counsel Advice does not equate a disallowed RBIL with an NOL as to the taxable year in which an RBIL is recognized in applying Section 382(h)(2)(B), such result is not necessarily determinative of the application and scope of Section 382(h)(4) nor of a particular interpretation (*i.e.*, the Narrow, Intermediate or Broad Approach).[47]

C. Carryforward Periods under Sections 172(b) and 1212(a)

Under each of the Narrow, Intermediate and Broad Approaches, Section 382(h)(4) incorporates the carryforward periods in Section 172(b) and Section 1212(a) that are in effect during the recognition year. Accordingly, we recommend that regulations be issued so providing.

If "rules similar to" means anything, it means that. If Congress had not intended to incorporate the carryforward periods, it could have written a standalone rule providing that disallowed RBILs would be carried forward without reference to NOLs. The carryforward period is fundamental to the carryforward rule applicable to NOLs, and part and parcel of Section 172(b), the governing carryforward provision for NOLs. Additionally, differing carryforward periods apply to NOLs and NCLs. The legislative history suggests that the purpose for the separate provision in Section 382(h)(4) regarding NCLs was to clarify that NCLs retain their character as capital losses notwithstanding the application of Section 382(h)(4). Although the legislative history does not mention the differing carryforward periods,[48] in our view, the legislative history in this instance simply undertook to explain the precipitating reason for the delineation. Moreover, one aspect of a capital loss retaining its character is that it has a limited five-year carryforward period.

Accordingly, in our view, any regulation confirming the interpretation that Section 382(h)(4) incorporates the carryforward periods in Section 172(b) and Section 1212(a) simply codifies existing law:

> Example 2 – Pre-Act Disallowed RBIL: Corp A, a domestic corporation and calendar year taxpayer, undergoes an ownership change at the end of 2015 at a time when it has no NOLs and no pre-change credits, but a significant net built-in loss. In 2016, Corp A has a $300 (ordinary loss) RBIL, $10 of which is allowed under the applicable Section 382 annual limitation, and $290 of which is

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[47] In a 2011 Chief Counsel Advice, the IRS rejected a taxpayer's argument similar to the assertion of the taxpayer in the Chief Counsel Advice discussed in the text. *See* IRS Chief Counsel Advice 201132022, April 28, 2011. In the 2011 Chief Counsel Advice, the IRS's rejection was based primarily on what "disallowed" meant in Section 382(h)(4) in the absence of sufficient taxable income. The IRS described the disallowed portion under Section 382(h)(4) as "a special attribute that may be carried forward only, subject to Section 382 limitations on use. The loss is not included in any NOL for the year, and thus cannot be carried back to preceding years."

[48] S. Rep. No. 445 (1988), at p. 50.

> disallowed and carried forward under Section 382(h)(4). Under Section 382, Corp A may absorb $10 of the 2016 RBIL in 2016 and each succeeding year. The 20-year limitation rule under Section 172(b) (prior to amendment by the Act) applies to the $290 of disallowed 2016 RBIL just as if it resulted in a $290 NOL. Accordingly, in addition to the $10 of RBIL allowed in 2016, Corp A is able to absorb up to $200 of the remaining disallowed RBIL over time ($10 annual limitation for each of the succeeding 20 taxable years to which the RBIL will be carried forward, assuming no short years). The remaining $90 of disallowed RBIL would be rendered effectively unusable and thus would expire unused at the conclusion of the carryforward period (subject to the discussion of Section 108(b) below).[49]

Note that a Section 382 limitation has a similar potential disallowance effect on 20-year NOL carryforwards, and even more so on 5-year capital loss carryforwards, as that illustrated in Example 2 in the case of a pre-Act disallowed RBIL.

> Example 3 – Post-Act Disallowed RBIL: Same facts as Example 2, except the built-in loss is recognized in 2018, rather than 2016. The $290 of disallowed RBIL is carried forward indefinitely under Section 172(b) (after amendment by the Act).

Some advisors have questioned whether the applicable carryforward period (*i.e.*, the 20-year carryforward period under the pre-Act rule, or the indefinite period under the Act) should be determined by reference to the year of the ownership change, rather than the taxable year in which the RBIL is recognized (as illustrated in Example 3). The argument for the change year is that the NUBIL concept was intended to put a loss corporation in a similar position to that which it would have been in had such built-in losses been recognized prior to the ownership change. However, such a reading seems to us contrary to a plain reading of Section 382(h)(4), which provides for a disallowed RBIL to be carried forward under similar rules to an NOL or NCL. For NOLs and NCLs, the carryforward period is governed by the taxable year in which the NOL or NCL arises.

D. 80% Limitation under Post-Act Section 172(a) and Related Issues

Under Section 172(a), as amended by the Act, NOLs arising in a taxable year beginning on or after January 1, 2018 and that are carried forward to a subsequent taxable year may offset no more than 80% of the taxable income of such subsequent taxable year (without taking a deduction for NOLs into account) (the "**80% Limitation**").[50] Whether the 80% Limitation is

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[49] Although we do not undertake herein to explore the ancillary consolidated return issues presented by the Broad Approach, we note that one such issue concerns whether carryforwards of disallowed RBIL that expire unused should be considered to be a noncapital, nondeductible expense. *See* Reg. §1.1502-32(b)(3)(iii)(A) ("[I]f a loss carryover (e.g., under section 172 or 1212) attributable to S expires or is reduced under section 108(b) and §1.1502-28, it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried.").

[50] We note that the 80% Limitation is similar to the 90% limitation on NOLs under the corporate alternative minimum tax (prior to amendment by the Act), and that no guidance has been issued with

applicable to ordinary loss RBIL carryforwards depends on whether one adheres to the Narrow Approach, on the one hand, or the Intermediate or Broad Approach, on the other hand, in applying rules similar to NOL carryforwards. If applicable, the 80% Limitation would be applied prior to, but effectively in tandem with, the Section 382 annual limitation.[51]

> Example 4 – 80% Limitation Does Not Apply: Same facts as Example 3 (involving a post-Act disallowed RBIL), except assume additionally that in 2019, Corp A has $5 of taxable income without taking into account any RBIL carryforward, and in 2020 Corp A has $20 of taxable income without taking into account any RBIL carryforward (and in each year had no current year RBILs). In 2019, Corp A can deduct up to $10 of the RBIL carryforward under the Section 382 annual limitation without regard to the 80% Limitation (with any unused portion increasing the Section 382 limitation for the next year).[52]

> Example 5 – 80% Limitation Applies: Same facts as Example 3. In 2019, Corp A would only be permitted to offset taxable income by the lesser of: (i) the Section 382 limitation and (ii) 80% of taxable income (rather than 100% of taxable income). Thus, in 2019, Corp A's taxable income would be reduced by $4 of disallowed RBIL (*i.e.*, 80% of $5) to $1, and the unused Section 382 limitation ($6) would carry forward to the next year under Section 382(b)(2). If the Section 382 limitation exceeds "the taxable income of the new loss corporation for such year *which was offset by pre-change losses*",[53] the unused limitation carries forward. Thus, in 2020, Corp A can deduct up to $16 of disallowed RBIL under the Section 382 limitation (*i.e.*, the base annual limitation of $10, plus the $6 prior unused limitation). In this instance, the 80% of taxable income limitation is also $16 (*i.e.*, 80% of the $20 of taxable income in 2020). Accordingly, in 2020, Corp A can use $16 of disallowed and carried forward RBIL to reduce its taxable income to $4.

Proponents of the Narrow Approach argue that applying the 80% Limitation to RBIL carryforwards is not necessary to serve the purpose of Section 382(h)(4) or to effect the policy of Section 382. The 80% Limitation did not exist at the time that Section 382(h)(4) was enacted or amended, and there is no indication that Congress intended the 80% Limitation to be applied to

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respect to the 90% limitation and how it might limit the use of RBIL carryforwards in the alternative minimum tax context.

[51] *See* Reg. §1.383-1(d)(3): "Paragraphs (d)(1) [general limitation] and (2) [ordering rule] of this section shall be applied after the application of all other limitations contained in subtitle A which are applicable to the use of a pre-change loss or pre-change credit in a post-change year. Thus, only otherwise currently allowable pre-change losses and pre-change credits will result in the absorption of the section 382 limitation and the section 383 credit limitation."

[52] How the $10 is taken into account depends on whether the IRS's approach in IRS Chief Counsel Advice 201309013 can be applied to subsequent years, as discussed below.

[53] Section 382(b)(2) (emphasis added).

the carryforward of disallowed RBILs, which were current year losses for which deductibility was deferred due to the Section 382 annual limitation.[54] The policy of Section 382 is served by carrying forward the loss (subject to the carryforward periods) and allowing the deduction in subsequent years subject to the applicable Section 382 limitation. Although a post-2017 NOL carryforward can be subject to both the Section 382 annual limitation and the 80% Limitation, the application of the 80% Limitation to such NOL carryforwards was a separate legislative decision that does not necessitate a broader application.[55]

Since, under the Narrow Approach, Section 172(a) is not the basis for the deduction of an RBIL carryforward in the subsequent year, there is a second level issue as to how the RBIL carryforward should be applied, to the extent of the Section 382 limitation. Is it applied against the subsequent year's taxable income in a manner similar to an NOL, *i.e.*, only to the extent of that year's taxable income as determined without regard to the RBIL carryforward? Or is it filtered into that year's regular computation, in an approach similar to that espoused by the 2012 Chief Counsel Advice discussed earlier, which applied Section 382 to limit the amount of the deduction but still permitted the deductible item as part of the regular computation of taxable income in the year of recognition? In the Chief Counsel Advice, the statutory authority for the deduction was clear since the RBIL was recognized in the year at issue. In the carryforward situation, the authority for the deduction under the Narrow Approach is necessarily implied. The Narrow Approach would be consistent with taking the RBIL carryforward into account (to the extent of the Section 382 annual limitation) in the same manner as if it were recognized in the carryforward year. As apparent from the Chief Counsel Advice, whatever the rule is should be set forth in regulations.

Under the Intermediate Approach and Broad Approach, the only clear statutory authority for allowing an RBIL to be deductible in a subsequent year is the notion that an RBIL carryforward is similar to an NOL carryforward under Section 172(a). As such, even if Section 382(h)(4) only applies for purposes of Section 382, the natural reading of Section 382(h)(4) is that the 80% Limitation in Section 172(a) applies. In addition, applying the 80% limitation treats RBILs as "economically equivalent to" NOLs, the intended impact of subjecting built-in losses to the Section 382 annual limitation, and thus is consistent with the neutrality principle underlying Section 382.[56]

As indicated, each of the three approaches is a reasonable interpretation under current law. Accordingly, we recommend that any regulations with respect to the applicability of the 80% Limitation to RBIL carryforwards be prospective only. However, we would support a

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[54] *See* Conference Report no 115-446 to accompany H.R. 1 at 235; General Explanation of Public Law 115-97, JCS-1-18 at 180-181 (in each case, describing the 80% Limitation without considering its application to Section 382(h)(4)).

[55] *See id*. (describing the proposed 90% limitation under the House Bill, the 80% Limitation included in the Senate Amendment, and the adoption of the Senate Amendment's 80% Limitation).

[56] 1986 Bluebook at 298.

taxpayer election to apply such regulation retroactively to open taxable years,[57] although one could argue that prior taxable years should be left open to potential dispute.

E. Section 108(b) Attribute Reduction of RBIL Carryforwards

If a corporation excludes discharge of indebtedness income under Section 108(a) by reason of the Bankruptcy or Insolvency Exceptions, such corporation's tax attributes as specified in Section 108(b), including its NOL and capital loss carryforwards, are subject to reduction. An RBIL carryforward is not one of the tax attributes specifically denoted in Section 108(b).

As a policy matter, treating an RBIL carryforward as a tax attribute subject to reduction would be consistent with the purpose of Section 108(b) of deferring (but not eliminating, absent any available tax attributes) the tax cost of the excluded COD income.[58] In furtherance of this purpose, Congress has from time to time amended Section 108(b) to include additional tax attributes.[59] We recognize that Treasury has only very limited regulatory authority under Section 108(b) and, thus, may require additional authority in order to treat RBIL carryforwards as subject to reduction. The application of Section 382(h)(4)(A) with respect to carrying forward any disallowed RBILs under rules "similar to" those for NOL and capital loss carryforwards potentially can be interpreted under current law or through regulation as subjecting RBIL carryforwards to reduction under Section 108(b) together with NOL and capital loss carryforwards. The Broad Approach would read Section 382(h)(4)(A) in this manner, but the Narrow and Intermediate Approaches would not.

Note that, unlike application of the carryforward periods and 80% Limitation, which are generally taxpayer unfavorable, treating RBIL carryforwards as a tax attribute subject to reduction under Section 108(b) could be taxpayer favorable or taxpayer unfavorable depending on which tax attributes, if any, would be reduced otherwise.[60]

Against the Broad Approach, one could note that the language of Section 382(h)(4)(A) focuses on "carrying forward" a disallowed RBIL and that Section 108(b*)* effectuates a reduction

[57] *See* Section 7805(b), under which, in general, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates: (i) the date on which such regulation is filed with the federal register, (ii) in the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the federal register, and (iii) the date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

[58] H.R. Rep. No. 96-833, at 9 (Mar. 19, 1980) ("[T]he rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.").

[59] *See, e.g.*, Pub. L. 103-66 Sections 13226(b)(1) and (2) (adding minimum tax credit and passive activity losses and credits to the list of attributes subject to reduction).

[60] For example, a taxpayer that would otherwise have "black hole" COD under Reg. §1.108-7(a)(2) would prefer to retain the RBIL carryforward, whereas a taxpayer that would otherwise be reducing a more usable tax attribute may prefer to reduce the RBIL carryforward.

in a carryforward, unlike the 80% Limitation which moderates the use of the carryforward and is linked to the deductibility of an NOL under Section 172(a).

Under the Broad Approach, the phrase "shall be carried forward . . . under rules similar to the rules for [NOL and capital loss carryforwards]" would be read as treating an RBIL carryforward as if it were an NOL or capital loss carryforward for all purposes of the Code, including Section 108(b). As recognized in the legislative history, in subjecting RBILs to the Section 382 annual limitation in the first instance, built-in losses are "economically equivalent to pre-acquisition NOL carryforwards."[61] Section 382(h)(4)(A) thus effectuates such equivalency with respect to the carryforward of any disallowed RBIL by effectively treating the RBIL as an NOL carryforward under any and all "rules" applicable to NOL carryforwards.

Either by legislation or, if applicable, regulation, we recommend that RBIL carryforwards be included as a tax attribute subject to reduction under Section 108(b). As indicated, one could argue that Section 382(h)(4)(A) already operates in such manner under current law and that any regulation would clarify such application. Here also, we recommend that any such regulation be prospective only, without any intended inference as to prior law, and would support a taxpayer election to apply such regulation retroactively to open taxable years.

F. Other Rules Related to Section 382(h)(4)

A Broad Approach to Section 382(h)(4), and sometimes even a Narrow Approach or Intermediate Approach, can have a ripple effect throughout the Code, as our discussion below of four further implications of Section 382(h)(4) demonstrates.

First, treating an RBIL carryforward similar to an NOL or capital loss carryforward for any purpose raises issues of coordination – namely, which tax attribute is absorbed, limited or reduced first or are they absorbed, limited or reduced on a pro-rata basis based on the year recognized or incurred. Accordingly, regulations should provide a coordination rule. Even if not treated as equivalent to an NOL, coordination rules should be adopted to clarify the ordering of deductions as between RBILs and other deductible items for a taxable year.

Second, where an RBIL relates to a Section 1231 asset, the character of the RBIL actually absorbed in the recognition year as an ordinary or capital loss is properly governed by the normal Section 1231 calculations for the recognition year.[62] However, what is the character of a disallowed RBIL carryforward that relates to a Section 1231 asset? Under one approach, the entire Section 1231 loss would carry forward as an ordinary loss (the "**All Ordinary Approach**"). Alternatively, under an arguably more technically appropriate "split" approach, the portion of the disallowed Section 1231 RBIL that would have offset Section 1231 gains for the current year carries forward as a capital loss, and any excess (*i.e.*, the portion that would have

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[61] 1986 Bluebook at 298.

[62] *See also* Section 1231(a)(4)(A)(ii) (for purposes of determining whether gains exceed losses under Section 1231, "the section 1231 losses shall be included [in the calculation] only if and to the extent taken into account in computing taxable income," without regard to the limitation on use of capital losses provided in Section 1211).

been treated as an ordinary loss absent the Section 382 limitation) carries forward as an ordinary loss (the "**Split Approach**").

The All Ordinary Approach and the Split Approach are illustrated in the following example:

> Example 6: Corp A, a domestic corporation and calendar year taxpayer, undergoes an ownership change at the end of 2018 at a time when it has no NOLs and no pre-change credits, but a significant net built-in loss. In 2019, Corp A has no Section 1231 losses other than a $300 RBIL for the current year that relates to a Section 1231 asset, $10 of which is allowed under the applicable Section 382 annual limitation, and $290 of which is disallowed and will be carried forward under Section 382(h)(4). Corp A's Section 1231 gains for the year are $210 such that its Section 1231 gains exceed its Section 1231 losses by $200 (taking the $10 of deductible RBIL into account but not the remaining RBIL).
>
> Under the All Ordinary Approach, all $290 of RBIL carryforward would be treated as ordinary and have an indefinite carryforward period. Under the Split Approach, the first $200 of RBIL carryforward (*i.e.*, the amount by which the Section 1231 gains exceed the absorbed Section 1231 losses) would be treated as capital loss, rather than an ordinary loss, and have a 5-year carryforward period. The remaining $90 of RBIL carryforward would be treated as ordinary and have an indefinite carryforward period.

The All Ordinary Approach stems both from the premise that Section 1231 gains and losses should net and that the resulting net income or loss should be taxed in a taxpayer favorable manner, and the practicality that Section 1231 losses either protect Section 1231 gains from being taxed at ordinary rates or (as to any amounts in excess of Section 1231 gains) are themselves treated as ordinary losses. Accordingly, consistent with the purpose of Section 1231, the All Ordinary Approach would characterize the entire Section 1231 RBIL as an ordinary loss and apply an indefinite carryforward period under Section 382(h)(4),[63] rather than treat a portion (depending on the amount of current year Section 1231 gains, if any) as a capital loss subject to a 5-year carryforward period.[64]

In contrast, the Split Approach would treat a Section 1231 RBIL as a capital loss subject to a 5-year carryforward period to the extent that the Section 1231 RBIL would have been treated as a capital loss in the year of recognition as an offset to the Section 1231 gain recognized in that year.[65] This approach is based on the fact that Section 1231 characterizes gains and losses as capital or ordinary based on the year in which the gains and losses are "recognized." If a loss is a capital loss under Section 1231 in the year it is recognized (because it does not exceed the

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[63] Section 172(b). If the All Ordinary Approach were applied to pre-Act years, the carryforward period would be 20 years.

[64] Section 1212(a).

[65] Section 1231(a).

Section 1231 gain recognized in that year), it would be carried forward as a capital loss, as no special rule provides that if Section 382 or a similar rule applies to the loss, it can be carried forward as an ordinary loss.

The Split Approach is more likely to result in the carried forward RBIL never being used. There may or may not be sufficient available capital gain in the next five years to absorb the RBIL carried forward as a capital loss, but that is true of any capital loss that gets caught in a Section 382 limitation.

The Split Approach also may be viewed as more consistent with the purpose of Section 1231, however, in that it prevents equal Section 1231 gains and losses recognized in the same year from resulting in a capital gain in the year of recognition and an ordinary loss in a later carryforward year.

The appropriate treatment of the resulting RBIL carryforward in a subsequent year would follow naturally depending on whether the Narrow Approach, on the one hand, or the Intermediate or Broad Approach, on the other hand, is adopted. Under the Narrow Approach, (i) if the All Ordinary Approach is adopted, the carryforward loss would be treated as an ordinary deduction in the subsequent year, and (ii) if the Split Approach is adopted, the carryforward loss would be treated as a capital loss in the subsequent year to the extent such loss would have offset Section 1231 gains had it been deductible in the year recognized and the remainder, if any, would be treated as an ordinary deduction in the subsequent year. By contrast, the Intermediate Approach would treat the relevant ordinary and capital portions of the carryforwards as NOL or NCL carryforwards, respectively, for the limited purposes (*i.e.*, within the four corners) of Sections 172 and 1212, whereas the Broad Approach would do so for all purposes of the Code.

Third, it is unclear whether a capital RBIL retains its character as a long-term or short-term capital loss in subsequent years when carried forward or, since carried forward under rules similar to those for carrying forward NCLs, is treated as an NCL in such later period and, thus, as a short-term loss regardless.[66] Although corporations face the same rates with respect to short-term and long-term capital gains, the mechanical rules in Schedule D of Form 1120 for netting short-term gains and losses and long-term gains and losses separately before netting any remaining short-term and long-term items could result in the expiration of losses that would otherwise have been utilized.[67]

The Narrow Approach would tend to favor the retention of the original character, while the Intermediate and Broad Approaches would tend to favor short-term loss treatment since that follows from treating a capital RBIL carryforward similar to, or as if it were, a carryforward of an NCL, which is treated as short-term capital loss under the flush language of Section 1212(a). Accordingly, we recommend that regulations provide for short-term loss treatment consistent with the Intermediate and Broad Approaches.

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[66] *See* Section 1212(a)(1) (flush language).

[67] The separate netting contained in Schedule D does not appear to be required by the statute or regulations in most cases. *See* Sections 1211 and 1222, and the Treasury regulations thereunder.

Fourth, it is unclear whether an RBIL carryforward, to the extent otherwise deductible under the Section 382 annual limitation in a subsequent year, would be available to offset excess inclusion income under Section 860E(a). NOL carryforwards are unavailable to offset such income.[68] The answer should be consistent with the answer under Section 108(b). If Section 382(h)(4)(A) can be read as subjecting an RBIL carryforward to Section 108(b) then the carryforward similarly should be subject to the rules applicable to excess inclusion income, and if not, then not.

IV. Select Issues Regarding Business Interest Carryforwards Under Sections 382 and 108

As discussed above, the Act significantly modified the limitation on interest deductions under Section 163(j). Under new Section 163(j), a taxpayer's deduction for business interest expense in a taxable year generally may not exceed the sum of the business interest income of such taxpayer for such taxable year, plus 30% of modified EBITDA (EBIT for tax years beginning on or after January 1, 2022).[69] Any business interest in excess of the limitation is disallowed and carried forward to succeeding taxable years.[70] Upon an ownership change, a corporation's business interest carryforward becomes subject to limitation under Section 382.[71] Both the statutory language making Section 382 applicable to business interest carryforwards and the practical integration of business interest carryforwards present certain issues discussed below.

In addition, we also discuss the interplay between business interest carryforwards and the COD rules.

A. Treatment of Disallowed Business Interest Incurred in the Year of an Ownership Change

Section 382(d)(3) provides that a pre-change loss includes any carryforward of disallowed business interest "under rules similar to the rules of paragraph (1)." Paragraph (1) of Section 382(d) applies to NOLs and provides:

[68] *See* Section 860E(a).

[69] Section 163(j)(1).

[70] Section 163(j)(2).

[71] Section 382(d)(3) ("The term 'pre-change loss' shall include any carryover of disallowed interest described in section 163(j)(2) under rules similar to the rules of paragraph (1).").

The term "pre-change loss" means—

(A) any net operating loss carryforward of the old loss corporation to the taxable year ending with the ownership change or in which the change date occurs, and

(B) the net operating loss of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before the change date.

Except as provided in subsection (h)(5) and in regulations [under Regulations Section 1.382-6], the net operating loss shall, for purposes of subparagraph (B), be allocated ratably to each day in the year.

The application of Section 382 to carryforwards of business interest to the year of the ownership change (and, as discussed below, the carryforward of the portion of any business interest incurred during the year that is allocable to the pre-change period) requires differentiating such carryforwards from later incurred business interest, as the Section 382 annual limitation applies only to the pre-change amounts.[72] This is the case even though Section 163(j) treats any carryforward of business interest simply as business interest paid or accrued in the succeeding year and generally avoids tracing.[73]

The reference in Section 382(d)(3) to "carryforwards" of disallowed business interest in relation to Section 382(d)(1) creates uncertainty in respect of disallowed business interest incurred in the year of an ownership change. Said another way, what does it mean to apply "rules similar to" the rules that apply to NOLs to such disallowed business interest?

It is our understanding that, in the absence of regulations, some advisors have taken the position that no portion of the carryforward of business interest incurred in the year of an ownership change is subject to the Section 382 annual limitation since Section 382(d)(3) only speaks of "carryforwards" and Section 382(d)(1)(A), the only part of Section 382(d)(1) that speaks directly of carryforwards, only subjects to limitation carryforwards from prior years.

However, we believe that Section 382(d)(3) is reasonably understood to encompass the portion of a disallowed business interest carryforward for the year of the ownership change allocated to the pre-change portion of the year. Section 382(d)(3) prescribes rules similar to the rules of Section 382(d)(1). Section 382(d)(1)(B) treats the portion of a net operating loss allocable to the period on or prior to an ownership change as a pre-change loss, supporting the analogous treatment for business interest carryforwards. This is consistent with the approach for all other tax attributes to which Section 382 applies, in conjunction with Section 383. Acting on similar language in Section 383(d), which provides that "[f]or purposes of this section, rules

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[72] *See also* Preamble to Proposed Regulations, Part 5(A).

[73] *See* Section 163(j)(2); Prop. Reg. §1.163(j)-2(c). The Proposed Regulations require member-by-member determinations in respect of allocation and absorption of disallowed business interest expense similar to the rules for NOL carryforwards. *See* Prop. Reg. §1.163(j)-5(b)(3).

similar to the rules of . . . (d)(1)(B) of section 382 shall apply," Treasury promulgated regulations allocating carryforwards of excess tax credits incurred in the year of an ownership change between the pre-change and post-change portions of the year and limiting the pre-change portion under Sections 382 and 383.[74] Accordingly, we support the Proposed Regulations in subjecting to limitation the portion of a carryforward of business interest incurred in the year of an ownership change that is allocable to the pre-change portion of the year.

How then should such a carryforward be allocated between the pre-change and post-change portions of the year? Reg. §1.382-6 generally governs the allocation of income, gain, loss and deduction for the year of an ownership change between the pre-change and post-change portions of the year and permits either ratable allocation or closing-of-the books at the taxpayer's election.[75] In addition, Reg. §1.382-6(e) provides that the principles of the regulations apply for purposes of allocating excess tax credits and that the loss corporation must use the same method of allocation, *i.e.*, a ratable allocation or the closing-of-the-books method.

Thus, in directing that rules "similar to the rules of" Section 382(d)(1) apply, Section 382(d)(3) effectively requires the application of rules "similar to" those under Reg. §1.382-6. We believe that this reasonably leaves room for one of two approaches for determining the allocation of business interest. We recommend the Elective Approach (as defined below). The Proposed Regulations adopt the Mandatory Proration Approach (as defined below).[76]

1. Consistent with current Reg. §1.382-6, loss corporations allocate the disallowed interest for the year (determined prior to taking into account any business interest carryforwards from prior years) ratably between the pre-change and post-change portions of the taxable year based on the number of days in each, but under Reg. §1.382-6(b)(2) may make a closing-of-the-books election for all affected tax attributes including disallowed business interest (collectively, the "**Elective Approach**").

   The closing-of-the books method is itself susceptible to alternative means of implementation: The first, which we would recommend, would be to compute the aggregate disallowed business interest for the year without regard to the ownership change, and then allocate the disallowed amount consistent with the overall allocation of business interest for the year (prior to taking into account any business interest carryforwards from prior years) based on a closing-of-the-books. The second would be to compute "adjusted taxable income" under Section 163(j)(8) separately for the

[74] *See* Reg. §1.383-1(c)(3) (defines "pre-change credits" by reference to the carryforward of excess credits "to" and "from" the taxable year of the ownership change, in the latter instance "to the extent such credit is allocable to the [pre-change] period").

[75] Under Reg. §1.382-6, current year pre-change deductions can offset current-year post-change income regardless of whether the "closing-of-the books" election in Reg. §1.382-6(b) applies, even though the pre-change deductions would have been subject to limitation had the taxable year actually closed on the change date.

[76] *See* Prop. Reg. §1.382-6(b)(4) and §1.382-2(a)(7).

pre-change and post-change periods.

2. Regardless of whether the loss corporation has made the closing-of-the-books election under Reg. §1.382-6(b)(2), loss corporations allocate a pro-rata amount of all business interest for the year (determined prior to taking into account any business interest carryforwards from prior years) – *i.e.,* both the deductible portion and the disallowed portion – ratably between the pre-change and post-change portions of the taxable year based on the number of days in each ("**Mandatory Proration Approach**").

In support of the Mandatory Proration Approach, the Preamble to the Proposed Regulations states that the Mandatory Proration Approach is consistent with the general application of the Proposed Regulations, which apply without tracing to a particular debt.[77] The Preamble also states that applying a ratable allocation regardless of a closing-of-the-books election avoids having to compute "adjusted taxable income" under Section 163(j)(8) separately for the pre-change and post-change periods.[78]

However, as discussed above in this Part IV, Section 382 entails a degree of tracing in any event, since it differentiates pre-change business interest carryforwards from post-change business interest carryforwards. Thus, the interim closing-of-the-books method is consistent with such limited tracing. As also indicated, in applying the closing-of-the-books method, the disallowed interest can be allocated in relation to the overall allocation of business interest, without the need for separate computations of adjusted taxable income (for example, if business interest is $100 allocated $20 to the pre-change portion of the change year and $80 to the post-change portion, and if disallowed business interest is $20, then pre-change disallowed business interest would be $4 and post-change disallowed business interest would be $16). Moreover, the Mandatory Proration Approach would result in the *deductible* portion of current year business interest, not just the disallowed portion, being allocated ratably despite a closing-of-the-books election.[79] Disconnecting the allocation of interest from the results of a closing-of-the-books election leads to a less predictable outcome for taxpayers, and likely would distort the economic outcome, thereby undermining the purpose of the closing-of-the-books election.

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[77] Preamble to Proposed Regulations, Part 14; *see also* Preamble to Proposed Regulations, Part 2(A) ("The limitation under section 163(j)(1) applies to the total amount of business interest expense of the taxpayer in a taxable year (including disallowed business interest expense carryforwards from prior taxable years) and does not directly trace to interest expense in respect of any particular debt obligation of the taxpayer. Similarly, the disallowed business interest expense carryforward allowed in a taxable year represents the total amount of disallowed business interest expense that is carried forward to the taxable year and does not directly trace to a particular debt obligation of a taxpayer.").

[78] Preamble to Proposed Regulations, Part 1.

[79] This is illustrated in an example in the Proposed Regulations and in the Preamble. *See* Prop. Reg. §1.382-6(b)(ii), and Preamble to Proposed Regulations, Part 15. Moreover, the example in the Preamble illustrates that the Mandatory Proration Approach would apply to the deductible business interest even if *no* portion of the interest is disallowed.

The allocation of interest using the closing-of-the-books method has been part of the normal application of the closing-of-the-books method under Section 382 over the years, prior to the Act, and is more economically accurate than proration. Indeed, the inaccuracy of the Mandatory Proration Method may be particularly acute in the context of Section 163(j) carryforwards, because many ownership changes occur in bankruptcy, where the taxpayer's debt is restructured substantially. Thus, there tends to be a significant change in debt levels on a precise date, the date on which the ownership change occurs. The Elective Approach may, therefore, be more consistent with the company's changed circumstances than to conflate the pre-change and post-change debt levels, as would occur under the Mandatory Proration Approach.

Accordingly, we recommend applying the Elective Approach to disallowed business interest, thus treating such interest in the same manner as all other tax attributes to which Reg. §1.382-6 applies.

B. Ordering Rule for Absorbing Business Interest Carryforwards

Prop. Reg. §1.383-1(d)(2) provides that business interest expense carryforwards are absorbed after pre-change capital losses and all RBILs, but before NOLs. Reg. §1.383-1(d)(2) also contains an ordering rule for absorption of attributes. When that regulation was promulgated (as a temporary regulation), the Preamble explained, "These ordering rules follow the ordering rules of the Code which, in the absence of sections 382 and 383, generally would apply with respect to the use of the pre-change tax attributes of the loss corporation."[80] The Preamble to the Proposed Regulations sets forth a similar rationale, stating that business interest expense carryforwards should be taken into account in a manner consistent with the order in which taxable income is determined.[81] Accordingly, the proposed ordering rules are consistent with, and we believe appropriately adhere to, the approach under existing regulations.

C. Business Interest Carryforwards and Interest Chargebacks Under Section 382(l)(5)(B)

Section 382(l)(5)(B) provides that, in the event the Section 382(l)(5) bankruptcy exception applies, the loss corporation's "pre-change losses and excess credits (within the meaning of section 383(a)(2)) which may be carried to a post-change year shall be computed as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation on indebtedness which was converted into stock pursuant to" the bankruptcy or similar case within the prior three- to four-year period (the "**interest chargeback rule**").

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[80] T.D. 8264 (July 1989).

[81] *See* Preamble to Proposed Regulations, Part 16 ("The Treasury Department and the IRS have determined that disallowed business interest expense carryforwards should be absorbed after pre-change capital losses and all recognized built-in losses, but before NOLs. Disallowed business interest expense carryforwards should be absorbed before NOLs because taxpayers must calculate their current-year income or loss in order to determine whether and to what extent they can use an NOL in that year, and deductions for business interest expense, including carryforwards from prior taxable years, factor into the calculation of current-year income or loss.").

Accordingly, the interest chargeback rule affects all types of pre-change losses, and puts the loss corporation in the same position as if such losses had been unavailable. Business interest carryforwards allocable to pre-change periods are "pre-change losses" by statute,[82] and if no deduction was *allowable* in the first place, prior to any application of Section 163(j), there would be no carryforward. Accordingly, we believe that business interest carryforwards are subject to the interest chargeback rule under Section 382(l)(5)(B), and recommend that regulations be issued so providing.

Redetermination of disallowed business interest carryforwards is consistent with the policy underlying the interest chargeback rule – namely, to treat the converted debt as if it had become equity roughly three years earlier.

IRS Field Service Advice 200006004[83] supports our view as it adopts an expansive view of the interest chargeback rule. The Advice involved a taxpayer that argued that interest for the pre-change portion of the change year should not be subject to the interest chargeback rule because the taxpayer did not incur an NOL during such taxable year. The IRS disagreed since, consistent with legislative history, additional income resulting from the disallowance of the interest expense in a particular year could absorb additional NOLs incurred prior to an ownership change, thereby reducing the amount of NOLs available to be carried forward to a post-change period. The Advice stated:

> In our view, this provision [Section 382(l)(5)(B)] affects the amount of *all* pre-change losses and excess credits that the loss corporation carries forward to post-change periods, not merely any losses or excess credits that happen to have been incurred during the specified recapture period. Thus, the computation under section 382(l)(5)(B) for any of the periods in the recapture period, disregarding any deduction for interest on indebtedness that was converted into stock, should generally result in a reduced deduction from income for that period.[84]

Accordingly, by its terms and consistent with the underlying policy, the interest chargeback rule should apply to the carryforward of disallowed business interest expense because disallowing interest expense in a pre-change period would reduce the amount of business interest carryforwards available to the taxpayer. A taxpayer should not be able to avoid the interest chargeback rule where the deductibility of the relevant interest is subject to a limitation under Section 163(j).

D. Select Section 108 Issues Regarding Business Interest Carryforwards

Comments were requested in the Preamble to the Proposed Regulations regarding the interaction between Section 163(j) and the rules addressing COD income under Section 108.[85]

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[82] Section 382(d)(3).

[83] June 28, 1999.

[84] Emphasis added.

[85] Preamble to Proposed Regulations, Part 3.

This Report addresses two such interactions: first, with respect to attribute reduction under Section 108(b), and second, with respect to technical arguments for avoiding immediate taxation on cancelled interest where a corporation has corresponding business interest carryforwards.

With respect to attribute reduction under Section 108(b), business interest carryforwards, like RBILs, are not set forth on the list in Section 108(b)(2) of attributes to be reduced.[86] Although subjecting business interest carryforwards to reduction under Section 108(b) is consistent with the policy that animates Section 108(b), Congress has not amended the statute to subject business interest carryforwards to reduction.[87] As such, Treasury may lack the statutory authority to reduce disallowed interest carryforwards under Section 108(b). If Treasury believes it lacks such statutory authority, we recommend that Treasury request legislation to subject business interest carryforwards to reduction under Section 108(b).

Separately, the cancellation of interest can potentially give rise to distortive and unintended results. For example, a solvent corporation that recognizes COD income due to the cancellation of business interest may only be able to offset a portion of such income with its business interest carryforwards because of a limitation under Section 382.

Under current law, neither Section 108(e)(2) nor Section 111(a) generally is available to provide relief to such an accrual basis taxpayer. Section 108(e)(2) only applies where payment of the cancelled liability would give rise to a deduction. However, in the case of an accrual basis taxpayer, the cancelled interest would have accrued and been deducted, subject to Section 163(j), prior to cancellation. Moreover, deferral under Section 163(j) is unrelated to payment and thus the cancellation would not appear to "undo" the deferral. There can be limited instances, such as the deferral of the deduction for interest expense under the AHYDO rules, where payment is required to obtain a deduction even for an accrual basis taxpayer and Section 108(e)(2) is potentially relevant,[88] but even in that instance, the application of Section 108(b) can be complicated by Section 163(j) since payment of the (cancelled) interest might simply have resulted in a disallowed business interest carryforward that might never be deducted (even though strong arguments can be made that Section 108(e)(2) does apply in such case).[89] Section 111(a), which generally excludes from income the recovery of an amount deducted in a prior taxable year to the extent such amount did not reduce the imposition of tax and is no longer

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[86] The treatment of RBIL carryforwards under Section 108(b) is discussed in Part III above.

[87] H.R. Rep. No. 96-833, at 9 (Mar. 19, 1980) ("the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge"). *See also* Letter from AICPA to Treasury dated February 21, 2019 at 36-38 (concluding that Treasury lacks regulatory authority to subject business interest carryforwards to reduction based on an interpretation of Congressional intent to exclude business interest carryforwards from the list of attributes that are subject to reduction).

[88] Section 163(e)(5)(A)(ii) (deferring the deduction for the non-disqualified portion of original issue discount until paid).

[89] *See* Letter dated May 13, 2019 from the ABA Section of Taxation to the IRS Commissioner regarding Comments on the Proposed Regulations under Section 163(j) and its interaction with Section 108 (the "**ABA Comment Letter**").

available as a carryforward, facially does not apply since the tax benefit for the cancelled interest has either been actually deducted or still exists in the form of a business interest carryforward (treating all interest as fungible).

We recommend that Treasury consider a regulatory fix under Section 163(j) to treat the cancellation of business interest first as a reduction in a business interest expense carryforward, with the cancelled interest thereby excluded under Section 111 given the absence of any continuing carryforward. Alternatively, any COD income related to cancelled business interest (whether or not such COD income is excluded from income) could be treated as business interest income for purpose of applying Section 163(j), thereby freeing up an equal amount of business interest carryforwards. We note that this second alternative has the effect of creating gross income and interest expense, which could have collateral consequences. Also, it is not clear that additional income and interest expense (and corresponding implications, *e.g.*, in the case of the base erosion and anti-avoidance tax) would always be appropriate in the context of a distressed taxpayer with debt forgiveness. For that reason, the first alternative may be better than this second alternative. In addition, either of these approaches would implicate the need for ordering rules as relates to the cancellation of principal versus interest (a subject of prior reports of the New York State Bar Association Tax Section).[90]

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[90] For a more extensive discussion of potential approaches and considerations, see the ABA Comment Letter. For further discussion of the ordering rules as relates to the cancellation of principal versus interest, see New York State Bar Association, Tax Section, Report on Final OID Regulations, 64 Tax Notes 1747 (September 26, 1994); New York State Bar Association, Tax Section, Report on Taxation of Distressed Debt (November 22, 2011), *reprinted at* 2011 TNT 226-20.