November 12, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re:       Proposed Regulations Under Section 382(h)

Dear Commissioner Rettig:

Enclosed please find comments on the Proposed Regulations under Section 382(h)
of the Internal Revenue Code. These comments are submitted on behalf of the Section of
Taxation and have not been approved by the House of Delegates or the Board of
Governors of the American Bar Association. Accordingly, they should not be construed as
representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or
your staff.

Sincerely,

Tom Callahan
Chair, Section of Taxation

Enclosure

cc:       Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
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Kevin M. Jacobs, Senior Technician Reviewer, Internal Revenue Service
Comments on Proposed Regulations Under Section 382(h)

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jonathan Forrest and William Pauls. Significant contributions to these Comments also were made by Julie Allen, Lawrence Axelrod, Donald Bakke, Amy Chapman, Bryan Collins, Mark Hoffenberg, Robert Liquerman, Olivia Orobona, Victor Penico, Anthony Sexton, and Bela Unell. These Comments were reviewed by Eric Solomon of the Committee on Government Submissions and Eric B. Sloan, Vice Chair for Government Relations for the Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date:      November 12, 2019
Executive Summary

When a “loss corporation” experiences an “ownership change,” section 382 generally imposes a limitation on the amount of the loss corporation’s taxable income for any post-change year that may be offset by pre-change losses and other tax attributes. In general, the section 382 limitation is equal to the value of the stock of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate in effect on the change date.

Although section 382 oftentimes is described as a provision that seeks to prevent “trafficking” in tax attributes, there is “a guiding principle discussed in the section 382 legislative history, which is commonly referred to as the ‘neutrality principle,’” that underlies the statute. Under this principle, which we also will refer to as the “Neutrality Principle,” the built-in gains and losses of a loss corporation, once recognized after an ownership change, generally are treated in the same manner as if they had been recognized before the ownership change. Importantly, in administering this area, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) have sought to give full effect to the Neutrality Principle.

1 Unless otherwise specified, all “section” and “§” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury regulations promulgated thereunder, all as in effect (or, in the case of proposed regulations, as proposed) as of the date of this letter. Furthermore, for ease of reference, the defined terms included this Executive Summary are also defined below in the Detailed Comments.

2 The term “loss corporation” generally includes any corporation that (i) is entitled to use a net operating loss (“NOL”) carryover, a capital loss carryover, or certain tax credit carryforwards, (ii) incurs such losses or has such unused credits for the taxable year that includes a testing date, (iii) has a net unrealized built-in loss, determined by treating the date on which such determination is made as the date on which an ownership change occurs, or (iv) is entitled to use a carryover of disallowed business interest expense described in section 163(j)(2). See § 382(k)(1); see also § 381(c)(20); Treas. Reg. § 1.382-2(a)(1)(i); Prop. Treas. Reg. § 1.382-2(a)(2)(vi).

3 In general, an ownership change occurs when the percentage of stock held by one or more “5-percent shareholders” of the loss corporation on a testing date has increased by more than 50 percentage points over the lowest stock ownership held by such shareholders during a testing period (usually a three-year period). See § 382(g)(1).

4 See § 382(a); see also § 383.

5 See § 382(b)(1).


7 See S. REP. NO. 99–313, at 235 (1986); H.R. REP. NO. 99–426, at 261 (1986); see also H.R. REP. NO. 99-841, at II-185 (1986) (Conf. Rep.) (explaining that, as a fundamental matter, the value of NOL carryforwards to the buying corporation ought not to be more than their value to the loss corporation); cf. TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION, REPORT ON NET OPERATING LOSS PROVISIONS OF H. 3838, at 3 (1986) (“Under the neutrality principle, NOLs would generally be available to the buyer of a corporation to the extent, but only to the extent, that they would have been available to the seller had the acquisition not taken place.”).

8 Notice of Proposed Rulemaking, Regulations Under Section 382(h) Related to Built-In Gain and Loss, 84 Fed. Reg. 47455, 47459 (Sept. 10, 2019) (“[I]n administering this area, the Treasury Department and the IRS have always sought to implement a guiding principle discussed in the section 382 legislative history, which is commonly referred to as the ‘neutrality principle.’”).
In order to implement the Neutrality Principle (and, correspondingly, prevent timing differences from impacting outcomes under section 382), Congress included rules in the statute applicable to items that are built-in at the time of the ownership change and are recognized shortly thereafter. Specifically, section 382(h) provides rules for the treatment of built-in gain or loss recognized during the five-year period beginning on the change date (the “recognition period”) with respect to assets owned by the loss corporation immediately before the ownership change. Generally, if a loss corporation is in a net unrealized built-in gain (“NUBIG”) position immediately before an ownership change, the section 382 limitation for any recognition period taxable year is increased by any recognized built-in gain (“RBIG”) for such taxable year, capped at the amount of NUBIG (as reduced by RBIG recognized in prior years). If, on the other hand, a loss corporation is in a net unrealized built-in loss (“NUBIL”) position immediately before an ownership change, any recognized built-in loss (“RBIL”) for any recognition period taxable year is treated as a pre-change loss subject to the section 382 limitation, to the extent of the NUBIL (as reduced by RBIL recognized in prior years).

Section 382 also provides rules for the treatment of certain items of income and deduction as RBIG or RBIL, respectively. Specifically, section 382(h)(6)(A) provides that any item of income “properly taken into account during the recognition period” is treated as RBIG if the item is “attributable to periods before the change date.” Section 382(h)(6)(B) provides that any item of deduction “allowable as a deduction during the recognition period” is treated as RBIL if the item is “attributable to periods before the change date.” In addition, the second sentence of section 382(h)(2)(B) provides that allowable depreciation, amortization, or depletion deductions are treated as RBIL except to the extent the loss corporation establishes that the amount of the deduction is not attributable to the asset’s built-in loss on the change date. The Neutrality Principle further directs that built-in items of income and deduction be treated consistently, i.e., if a deduction item is treated as RBIL, the mirror income item should be treated as RBIG, and vice versa.

The Service issued Notice 2003-65 in response to uncertainty regarding the determination of built-in items under section 382(h)(6). In brief, Notice 2003-65 sets forth (i) a

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9 See § 382(h)(1)(A).
10 See § 382(h)(1)(B).
11 Cf. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 320 and 320 n.36 (1987) (recognizing that, following the amendments made to section 382 by the Tax Reform Act of 1986: “Depreciation deductions cannot be treated as accrued deductions or built-in losses. . . . Similarly, section 382 does not provide relief for built-in income other than gain on disposition of an asset.”); Tech. Adv. Mem. 200217009 (Dec. 4, 2001) (“The juxtaposition of the footnote with the statement of Congressional position regarding depreciation deductions arguably suggests that income and deductions from wasting assets should be treated similarly.”); IRS Field Service Advice 1998-415 (July 8, 1993) (“Although Congress did not delineate the types of income subject to I.R.C. section 382(h)(6)(A), it did indicate, by enacting I.R.C. section 382(h)(2), in the flush language, that depreciation is a deduction treated as recognized built-in loss. Under I.R.C. section 382(h)(2), post-change depreciation that is attributable to pre-change built-in loss is treated as recognized built-in loss. The flip side to this situation is that post-change income attributable to pre-change depreciation, which generated the built-in gain, should be treated as recognized built-in gain.”) (emphasis added), reprinted in 98 TNT 229-58 (LEXIS, FEDTAX Library, TNT File).
prescriptive rule for the NUBIG/NUBIL computation – the hypothetical sale model – and (ii) two safe harbors for computing RBIG and RBIL – the “1374 Approach” and the “338 Approach.” The 1374 Approach is patterned on section 1374, which addresses certain federal income tax consequences arising with respect to built-in gains of C corporations that become S corporations, and generally relies on accrual method accounting principles. The 338 Approach compares actual amounts of income, gain, deduction, and loss to the amounts that would have been realized had a section 338 election been made with respect to a hypothetical stock purchase on the change date.

On September 9, 2019, Treasury and the Service released proposed regulations under section 382(h) (the “Proposed Regulations”), which would supplant Notice 2003-65 in providing guidance regarding the identification and quantification of built-in items for purposes of section 382(h). The Proposed Regulations address a number of issues under section 382(h), and we commend Treasury and the Service for their commitment to provide further guidance in this area. That said, if finalized in their present form, the Proposed Regulations would significantly change the landscape of current law, and would do so in ways that are inconsistent with the Neutrality Principle. Accordingly, we urge Treasury and the Service to reconsider the Proposed Regulations in view of the recommendations that we provide below.

Of principal importance are our recommendations concerning (i) the NUBIG/NUBIL computation and (ii) the treatment of foregone amortization as an “item of income” for purposes of the RBIG determination. Specifically, our recommendations on these issues are as follows:

1. **NUBIG/NUBIL Computation.** We recommend generally following the approach of the Proposed Regulations with respect to the NUBIG/NUBIL computation, but with modifications to allow the full amount of all of the liabilities of the loss corporation (both recourse and nonrecourse) to be taken into account in that computation. In order to give effect to our recommendation, we would propose that the first part of the NUBIG/NUBIL computation in Prop. Treas. Reg. § 1.382-7(c)(3) be amended as suggested below in Part II.D. of the Detailed Comments.

2. **Foregone Amortization as a Proxy for an “Item of Income” for RBIG Purposes.** We recommend that Prop. Treas. Reg. § 1.382-7(d)(2)(i) be amended to include foregone amortization as an “item of income” taken into account in the determination of RBIG. We further recommend:

   a. Specific modifications to the determination of foregone amortization in order to make such amount more reasonable from an economic perspective;

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13 The Section previously provided formal comments to Treasury and the Service concerning Notice 2003-65 on April 29, 2005. That comment letter is available on the Section’s website at: https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/2005/050429corp.pdf

b. That the method used to take into account foregone amortization as RBIG mirror the flush language of section 382(h)(2)(B) and the approach of Prop. Treas. Reg. § 1.382-7(d)(3)(iii) – specifically, we recommend that the final regulations include a provision that reads in the manner set forth in Part IV.B. of the Detailed Comments;

c. That foregone amortization be computed using tax lives and tax depreciation; and

d. An annual approach to the determination of foregone amortization be adopted in the context of a consolidated group.

In addition to these principal considerations, we address many aspects of the Proposed Regulations in greater detail below and provide our recommendations throughout the entirety of that discussion. Specifically, we respectfully request that, in finalizing the Proposed Regulations, Treasury and the Service consider the following recommendations with respect to each of the topics that we outline below:

1. Computation of RBIG and RBIL

   a. We recommend that the rule for computing RBIGs incorporate items of income that are deferred due to a timing limitation.

   b. We recommend that, to the extent that the Proposed Regulations contemplate the treatment of items of loss or deduction deferred under the provisions of Treas. Reg. § 1.446-4 as RBIL, the final regulations include the income and gain items deferred under those provisions as RBIG. We further recommend that, because these hedging items are so closely tied to the performance of the underlying asset or liability, to the extent recognized in the same taxable year, gain or loss on a hedge be aggregated with gain or loss on a hedged item and only the net amount be taken into account as RBIG or RBIL, as appropriate.

   c. We recommend that, because costs to perform and prepaid income are so inexorably linked, the net of the two items for any particular taxable year be treated as RBIG or RBIL, as appropriate, for that year.

   d. We recommend that only the present value of deductible liabilities be taken into account as RBIL. To accomplish this result, we further recommend that:

      i. With respect to deductible liabilities that are not contingent in timing or amount, an “interest” component be computed for such liability similar to section 483, and the amount of the liability taken into account

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15 We recognize that many of the concepts we discuss below concerning determinations of RBIG for purposes of section 382 have equivalent applicability in the context of section 384. We would be pleased to address in future comments, the potential interplay of our recommendations in this letter with the development of further guidance under section 384.
account for purposes of the NUBIG/NUBIL computation – and potentially giving rise to RBIL in the future – be limited to the “principal” component resulting from that computation.

ii. With respect to deductible liabilities that are contingent in timing or amount, we generally recommend using the amount of the liability reflected on an applicable financial statement (“AFS”)\(^{16}\) to determine the amount of such liability for purposes of the NUBIG/NUBIL computation, unless another method of determining the amount of the liability is more appropriate (for example, in the pension plan context, as discussed below). However, if and when any payments are made with respect to the contingent liability, such payments should be bifurcated into “principal” and “interest” components (again, similar to section 483), with only the principal component of such payments being treated as RBIL.

e. We recommend that the final regulations expressly provide that, if a taxpayer has an AFS, only the contingent liabilities reflected on the AFS be taken into account for purposes of these rules (subject to the refinements offered below in Part III.C.2. in the pension plan context). Thus, for example, if a liability is not reflected on an AFS because it is too contingent or immaterial, taxpayers should be allowed to treat those liabilities as having a value of zero. We further recommend that, in keeping with Prop. Treas. Reg. § 1.382-7(c)(3)(iii)(A), in the rare circumstance where a taxpayer does not have an AFS, the taxpayer need not take into account contingent liabilities for purposes of these rules.

f. We recommend that, for purposes of calculating the amount of pension benefit liabilities attributable to qualified defined benefit plans, either the “accumulated benefit obligation method” or the “vested benefit obligation method” as further described below in Part III.C.2. of the Detailed Comments) be utilized.

g. We recommend that, if post-change contributions to a qualified defined benefit plan are treated as giving rise to RBIL, a methodology be provided in the final regulations to determine the amount of the contributions that give rise to RBIL. We further recommend treating only a payment that results in an increase in the aggregate funding level as giving rise to RBIL.

h. We recommend that liabilities that will give rise to basis when properly taken into account should be taken into account in the same manner as deductible

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\(^{16}\) As set forth in the Proposed Regulations, the term “applicable financial statement” would be defined by reference to “section 451(b)(3) and the regulations in this part under section 451 of the Internal Revenue Code (determined without regard to whether the taxpayer has another statement described in section 451(b)(3) and the regulations in this part under section 451 of the Internal Revenue Code).” Prop. Treas. Reg. § 1.382-7(c)(3)(iii)(A).
liabilities, i.e., as a reduction to NUBIG or an increase in NUBIL. We further recommend that, if basis is created in connection with such liabilities, the basis should be treated as pre-change basis for purposes of computing RBIG or RBIL on additional depreciation or amortization or on a later recognition event associated with the underlying asset.

i. We recommend that, to the extent the AFS of a taxpayer or of its 50-percent-or-greater shareholder reflects a reasonably contemporaneous assessment of an off-market executory contract, these amounts should be subject to the RBIG and RBIL rules. We further recommend providing that off-market executory contracts give rise to RBIG or RBIL only where reflected on an AFS.

j. We recommend that the period during which bad debt deductions give rise to RBIL match the period during which discharge of indebtedness income ("COD") can give rise to RBIG. We further recommend that the period for both be the full recognition period. However, if the decision is made to retain RBIG treatment for COD for only one year, we recommend a similar treatment for bad debt deductions.

k. We recommend that the Section 1248 Exclusion from RBIG on the sale of CFC stock not be included in the final regulations. We further recommend that the same approach be applied to situations where the loss corporation recognizes Subpart F income under section 964(e) with respect to its CFC’s gain on the sale of lower-tier CFC stock.

l. We recommend that the final regulations provide that RBIG includes the taxed portion of a dividend (i.e., the dividend income that is not offset by a dividends-received deduction) to the extent of the lesser of (i) the pre-change earnings and profits ("E&P") of the distributing corporation, increased by the net built-in gain in the distributing corporation’s assets as of the change date, and (ii) the built-in gain with respect to the distributing corporation’s stock as of the change date.

2. Treatment of Built-In COD

a. We recommend the following approach be applied to balance (i) the concerns expressed by Treasury and the Service regarding the arguably inappropriate benefits obtained by taxpayers taking into account built-in COD under section 382(h)(6) with (ii) the difficult issues of administrability resulting from, and the distortive results caused by, the Proposed Regulations:

i. COD that is recognized at any point in the recognition period (not just in the 12-month period following the change) that is included in taxable income be treated as an RBIG item and, accordingly, increase the annual section 382 limitation.
ii. COD that is recognized at any point during the recognition period that is excluded from gross income and that results in “black-hole” COD or the reduction of attributes other than tax basis in “section 382 assets” be treated as utilizing available NUBIG (i.e., like an item of RBIG). We describe this approach as “charging-off” the NUBIG cap. Whether the excluded COD results in RBIG should depend upon whether pre-change attributes are reduced (no RBIG) or post-change attributes are reduced (RBIG).

b. We recommend that language be added to the final regulations providing that any foregone amortization calculation does not permit reliance on liabilities in excess of asset fair market value.

3. Clarification of the Recognition Period and Related Considerations. We recommend that the final regulations clarify that:

   a. The “recognition period” begins at the end of the “change date”;

   b. Items recognized on the change date that are built-in items immediately before the ownership change (including items that occur simultaneously with the ownership change) be included in an initial, tentative NUBIG/NUBIL computation;

   c. Items recognized on the change date that would be RBIG if recognized on a subsequent date in the change year be treated as RBIG and allocated under section 382(h)(5)(A) to the post-change period (or items that would be RBIL if recognized on a subsequent date in the change year be treated as RBIL and similarly allocated to the post-change period);

   d. Items not allocated under section 382(h)(5)(A) be allocated under the general rules of Treas. Reg. § 1.382-6;

   e. The initial, tentative NUBIG/NUBIL computation be revised by removing built-in items taken into account in the change year that are allocated to the pre-change period;

   f. Items recognized simultaneously with the ownership change be treated as built-in items taken into account in the NUBIG/NUBIL computation and as RBIG or RBIL, as appropriate; and

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17 As set forth in the Proposed Regulations, the term “section 382 asset” is defined as “any asset that the loss corporation owns immediately before the ownership change, including goodwill and other intangible assets, but excluding those assets described in section 382(h)(3)(B)(ii). For purposes of this definition, all accounts receivable, other than those that were acquired in the ordinary course of the loss corporation’s business, are treated as items described in section 382(h)(3)(B)(ii).” Prop. Treas. Reg. § 1.382-7(b)(10).
g. Regardless of the approach that Treasury and the Service take with respect to includible items of income or deduction that occur simultaneously with an ownership change, the approach in the two sets of proposed regulations under section 382(h) and Treas. Reg. § 1.1502-76 does not apply to built-in COD that is excluded from gross income.

4. Effective Date Considerations

a. We recommend specific “grandfathering” rules be applied to two types of loss corporations for purposes of allowing such corporations to apply the approaches of Notice 2003-65, if desired, even if the ownership change occurs after the effective date of the final regulations.

i. We recommend that the first type of loss corporation to grandfather is a loss corporation whose ownership change is subject to a binding agreement (e.g., to acquire the stock of such company) that is in place on the date that the Proposed Regulations are finalized. For this purpose, we would expect an agreement to be considered “binding” even though subject to customary closing conditions.

ii. We recommend that the second type of loss corporation to grandfather is a loss corporation that is in, or is emerging from, a case under title 11 of the United States Code or a receivership, foreclosure, or similar proceeding in a federal or state court, where the initial court petition (or other similar formal written request) has been filed prior to the effective date of any final regulations promulgated under section 382(h).

b. We recommend that Treasury and the Service explicitly confirm in the final regulations that taxpayers experiencing ownership changes prior to the publication of the final regulations in the Federal Register will continue to be able to rely on Notice 2003-65 for purposes of their previous NUBIG/NUBIL computations with respect to those ownership changes and, further, their RBIG and RBIL determinations following those ownership changes.

We appreciate consideration given to our recommendations concerning the Proposed Regulations, and we would be pleased to discuss these comments further if that would be helpful.
TABLE OF CONTENTS

I. Background .......................................................................................................................... 12
   A. Overview of Section 382 and Its Underlying Principles .................................................. 12
   B. Notice 2003-65 ................................................................................................................ 17
      1. The 1374 Approach ...................................................................................................... 17
      2. The 338 Approach ....................................................................................................... 19
      3. Taxpayer Reliance on Notice 2003-65 ....................................................................... 20
   C. The Proposed Regulations ............................................................................................ 21

II. NUBIG/NUBIL Computation ............................................................................................. 21
   A. The Guidance Provided by the Statute ......................................................................... 21
   B. The Approach of Notice 2003-65 ................................................................................. 22
   C. The Approach of the Proposed Regulations ................................................................... 23
   D. The Proposed Regulations’ Approach to the NUBIG/NUBIL Computation Should Be Modified to Take into Account All Liabilities ................................................. 26

III. Computation of RBIG and RBIL ......................................................................................... 27
   A. Departure from a Strict Accrual Standard ...................................................................... 27
   B. Time Value Issue for Deductible Liabilities .................................................................. 30
   C. Issues Related to Contingent Liabilities ....................................................................... 32
      1. General Approach to Contingent Liabilities ............................................................... 32
      2. Certain Aggregate Liabilities (e.g., Pensions) ............................................................ 32
   D. The Proposed Regulations’ Underinclusive Approach to Liabilities ............................ 34
      1. Liabilities Giving Rise to Basis .................................................................................. 34
      2. Liabilities Associated with Off-Market Executory Contracts .................................... 35
   E. Bad Debt Deductions ...................................................................................................... 36
   F. Recommended Treatment of Gain from the Sale of Stock and Dividends ...................... 37
      1. Gain on the Sale of Stock ........................................................................................... 38
      2. Dividends with Respect to Stock .............................................................................. 39

IV. Foregone Amortization as a Proxy for an “Item of Income” for RBIG Purposes .............. 40
   A. Recommended Treatment of Foregone Amortization .................................................... 42
      1. Application of the Neutrality Principle Demands a Balanced Approach to the Determination of RBIG and RBIL ................................................................. 42
      2. Wasting Assets Do Not Have To Be Disposed of To Generate Income .................... 45
3. A Tracing Approach Would Be Difficult To Administer ........................................ 47
4. Ample Authority Supports the Treatment of the Consumption of Change Date Built-in Gain of a Wasting Asset as RBIG ......................................................... 48
5. Allowing Foregone Amortization as a Proxy for an Item of Income for RBIG Purposes Is Intended To Prevent Taxpayers from Engaging in Self-Help .... 52
6. Conclusion ........................................................................................................ 52

B. Method for Taking into Account Foregone Amortization as RBIG ............... 53

V. Treatment of Built-In COD ............................................................................... 55
   A. Application of Statutory Language to Built-In COD ....................................... 55
   B. Treatment of Built-In COD Under Notice 2003-65 ....................................... 57
   C. Issues with the Approach to Built-In COD Under Proposed Regulations ..... 57
      1. Distinction Between Recourse and Nonrecourse Liabilities...................... 57
      2. Valuation Issues ...................................................................................... 60
   D. Recommendation ....................................................................................... 61

VI. Clarification of the Recognition Period and Related Considerations .......... 64
   A. Overview of the Relevant Provisions .......................................................... 65
   B. Illustrative Examples .................................................................................. 67
   C. The Recognition Period Should Begin at the End of the Change Date ....... 67
   D. Recommended Treatment of Change Date Items ......................................... 68
   E. Recommended Treatment of Items Recognized Simultaneously with the Ownership Change .............................................................................. 69

VII. Effective Date Considerations ...................................................................... 70
   A. The Proposed Regulations .......................................................................... 70
   B. Effective Date Transition Recommendations ............................................. 70
Detailed Comments

I. Background

In order to better frame our comments, we begin below by providing an overview of the provisions of section 382, including an explanation of the principles underlying that provision generally and section 382(h) specifically, and an explanation of the approaches of Notice 2003-65.18

A. Overview of Section 382 and Its Underlying Principles

When a “loss corporation”19 experiences an “ownership change,”20 section 382 generally imposes a limitation on the amount of the loss corporation’s taxable income for any post-change year that may be offset by pre-change losses and other tax attributes.21 In general, the section 382 limitation is equal to the value of the stock of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate in effect on the change date.22

Although section 382 oftentimes is described as a provision that seeks to prevent “trafficking” in tax attributes, there is “a guiding principle discussed in the section 382 legislative history, which is commonly referred to as the ‘neutrality principle,’”23 that underlies the statute. Under this principle, which we also will refer to as the “Neutrality Principle,” the built-in gains and losses of a loss corporation, once recognized after an ownership change, generally are treated in the same manner as if they had been recognized before the ownership change.24 Importantly, in administering this area, the Department of the Treasury (“Treasury”)...
and the Internal Revenue Service (the “Service”) have sought to give full effect to the Neutrality Principle.\textsuperscript{25}

In order to implement the Neutrality Principle (and, correspondingly, prevent timing differences from impacting outcomes under section 382), Congress included rules in the statute applicable to items that are built-in at the time of the ownership change and are recognized shortly thereafter. Specifically, section 382(h) provides rules for the treatment of built-in gain or loss recognized during the five-year period beginning on the change date (the “recognition period”) with respect to assets owned by the loss corporation immediately before the ownership change. Generally, if a loss corporation is in a net unrealized built-in gain (“NUBIG”) position immediately before an ownership change, the section 382 limitation for any recognition period taxable year is increased by any recognized built-in gain (“RBIG”) for such taxable year, capped at the amount of NUBIG (as reduced by RBIG recognized in prior years).\textsuperscript{26} If, on the other hand, a loss corporation is in a net unrealized built-in loss (“NUBIL”) position immediately before an ownership change, any recognized built-in loss (“RBIL”) for any recognition period taxable year is treated as a pre-change loss subject to the section 382 limitation, to the extent of the NUBIL (as reduced by RBIL recognized in prior years).\textsuperscript{27} Congress explained the purpose of these rules as follows:

The committee concluded that built-in losses should be subject to special limitations 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 investing the proceeds in assets similar to the assets sold).

The committee bill also provides relief for [a] loss corporation having built-in gain assets. Built-in gains are often the product of special tax provisions that accelerate deductions or defer income (\textit{e.g.}, accelerated depreciation or installment sales reporting). Absent a special rule, the use of NOL carryforwards to offset built-in gains recognized after an acquisition would be limited, even though the carryforwards would have been fully available to offset neutrality principle, NOLs would generally be available to the buyer of a corporation to the extent, but only to the extent, that they would have been available to the seller had the acquisition not taken place.”).

\textsuperscript{25} Notice of Proposed Rulemaking, \textit{Regulations Under Section 382(h) Related to Built-In Gain and Loss}, 84 Fed. Reg. 47455, 47459 (Sept. 10, 2019) ("[I]n administering this area, the Treasury Department and the IRS have always sought to implement a guiding principle discussed in the section 382 legislative history, which is commonly referred to as the ‘neutrality principle.’").

\textsuperscript{26} See § 382(h)(1)(A).

\textsuperscript{27} See § 382(h)(1)(B).
such gains had the gains been recognized before the change in ownership occurred.  

Under the statute, a loss corporation’s NUBIG/NUBIL computation takes into account the amount by which the fair market value of the assets of such corporation immediately before the ownership change is more or less, respectively, than the aggregate adjusted basis of those assets at such time. If the result of that calculation does not exceed a threshold amount – i.e., the lesser of (i) $10 million or (ii) 15 percent of the aggregate fair market value of certain assets of the loss corporation immediately before the ownership change – the loss corporation’s NUBIG or NUBIL is zero.

RBIG includes any gain recognized during the recognition period on the disposition of any asset, to the extent the new loss corporation establishes that (i) such asset was held by the old loss corporation immediately before the change date, and (ii) such gain does not exceed the asset’s built-in gain on the change date. RBIL includes any loss recognized during the recognition period on the disposition of any asset, except to the extent the new loss corporation establishes that (i) such asset was not held by the old loss corporation immediately before the change date, or (ii) such loss exceeds the asset’s built-in loss on the change date. The Neutrality Principle directs the outcome that RBIL be limited in the same manner as a pre-change NOL carryforward or net capital loss carryforward. Similarly, in the built-in gain context, the Neutrality Principle dictates that section 382-limited losses be freely usable against RBIG because, had the gain been taken into account before the ownership change, use of the loss would not have been subject to (that is, limited by) section 382. Under section 382(h), RBIG results in a dollar-for-dollar increase in the loss corporation’s section 382 limitation in order to replicate this pre-ownership-change treatment.

Section 382 also provides rules for the treatment of certain items of income and deduction as RBIG or RBIL, respectively. Specifically, section 382(h)(6)(A) provides that any item of income “properly taken into account during the recognition period” is treated as RBIG if

28 S. REP. NO. 99-313, at 235 (1986); see also Notice 2003-65, 2003-2 C.B. 747 (“Section 382(h) . . . reflects that, as a general matter, losses that offset built-in gain should not be subject to the section 382 limitation merely because the gain is recognized after an ownership change because if the gain had been recognized before the ownership change, it would have been offset without limitation by the loss corporation’s net operating losses. Similarly, built-in loss should not escape the section 382 limitation merely because it is recognized after an ownership change because if the loss had been recognized before the ownership change, it would have been subject to the section 382 limitation.”).

29 See § 382(h)(3)(A)(i). The amount of NUBIG or NUBIL initially determined under section 382(h)(3) also is adjusted to reflect the application of section 382(h)(6)(C) (discussed further below).

30 See § 382(h)(3)(B).

31 See § 382(h)(2)(A).

32 See § 382(h)(2)(B).

33 Given this outcome, there is a presumption in the statute that gain recognized during the recognition period is not RBIG unless the new loss corporation establishes otherwise. See § 382(h)(2)(A). The opposite presumption is provided in relation to RBIL, i.e., a loss recognized during the recognition period is RBIL unless the new loss corporation establishes otherwise. See § 382(h)(2)(B).
the item is “attributable to periods before the change date.” Section 382(h)(6)(B) provides that any item of deduction “allowable as a deduction during the recognition period” is treated as RBIL if the item is “attributable to periods before the change date.” In addition, the second sentence of section 382(h)(2)(B) provides that allowable depreciation, amortization, or depletion deductions are treated as RBIL except to the extent the loss corporation establishes that the amount of the deduction is not attributable to the asset’s built-in loss on the change date. The Neutrality Principle further directs that built-in items of income and deduction be treated consistently, i.e., if a deduction item is treated as RBIL, the mirror income item should be treated as RBIG, and vice versa.34

Prior to the amendment made by the Technical and Miscellaneous Revenue Act of 1988 (the “1988 Act”),35 section 382(h)(6) merely authorized Treasury regulations to “treat amounts which accrue on or before the change date but which are allowable as a deduction after such date as recognized built-in losses.”36 Notably, the legislative history to the 1988 Act explains the expansion of section 382(h)(6) to cover built-in income items and the significance of the change in terminology from “accrue” to “attributable to” as follows:

The amendment clarifies that any item of income which is properly taken into account during the recognition period but that is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Such items would include accounts receivable of a cash basis taxpayer that arose before the change date and are collected after that date, the gain on completion of a long-term contract performed by a taxpayer using the completed contract method of accounting that is attributable to periods before the

34 Cf. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 320 and 320 n.36 (1987) (recognizing that, following the amendments made to section 382 by the Tax Reform Act of 1986: “Depreciation deductions cannot be treated as accrued deductions or built-in losses . . . . Similarly, section 382 does not provide relief for built-in income other than gain on disposition of an asset.”); Tech. Adv. Mem. 200217009 (Dec. 4, 2001) (“The juxtaposition of the footnote with the statement of Congressional position regarding depreciation deductions arguably suggests that income and deductions from wasting assets should be treated similarly.”); IRS Field Service Advice 1998-415 (July 8, 1993) (“Although Congress did not delineate the types of income subject to I.R.C. section 382(h)(6)(A), it did indicate, by enacting I.R.C. section 382(h)(2), in the flush language, that depreciation is a deduction treated as recognized built-in loss. Under I.R.C. section 382(h)(2), post-change depreciation that is attributable to pre-change built-in loss is treated as recognized built-in loss. The flip side to this situation is that post-change income attributable to pre-change depreciation, which generated the built-in gain, should be treated as recognized built-in gain.”) (emphasis added), reprinted in 98 TNT 229-58 (LEXIS, FEDTAX Library, TNT File).


36 Section 382(h)(6), prior to amendment by Section 1006(d)(22) of Pub. L. No. 100-647. The legislative history of the pre-1988 Act version of section 382(h)(6) cited deductions deferred by sections 267 or 465 as examples of “accrued” deductions. See H.R. REP. NO. 99-841, at II-191 (1986) (Conf. Rep.); see also STAFF OF THE SENATE FINANCE COMMITTEE, THE SUBCHAPTER C REVISION ACT OF 1985, S. PRT. NO. 99-47, at 247 (1985) (a draft proposal upon which the amendments made to section 382 by the Tax Reform Act of 1986 were based described the corresponding provision as “intended to apply to items that accrue and would be deductible prior to the change but for some provision in the law (e.g., section 267)”.

change date, and the recognition of income attributable to periods before the change date pursuant to section 481 adjustments, for example, where the loss corporation was required to change to the accrual method of accounting pursuant to Code section 448.37

A close legislative precursor to the 1988 Act – the Omnibus Budget Reconciliation Act of 198738 (the “1987 Act”) – added section 384 to the Code, which generally limits the ability of a “gain corporation” to use another corporation’s losses to shelter built-in gains recognized within five years of an acquisition.39 In so doing, Congress gave effect to built-in income items in the determination of RBIG for purposes of section 384 in a manner similar to the one that it would employ under section 382(h)(6)(A) by directing that “[a]ny item of income which is properly taken into account for any recognition period taxable year but which is attributable to periods before the acquisition date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account and shall be taken into account in determining the amount of the net unrealized built-in gain.”40 Significantly, the legislative history to the 1987 Act provides the following explanation concerning the determination of built-in gains for purposes of section 384:

The bill provides that loss corporations will be precluded from using their losses to shelter built-in gains of an acquired company recognized within 5 years of the acquisition. Built-in gains for this purpose includes any item of income which is attributable to periods before the acquisition date. For example, built-in gains for this purpose include so-called “phantom” gains on property for which depreciation had been taken prior to the acquisition. It is likewise expected that built-in gains for this purpose will also include any income recognized after an acquisition in which the fair market value of the property acquired is less than the present value of the taxes that would be due on the income associated with the property (for example, in the case of a “burnt-out” leasing subsidiary with built-in income transferred to a loss corporation).41

Under section 382(h)(6)(C), the amount of NUBIG or NUBIL is adjusted for items of income and deduction that would be treated as RBIG or RBIL, respectively, under section 382(h)(6) if those amounts were taken into account (or allowed as deductions) during the recognition period. Notably, section 382(h)(6)(C) originally provided for an adjustment to the amount of NUBIG for items of built-in income “treated as recognized built-in gains” under

39 See § 384(a).
40 § 384(c)(1)(B).
section 382(h)(6)(A). This language was amended by a technical correction to provide that the amount of NUBIG includes items of income “which would be treated as recognized built-in gain . . . if such amounts were properly taken into account . . . during the recognition period.”42 The legislative history to the amendment reveals that, under this language, “[i]tems of income . . . that would be treated as built-in gain . . . if recognized within the recognition period are included in the computation of net unrealized built-in gain . . . without regard to when or whether such items are actually recognized within the recognition period.”43 Accordingly, the amendment to section 382(h)(6)(C) eliminated (i) the uncertainty that previously existed surrounding the potential need to redetermine NUBIG or NUBIL amounts due to a taxpayer’s subsequently taking into account items of RBIG or RBIL44 and (ii) any perceived requirement that there be an actual recognition of an item of income for this purpose.

Lastly, the statute provides authority to prescribe “such regulations as may be necessary or appropriate to carry out the purposes of . . . [section 382] and section 383.”45

B. Notice 2003-6546

The Service issued Notice 2003-65 in response to uncertainty regarding the determination of built-in items under section 382(h)(6).47 In brief, Notice 2003-65 sets forth (i) a prescriptive rule for the NUBIG/NUBIL computation – the hypothetical sale model – and (ii) two safe harbors for computing RBIG and RBIL – the “1374 Approach” and the “338 Approach.” The 1374 Approach is patterned on section 1374, which addresses certain federal income tax consequences arising with respect to built-in gains of C corporations that become S corporations, and generally relies on accrual method accounting principles. The 338 Approach compares actual amounts of income, gain, deduction, and loss to the amounts that would have been realized had a section 338 election been made with respect to a hypothetical stock purchase on the change date.

1. The 1374 Approach

The 1374 Approach generally relies on the accrual method of accounting to identify income or deduction items as RBIG or RBIL, respectively. Under this approach, items of income or deduction properly included in income or allowed as a deduction during the recognition period generally are treated as RBIG or RBIL, respectively, if an accrual method taxpayer would have included the item in income or been allowed a deduction for the item before

44 Stated differently, the amendment to section 382(h)(6)(C) made clear that the NUBIG/NUBIL computation is a one-time determination that must be made at the time of the ownership change.
45 § 382(m) (emphasis added).
47 The Section previously provided formal comments to Treasury and the Service concerning Notice 2003-65 on April 29, 2005. That comment letter is available on the Section’s website at: https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/2005/050429corp.pdf
the change date. However, for purposes of determining whether an item is RBIL, section 461(h)(2)(C) and Treas. Reg. § 1.461-4(g) (concerning certain liabilities for which payment is economic performance) do not apply.

Consistent with the flush language of section 382(h)(2)(B), the 1374 Approach departs from the tax accrual rule in its treatment of amounts allowable as depreciation, amortization, or depletion deductions during the recognition period. Except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset’s adjusted basis over its fair market value on the change date, the 1374 Approach treats these amounts as RBIL, regardless of whether they accrued for tax purposes before the change date. Notice 2003-65 provides that a loss corporation may use any reasonable method to establish that the amortization deduction amount is not attributable to an asset’s built-in loss on the change date. One method that Notice 2003-65 indicates would be acceptable is to compare the amount of the amortization deduction actually allowed to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its fair market value on the change date. The amount by which the actual amortization deduction does not exceed the amount of the hypothetical amortization deduction is not RBIL.

The 1374 Approach generally treats any income or deduction item properly taken into account during the first 12 months of the recognition period as discharge of indebtedness income (“COD”) that is included in gross income pursuant to section 61(a)(12) or as a bad debt deduction under section 166 as RBIG or RBIL, respectively, if the item arises from a debt owed by or to the loss corporation at the beginning of the recognition period. Any reduction of tax basis under sections 108(b)(5) and 1017(a) resulting from COD realized during the first 12 months of the recognition period is treated as having occurred immediately before the ownership change for purposes of determining whether recognized gain or loss on a disposition

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48 See id. at § III.B.2.a. Notice 2003-65 provides that, in general, the 1374 Approach does not treat income from a built-in gain asset during the recognition period as RBIG because such income did not accrue before the change date. See id. at § III.B.2.a.(i).

49 See id. at § III.B.2.a. There are certain deviations from this general rule set forth in the Treasury regulations under section 1374. For example, notwithstanding this general rule, any amount properly deducted in the recognition period under section 267(a)(2) is treated as RBIL to the extent (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is paid (A) in the first two-and-a-half months of the recognition period or (B) to a related party owning, under the attribution rules of section 267, less than 5 percent, by voting power and value, of the corporation’s stock, both as of the beginning of the recognition period and when the amount is paid. Likewise, any amount properly deducted in the recognition period under section 404(a)(5) is treated as RBIL to the extent (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is not paid to a related party to which section 267(a)(2) applies. See Treas. Reg. § 1.1374-4(c).


51 See id.

52 See id.

53 See id.

54 See id. at § III.B.2.b.
of the reduced-basis asset during the recognition period is RBIG or RBIL. However, the reduction of tax basis does not affect the loss corporation’s NUBIG or NUBIL.56

Taxpayers in a NUBL position historically have adopted the 1374 Approach because it captures only a narrow subset of items, which is desirable to minimize the extent to which items will be subject to limitation as RBIL. Taxpayers in a NUBIG position historically have not adopted the 1374 Approach because it is undesirable to limit RBIG, which increases the section 382 limitation.

2. The 338 Approach

As noted above, the 338 Approach generally compares a loss corporation’s actual amounts of income, gain, deduction, and loss to the amounts that would have resulted had a section 338 election been made with respect to a hypothetical sale of all the loss corporation’s stock on the change date.57

A significant feature of the 338 Approach is that it allows built-in gain assets for which depreciation, amortization, or depletion deductions can be taken to generate RBIG without a realization event.58 Specifically, the 338 Approach treats as RBIG the excess of (i) the cost recovery deduction that would have been allowable with respect to a built-in gain asset had an election under section 338 been made for the hypothetical purchase of that asset;59 over (ii) the loss corporation’s actual allowable cost recovery deduction for the asset.60 Taxpayers in a NUBIG position historically have adopted the 338 Approach due to this feature.

The 338 Approach treats a deduction for the payment of a liability that is contingent on the change date as RBIL to the extent of the estimated liability on the change date.61

Under the 338 Approach, COD that is included in gross income under section 61(a)(12) and attributable to any pre-change debt of the loss corporation is RBIG in an amount not exceeding the excess, if any, of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date.62 Any reduction of tax basis under sections 108(b)(5) and 1017(a) resulting from COD realized during the recognition period is treated as having occurred immediately before the ownership change for purposes of determining

55 See id.
56 See id.
57 See id. at § IV.
58 See id. at § IV.B.2.
59 The amount is determined based on the fair market value of the asset on the change date and a cost recovery period that begins on the change date. See id.
60 See id. As described in detail below in Part IV of this letter, this difference typically is referred to as “foregone amortization.”
61 See id. at § IV.C.
62 See id. at § IV.D.
whether recognized gain or loss on a disposition of the reduced-basis asset during the recognition period is RBIG or RBIL, to the extent of the excess, if any, of the adjusted issue price of the debt over the fair market value of the debt on the change date.\(^{63}\) However, the reduction of tax basis does not affect the loss corporation’s NUBIG or NUBIL.\(^{64}\)

3. **Taxpayer Reliance on Notice 2003-65**

Notice 2003-65 provides that taxpayers may rely on either of the approaches set forth therein (but not elements of both) for purposes of applying section 382(h) to ownership changes that occurred prior to the issuance of the notice or after the issuance of the notice and prior to the effective date of temporary or final regulations under section 382(h).\(^{65}\) However, Notice 2003-65 further provides that the approaches described in the Notice serve as safe harbors, and are not the exclusive methods by which a taxpayer may identify built-in items for purposes of section 382(h).\(^{66}\) Notice 2003-65 states that other methods taxpayers use to identify built-in items for purposes of section 382(h) will be examined on a case-by-case basis.\(^{67}\)

Our collective experience with Notice 2003-65 has demonstrated that it has successfully resolved disputes under section 382(h) arising in the examination of some taxpayers, and has permitted other taxpayers to determine the amount of their RBIGs and RBILs with significantly more certainty that their positions will not be challenged by the Service. Although issues have been identified with the operation of the 1374 Approach and the 338 Approach over the course of the last 16 years, we believe that the effort and thinking surrounding the development of Notice 2003-65 are praiseworthy and that a wholesale reconsideration of the outcomes offered by Notice 2003-65 may prove preferable only if it occurs in a balanced and consistent manner.

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\(^{63}\) See id.

\(^{64}\) See id.

\(^{65}\) See id. at § V. Notice 2018-30 amended Notice 2003-65 by reversing an unintended change in the amount of RBIG or RBIL that otherwise could have been determined under the 1374 Approach or the 338 Approach as a result of amendments in the Act to section 168(k). Cf. Notice of Proposed Rulemaking, Regulations Under Section 382(h) Related to Built-In Gain and Loss, 84 Fed. Reg. 47455, 47458 (Sept. 10, 2019) (“For example, the Treasury Department and the IRS have observed that amendments in the Act to section 168(k) invalidate the key assumption underlying application of the 338 Approach to depreciable (‘wasting’) assets, which is to reflect an estimate of income or expense generated by an asset during a particular period. Consequently, to prevent unintended collateral consequences of the additional first-year depreciation available under amended section 168(k), the Treasury Department and the IRS published Notice 2018-30 (2018-21 I.R.B. 610). Without the additional guidance set forth in Notice 2018-30, the Treasury Department and the IRS concluded that the 338 Approach’s hypothetical cost recovery deduction resulting from a hypothetical application of additional first-year depreciation under section 168(k) would fail to provide a reasonable estimate of the income or expense produced by a built-in gain or loss asset during the recognition period.”).


\(^{67}\) See id. Specifically, Notice 2003-65 provides that the Service will not assert an alternative interpretation of section 382(h) against a taxpayer that consistently applies either the 1374 Approach or the 338 Approach. See id. Taxpayers may use either the 1374 Approach or the 338 Approach, but not elements of both, for each ownership change with respect to a loss corporation or a loss subgroup (as defined in Treas. Reg. § 1.1502-91(d)). See id.
C. The Proposed Regulations

On September 9, 2019, Treasury and the Service released proposed regulations under section 382(h) (the “Proposed Regulations”), which would supplant Notice 2003-65 in providing guidance regarding the identification and quantification of built-in items for purposes of section 382(h). The Proposed Regulations address a number of issues under section 382(h), and we commend Treasury and the Service for their commitment to provide further guidance in this area. That said, if finalized in their present form, the Proposed Regulations would significantly change the landscape of current law and would do so in ways that are inconsistent with the Neutrality Principle. Accordingly, we urge Treasury and the Service to reconsider the Proposed Regulations in view of the recommendations that we provide below.

II. NUBIG/NUBIL Computation

For the reasons discussed below, we recommend generally following the approach of the Proposed Regulations with respect to the NUBIG/NUBIL computation, but with modifications to allow the full amount of all of the liabilities of the loss corporation (both recourse and nonrecourse) to be taken into account in that computation. By eliminating the distinction between recourse and nonrecourse liabilities, we believe that our suggested modifications will further simplify the NUBIG/NUBIL computation and avoid the necessity of adjusting that computation for subsequent events. In addition, we believe that our suggested modifications mitigate the “duplicated benefit” discussed in the preamble to the Proposed Regulations and represent the proper balance between accuracy and administrability.

A. The Guidance Provided by the Statute

As explained in Part I of this letter, Congress provided rules in section 382 applicable to items that are built-in at the time of the ownership change and recognized shortly thereafter in order to implement the Neutrality Principle and, correspondingly, prevent timing differences from impacting outcomes under section 382. Specifically, section 382(h) provides rules for the treatment of built-in gain or loss recognized during the recognition period with respect to assets owned by the loss corporation immediately before the ownership change. Generally, if a loss corporation is in a NUBIG position immediately before an ownership change, the section 382 limitation for any recognition period taxable year is increased by any RBIG for such taxable year, capped at the amount of NUBIG (as reduced by RBIG recognized in prior years). If, on the other hand, a loss corporation is in a NUBIL position immediately before an ownership change, any RBIL for any recognition period taxable year is treated as a pre-change loss subject to the section 382 limitation, at least to the extent of the NUBIL (as reduced by RBIL recognized in prior years).

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69 See § 382(h)(1)(A).
70 See § 382(h)(1)(B).
For purposes of these rules, section 382(h)(3)(A)(i) provides that a NUBIG or NUBIL with respect to any old loss corporation is the amount by which (i) the fair market value of the assets of such corporation immediately before an ownership change is more or less, respectively, than (ii) the aggregate adjusted basis of such assets at such time. As directed by section 382(h)(6)(C), this amount is then adjusted by the amount of certain built-in items of income or deduction. If the result of this calculation does not exceed a threshold amount – i.e., the lesser of (i) $10 million or (ii) 15 percent of the aggregate fair market value of certain assets of the loss corporation immediately before the ownership change – the loss corporation’s NUBIG or NUBIL is zero.71

The pertinent legislative history discussing the NUBIG/NUBIL computation under section 382(h)(3)(A)(i) does not provide a detailed analysis of the statute’s methodology; however, that legislative history does provide that:

Although the special treatment of built-in gains and losses will generally require valuations of a loss corporation’s assets, the bill limits the circumstances in which valuations will be required by providing a de minim[i]s rule. The committee’s bill also provides a simplifying presumption in the case of certain stock acquisitions where it is reasonable to equate the value of the consideration used to acquire the stock with the value of a corporation’s assets.72

The simplifying presumption noted in the excerpt is set forth in section 382(h)(8), which states that, for purposes of determining a NUBIL, where 80 percent or more of the value of the stock of a corporation is acquired in a single transaction (or series of related transactions during any 12-month period), the fair market value of the corporation’s assets cannot exceed the “grossed up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items.”

B. The Approach of Notice 2003-65

Under both the 1374 Approach and the 338 Approach, the NUBIG/NUBIL computation is done by reference to the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change.73 Under this hypothetical sale model, the loss corporation is treated as selling all of its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities, ignoring contingencies.74 The gross amount realized on such sale is then:

- Decreased by the loss corporation’s aggregate adjusted basis in all of its assets;

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71 See § 382(h)(3)(B).
74 See id. at §§ III.A., IV.A.
• Decreased by any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale;

• Increased or decreased by the corporation’s section 481 adjustments that would be taken into account as a result of the hypothetical sale; and

• Increased by any RBIL that would not be allowed as a deduction under sections 382, 383, or 384 on the hypothetical sale.75

To the extent the amount realized under this calculation is positive, such amount is the loss corporation’s NUBIG; to the extent it is negative, such amount is the loss corporation’s NUBIL (in each case, subject to threshold amounts).76

Over the past 16 years of working with Notice 2003-65 and considering its parameters for the NUBIG/NUBIL computation, we have found its guidance to be quite helpful in most instances, notwithstanding what some might describe as the “shortcomings” that have been identified with respect to the operation of Notice 2003-65. For instance, there may be concerns regarding the NUBIG/NUBIL computation when a loss corporation has excluded COD, and that asymmetry may occur if certain amounts are included in the NUBIG/NUBIL computation when those amounts cannot be treated as RBIG or RBIL (such as contingent liabilities under the 1374 Approach), which could be argued contravenes section 382(h)(6)(C). We have taken these perceived shortcomings into account in developing our recommendation concerning the NUBIG/NUBIL computation.

C. The Approach of the Proposed Regulations

The preamble to the Proposed Regulations identified several weaknesses present in the NUBIG/NUBIL computation set forth in Notice 2003-65. Most significantly, the preamble states that:

[T]he Treasury Department and the IRS have determined that this failure [of Notice 2003-65] to distinguish between includable and excludable COD income results in the overstatement of RBIG (or understatement of RBIL) in contravention of section 382(h)(6)(C). This failure also effectively provides for a duplicated benefit under section 382(h) RBIG rules in certain cases. The Treasury Department and the IRS interpret section 382(h)(6)(C) as requiring inclusion in the NUBIG/NUBIL computation only the amounts that would be treated as RBIG or RBIL if those amounts were properly taken income account during the recognition period.

75 See id. Notice 2003-65 thus incorporated the rules of Treas. Reg. § 1.1374-3(a) as a general model for the NUBIG/NUBIL computation.

76 See id.
Further, the Treasury Department and the IRS have determined that the treatment of COD income under Notice 2003-65 violates the neutrality principle previously discussed.\(^{77}\)

The preamble to the Proposed Regulations also discusses several issues associated with excluded COD and the attribute reduction rules and, in so doing, states that:

To the extent that pre-change losses have already been used to offset this pre-change income, the neutrality principle prohibits an increase in the section 382 limitation. Indeed, such an increase could make excluded COD income more attractive than included COD income (or any other built-in gain item) for purposes of section 382. For this reason, the Treasury Department and the IRS have determined that the recognition of such excluded COD income should not generate RBIG.\(^{78}\)

To address these perceived deficiencies in the NUBIG/NUBIL computation set forth in Notice 2003-65, the Proposed Regulations depart from the notice’s NUBIG/NUBIL computation in several meaningful ways.\(^{79}\) As a starting point, the Proposed Regulations’ NUBIG/NUBIL computation would take into account the aggregate amount that would be realized in a hypothetical disposition of all of the loss corporation’s assets in two steps treated as taking place immediately before the ownership change.\(^{80}\) In the first step, the loss corporation would be treated as satisfying any inadequately secured nonrecourse liability by surrendering to each creditor the assets securing such debt.\(^{81}\) In the second step, the loss corporation would be treated as selling all remaining assets pertinent to the NUBIG/NUBIL computation in a sale to an unrelated third party, with the hypothetical buyer assuming no amount of the seller’s liabilities.\(^{82}\) The total hypothetical amount realized by the loss corporation pursuant to the first and second steps then would be:

- Decreased by the loss corporation’s basis in its assets;\(^{83}\)
- Decreased by the sum of the loss corporation’s deductible liabilities (both fixed and contingent (and, for this purpose, by treating the amount of a contingent liability as its

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\(^{77}\) Notice of Proposed Rulemaking, Regulations Under Section 382(h) Related to Built-In Gain and Loss, 84 Fed. Reg. 47455, 47459 (Sept. 10, 2019).

\(^{78}\) Id.

\(^{79}\) See generally Prop. Treas. Reg. § 1.382-7(c)(3)(i).

\(^{80}\) See Prop. Treas. Reg. § 1.382-7(c)(3)(i)(A).


\(^{83}\) See Prop. Treas. Reg. § 1.382-7(c)(3)(i)(B).
estimated value as reflected on the corporation’s most recent “applicable financial statement”)),

- Increased or decreased, as applicable, by the net amount of positive and negative section 481 adjustments that would be required to be included on account of the hypothetical disposal of all of the loss corporation’s assets,\(^8\) and

- Increased or decreased, as applicable, by the net amount of the total RBIG and RBIL income and deduction items that could be recognized during the recognition period.\(^8\)

The Proposed Regulations would provide that a loss corporation is permitted to adjust the NUBIG or NUBIL determined using the preceding calculation for certain “first-year recourse COD income.”\(^8\) This adjustment could cause a loss corporation that otherwise would have a NUBIL to have a NUBIG or to meet the threshold requirement of section 382(h)(3)(B).\(^8\)

Specifically, the NUBIG or NUBIL may be adjusted for first-year recourse COD income that:

- Is included in gross income under section 61(a)(12);

- Is excluded under section 108(a), to the extent section 108(b) reduces attributes that are not pre-change losses; or

- Is excluded under section 108(a), to the extent that section 1017(a) reduces the basis of the loss corporation’s “section 382 assets.”\(^8\)

If a loss corporation chooses to adjust its NUBIG or NUBIL in the manner described above, the adjustment is made as of the change date and the loss corporation must file a statement (or an amended statement) to reflect the adjustment.\(^9\)

\(^8\) See Prop. Treas. Reg. § 1.382-7(c)(3)(i)(C), (D).


\(^8\) See Prop. Treas. Reg. § 1.382-7(c)(3)(i)(F), (G).

\(^8\) See Prop. Treas. Reg. § 1.382-7(c)(3)(ii)(A), (B). As set forth in the Proposed Regulations, the term “first-year recourse COD income” is defined as “any income from discharge of indebtedness (including from liabilities described in paragraph (c)(3)(i)(C) of this section) that the loss corporation recognizes (including income that is excluded from gross income under section 108(a)(1)) during the first twelve months of the recognition period on all of the loss corporation’s liabilities immediately before the ownership change (excluding nonrecourse liabilities) to the extent of its pre-change excess recourse liabilities.” Prop. Treas. Reg. § 1.382-7(b)(4).


\(^8\) See id. As set forth in the Proposed Regulations, the term “section 382 asset” is defined as “any asset that the loss corporation owns immediately before the ownership change, including goodwill and other intangible assets, but excluding those assets described in section 382(b)(3)(B)(ii). For purposes of this definition, all accounts receivable, other than those that were acquired in the ordinary course of the loss corporation’s business, are treated as items described in section 382(b)(3)(B)(ii).” Prop. Treas. Reg. § 1.382-7(b)(10).

Overall, the Proposed Regulations provide a methodology for the NUBIG/NUBIL computation that very likely would result in taxpayers having lower NUBIGs or larger NUBILs, an outcome that also is very likely to have a dramatic negative impact on insolvent and bankrupt corporations. This result is driven by the fact that the Proposed Regulations do not take into account the amount of recourse liabilities in excess of the fair market value of the corporation’s assets. The disparate treatment of recourse and nonrecourse liabilities in the Proposed Regulations also adds unnecessary complexity to the NUBIG/NUBIL computation, in particular, by allowing subsequent adjustments to that calculation in certain cases, and is likely to encourage taxpayers to attempt to modify their debt structures (potentially by making entity classification elections) to maximize the amount of nonrecourse liabilities. In addition, the Proposed Regulations (i) do not take into account any income that would be accelerated upon the hypothetical sale of assets unless such amounts would be treated as RBIG and taken into account in NUBIG or NUBIL under section 382(h)(6)(C), and (ii) otherwise would eliminate the increase that had been afforded by Notice 2003-65 for any RBIL that would not be allowed as a deduction under sections 382, 383, or 384 on the hypothetical sale.

D. The Proposed Regulations’ Approach to the NUBIG/NUBIL Computation Should Be Modified to Take into Account All Liabilities

We recommend generally following the approach of the Proposed Regulations with respect to the NUBIG/NUBIL computation, but with modifications to allow the full amount of all of the liabilities of the loss corporation (both recourse and nonrecourse) to be taken into account. In support of this recommendation, we have included a thorough discussion of COD and the proposed treatment of liabilities in Part V of this letter. As discussed below, our proposed approach includes a “charge-off” provision that would mitigate the potential “duplicated benefit” discussed in the preamble to the Proposed Regulations by reducing the amount of available NUBIG by excluded COD that results in (i) “black-hole” COD or (ii) the reduction of pre-change attributes (other than tax basis in section 382 assets).

We believe that our recommended approach significantly reduces the complexity associated with the approach of the Proposed Regulations, while resulting in the identical amount of usable NUBIG – i.e., NUBIG that will support potential RBIGs – if the Proposed Regulations had extended the adjustment for first-year recourse COD income to include similar COD recognized within the recognition period (which we think is the most appropriate outcome). The only potential taxpayer benefit that we have identified with respect to this approach is that some insolvent or bankrupt corporations may have a smaller NUBIL or move from a NUBIL to a

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91 Under section 108(b), so-called “black-hole” COD arises where the debtor’s total amount of excluded COD exceeds all tax attributes available for reduction, including tax basis in assets. Importantly, tax basis in assets may be protected from reduction under the “liability floor” of section 1017, which generally prevents tax basis in assets from being reduced below the amount of liabilities (including intercompany liabilities) of a debtor immediately after the relevant transaction (and, in the case of the “tier-down” rules of Treas. Reg. § 1.1502-28, this liability floor is tested at “tier-down” subsidiaries immediately before the relevant transaction). Accordingly, a loss corporation may have black-hole COD but still be in an economic NUBIL position on the change date (even after taking tax basis reduction into account).
NUBIG, but we believe that this potential distortion is a relatively small price for increased administrability.

In order to give effect to our recommendation, we would propose that the first part of the NUBIG/NUBIL computation in Prop. Treas. Reg. § 1.382-7(c)(3) be amended to read as follows:

(3) Computation of net unrealized built-in gain and net unrealized built-in loss—(i) In general. A loss corporation’s net unrealized built-in gain, if positive, or net unrealized built-in loss, if negative, is the amount equal to —

(A) The amount that would be realized (taking into account section 382(h)(8)) if, immediately before the ownership change, the loss corporation had sold all of its section 382 assets, including goodwill, at fair market value to an unrelated third party that assumed all of its liabilities, ignoring contingencies; decreased by . . .

III. Computation of RBIG and RBIL

The Proposed Regulations diverge from the 1374 Approach in several material ways that have significant impacts on the computation of RBIG and RBIL. We discuss these considerations further below.

A. Departure from a Strict Accrual Standard

The 1374 Approach applied a fairly strict accrual standard to determine which items were built-in items on the change date. Consistent with the flush language of section 382(h)(2)(B), the 1374 Approach did depart from the accrual standard for depreciation, amortization, or depletion deductions allowable during the recognition period. The 1374 Approach also departed from the accrual standard for liabilities if payment of the liability constituted economic performance, although this exception was quite narrow and by definition applied only to RBILs.

The Proposed Regulations would create a broader exception from accrual accounting, treating as built-in items any deductions that would have been taken by an accrual method.

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92 We recognize that many of the concepts we discuss below concerning determinations of RBIG for purposes of section 382 have equivalent applicability in the context of section 384. That said, we welcome further discussion of the potential interplay of our recommendations in this letter with the development of further guidance under section 384.

93 Except as otherwise noted, this discussion assumes that the government adopts our recommendation that the NUBIG/NUBIL computation take into account the amount that would have been realized on a sale of all of the loss corporation’s assets to a buyer that assumed all of the loss corporation’s liabilities, ignoring contingencies.

94 See Notice 2003-65, 2003-2 C.B. 747, at § III.B.2.a.. The 1374 Approach also departed from the accrual standard in a few other respects, such as for deductions that were accrued but deferred under section 267.
taxpayer without taking into account “any taxable income or timing limitations.” For this purpose, the Proposed Regulations would define a “taxable income or timing limitation” as follows:

(i) A limitation set forth in the Code on the amount of a deduction that may otherwise be claimed by a loss corporation, based on, or derived from, any amount of a loss corporation’s taxable income (see, for example, section 170(b)(2)(A)); or

(ii) A limitation set forth in the Code that defers the timing of a deduction that is otherwise allowable under the Code or regulations (see, for example, sections 267(a)(2) and 469).95

Taxable income limitations described in clause (i) of this definition generally would apply only to RBILs. However, we anticipate that the limitation described in clause (ii) of this definition would apply equally to income and deduction items. While we acknowledge that items of deduction that are disallowed and deferred by a Code provision such as section 267(a)(2) or section 469 may be best treated as built-in items for purposes of section 382(h),96 we believe it is inconsistent with the Neutrality Principle to treat as built-in items only deductions that have been deferred and not income items that have been deferred. In fact, in many cases, including those described below, failing to include deferred income items creates inappropriate results. Accordingly, we recommend that the rule for RBIGs also incorporate items of income that are deferred due to a timing limitation, including those items discussed further below.

Mark-to-market adjustments. Various sections of the Code and Treasury regulations impose a mark-to-market method of accounting for specific items. For example, section 475 imposes mark-to-market accounting on dealers in securities and section 1256 imposes mark-to-market treatment for certain derivative contracts. Where an item is marked to market, the resulting gain or loss may be taken into account immediately or deferred for some period. In some cases, a mark-to-market changes the basis of the underlying asset.97 However, in other cases, the consequences of the mark-to-market regime do not result in an adjustment to the basis of the underlying security, but rather “proper adjustments” are made in the computation of gain or loss on the underlying securities to prevent double-counting.98 In the context of the consolidated return basis adjustment rules, Treasury and the Service have recognized that these adjustments are essentially equivalent to basis adjustments.99 We recommend that a similar rule be adopted here, taking into account pre-ownership-change adjustments under section 475 or similar provisions as equivalent to basis for purposes of the determination of RBIG or RBIL.

95 Prop. Treas. Reg. § 1.382-7(b)(12).
96 This outcome is in line with the rules of Treas. Reg. § 1.1374-4(b)(2) and (c)(1).
97 See, e.g., § 1296(b)(1) (providing an optional mark-to-market regime for certain foreign stock and for basis adjustments to account for such marks).
98 See, e.g., § 475(a)(2).
**Hedging transactions.** Treas. Reg. § 1.446-4 provides rules requiring taxpayers to account for hedges in a way that clearly reflects income by reasonably matching items of income, gain, deduction, and loss from the hedging transaction to the timing of income, gain, deduction, and loss from the items being hedged. One example of a method that is prescribed in certain situations (for example, hedging transactions that hedge aggregate risk) is the “mark-and-spread” method, where hedging transactions are marked to market periodically, but the gains and losses recognized on those marks (as well as realized gains and losses from hedging transactions) are spread over the remaining period of the aggregate risk that they hedge.\(^{100}\)

To the extent that the Proposed Regulations contemplate the treatment of items of loss or deduction deferred under the provisions of Treas. Reg. § 1.446-4 as RBIL, we recommend that, in keeping with the Neutrality Principle, the final regulations include the income and gain items deferred under those provisions as RBIG. Furthermore, because these hedging items are so closely tied to the performance of the underlying asset or liability, we recommend that, to the extent recognized in the same taxable year, gain or loss on a hedge be aggregated with gain or loss on a hedged item and only the net amount be taken into account as RBIG or RBIL, as appropriate.\(^{101}\)

**Prepaid income and costs to perform.** Treas. Reg. § 1.382-7 and Prop. Treas. Reg. § 1.382-7(d)(2)(vi) provide that prepaid income – *i.e.*, any amount received prior to the change date that is attributable to performance occurring on or after the change date – is not RBIG. If costs to perform are treated as a deductible liability included in the NUBIG/NUBIL computation and that give rise to RBIL, the failure to include prepaid income as part of the NUBIG/NUBIL computation and to treat prepaid income as RBIG is both inconsistent with the Neutrality Principle and distortive.\(^{102}\) Thus, to further the Neutrality Principle, we believe it is appropriate to include, on a netted basis, prepaid income and costs to perform as RBIG and RBIL, respectively, as these items are built-in items as of the change date.

For example, assume corporation C’s only asset is the advance payment of $100 it has received to perform certain services over the next two years. Assume the cost to perform under the contract is $90, meaning that economically C has net built-in income of $10. Under the Proposed Regulations, C’s NUBIG/NUBIL computation would start with the fair market value of its assets, or $100, and this amount would be reduced by $100 of basis. If the $90 of costs to perform are treated as a contingent or non-contingent deductible liability described in Prop. Treas. Reg. § 1.382-7(c)(3)(C) or (D), this would cause C to have a NUBIL of $90, despite the fact that C economically has net built-in income of $10 as of the change date.\(^{103}\) Consistent with

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\(^{100}\) See Treas. Reg. § 1.446-4(e).

\(^{101}\) If, however, the hedges are taken into account in a different taxable year from the hedged items, the full built-in gain or loss should be taken into account as RBIG or RBIL, consistent with our recommendation for prepaid income and cost to perform deductions.

\(^{102}\) A strict reading of Notice 2003-65 arguably results in the same distortive results described below.

\(^{103}\) Our recommendation that the NUBIG/NUBIL computation take into account the amount that would have been realized on a sale of all of the loss corporation’s assets to a buyer that assumed all of the loss corporation’s liabilities, ignoring contingencies, also does not correct this distortion. Under our proposal, someone buying all of C’s assets subject to C’s liabilities would have paid $10 for the assets plus liability assumption of $90. That amount (footnote continued on the next page)
the Neutrality Principle, the most appropriate result is for C to have a $10 NUBIG. This result would be obtained under the Proposed Regulations if both the prepaid income of $100 and costs to perform of $90 were taken into account as RBIG and RBIL items, respectively, that were reflected in the NUBIG/NUBIL computation.\footnote{In most cases, taxpayers will have costs to perform lower than associated revenue. That factor might suggest that taxpayers are generally advantaged by including these items. On the other hand, costs to perform are subject to strict economic performance standards, whereas prepaid income generally can be deferred for only one year. That outcome might mean that many taxpayers have already taken into account the income for tax purposes that is associated with future costs to perform. While these two factors may not balance, we nevertheless believe that this result is appropriate in light of the Neutrality Principle.}

An additional consideration is whether costs to perform and prepaid income should be netted for purposes of determining RBIG and RBIL or treated as separate items. Although RBIG and RBIL items generally are not netted, we believe that costs to perform and prepaid income are so inexorably linked that, for any particular taxable year, it would be appropriate to treat the net of the two items as RBIG or RBIL, as appropriate, for that year. Netting the two items prevents a taxpayer otherwise in a NUBIG position from recognizing RBIG in excess of the actual net built-in income as of the change date, and similarly prevents a taxpayer otherwise in a NUBIL position from recognizing RBIL in excess of the actual built-in deduction as of the change date. This outcome offers a more neutral result for taxpayers that are in a NUBIG or NUBIL position as a result of other items, as it prevents inclusion of only one side of the prepaid income and associated costs to perform as RBIG or RBIL.\footnote{If, however, prepaid income has already been included in taxable income and costs to perform are still deferred, we believe it is appropriate to treat all of the costs to perform during the recognition period as RBIL.}

\section*{B. Time Value Issue for Deductible Liabilities}

If the determination is made to revert to a NUBIG/NUBIL computation that begins with a value of the loss corporation’s assets obtained by adding the amount of liabilities to the stock value of the loss corporation,\footnote{The first component of the NUBIG/NUBIL computation in Notice 2003-65 is “the amount realized if immediately before the ownership change the loss corporation had sold all of its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities.” Notice 2003-65, 2003-2 C.B. 747, at § III.A. That component generally is viewed as referring to the cash consideration that would be paid for the assets (or, as a practical matter, the consideration that would be paid for all of the equity of the loss corporation) grossed up by liabilities.} the amount used for deductible liabilities may be largely irrelevant for purposes of that computation. Nevertheless, for a taxpayer in a NUBIL position, the amount of potential RBIL is an important issue.

realized of $100 would be reduced by $100 of basis and $90 of deductible liabilities (if costs to perform are deductible liabilities described in Prop. Treas. Reg. § 1.382-7(c)(3)(C) or (D)). This outcome again causes C to have a NUBIL of $90 despite C’s $10 of net built-in income as of the change date. Because Notice 2003-65 explicitly includes deductible liabilities in the NUBIG/NUBIL computation, but does not explicitly include items of income that would be taken into account on a hypothetical sale of all of the assets, this result arguably mimics the result provided by Notice 2003-65. That said, some practitioners have interpreted Notice 2003-65 as sufficiently flexible to include such items of income in the NUBIG/NUBIL computation.
For purposes of determining the amount that is an RBIL, we considered whether it would be appropriate to take into account only the present value of a built-in deduction item as of the change date. After considering several approaches, we recommend that only the present value of deductible liabilities be taken into account as RBIL. To accomplish this result, we further recommend that:

- With respect to deductible liabilities that are not contingent in timing or amount, an “interest” component be computed for such liability similar to section 483, and the amount of the liability taken into account for purposes of the NUBIG/NUBIL computation – and potentially giving rise to RBIL in the future – be limited to the “principal” component resulting from that computation.

- With respect to deductible liabilities that are contingent in timing or amount, we recommend using the amount of the liability reflected on an applicable financial statement (“AFS”) to determine the amount of such liability for purposes of the NUBIG/NUBIL computation, unless another method of determining the amount of the liability is more appropriate (for example, in the pension plan context, as discussed below). However, if and when any payments are made with respect to the contingent liability, such payments should be bifurcated into “principal” and “interest” components (again, similar to section 483), with only the principal component of such payments being treated as RBIL.

Further to the preceding point, we note that the Proposed Regulations include an operating rule for contingent liabilities that would provide that, if contingent liabilities are reflected on the face of an AFS, the value of the liabilities is deemed to be the amount shown on the AFS. We recommend that the final regulations expressly provide that, if a taxpayer has an AFS, only the contingent liabilities reflected on the AFS be taken into account for purposes of these rules (subject to the refinements offered below in Part III.C.2. in the pension plan context). Thus, for example, if a liability is not reflected on an AFS because it is too contingent or immaterial, taxpayers should be allowed to treat those liabilities as having a value

107 The interest component would need to be computed only where the liability in question did not already bear adequate stated interest.

108 This approach would be in keeping with the treatment of installment sales, where generally only the gain in the asset is treated as RBIG and the interest component of any installment payments is not. It also results in treating liabilities alike whether or not they bear adequate stated interest.

109 As set forth in the Proposed Regulations, the term “applicable financial statement” would be defined by reference to “section 451(b)(3) and the regulations in this part under section 451 of the Internal Revenue Code (determined without regard to whether the taxpayer has another statement described in section 451(b)(3) and the regulations in this part under section 451 of the Internal Revenue Code).” Prop. Treas. Reg. § 1.382-7(c)(3)(iii)(A).

110 See Prop. Treas. Reg. § 1.382-7(c)(3)(ii)(A). We note here that the references to “paragraph (c)(3)(i)(C)” in Prop. Treas. Reg. § 1.382-7(c)(3)(iii)(A) should be corrected to be references to “paragraph (c)(3)(i)(D)”.

111 Further, we believe that, in keeping with the Proposed Regulations, the contingent liabilities taken into account for this purpose should be those liabilities which, upon the removal of the contingency, the loss corporation would be allowed a deduction (including a deduction for a capital loss) for federal income tax purposes on payment or accrual.
of zero. Furthermore, in keeping with Prop. Treas. Reg. § 1.382-7(c)(3)(iii)(A), we recommend that, in the rare circumstance where a taxpayer does not have an AFS, that taxpayer need not take into account contingent liabilities for purposes of these rules.

C. Issues Related to Contingent Liabilities

The Proposed Regulations would include in the NUBIG/NUBIL computation and as potential RBILs the “estimated value of any liability of the loss corporation that is contingent immediately before the ownership change, for which, upon the removal of the contingency, the loss corporation would be allowed a deduction (including a deduction for a capital loss) on payment or accrual (determined without regard to any taxable income or timing limitation).”112

1. General Approach to Contingent Liabilities

As a general matter, subject to our discussion above in Part III.B., we acknowledge that certain contingent liabilities are properly taken into account as RBILs. For example, in a case where a tort liability has been incurred, but the ultimate amount for which it will be settled is not final, the final settlement amount is conceptually a built-in item. As with other deductible items, we think the corollary items of income – for example, the amount realized on settlement of a tort suit that would be included in taxable income – also should be RBIG.113

2. Certain Aggregate Liabilities (e.g., Pensions)

There are some contingent liabilities that are reflected on an AFS in the aggregate.114 We believe the most significant category of aggregated liabilities for purposes of section 382(h) is pension benefit liabilities attributable to qualified defined benefit plans (“DB Plan Liabilities”). Employers generally accrue DB Plan Liabilities for categories of employees or their employee base as a whole rather than for specific persons with specific anticipated liabilities. Furthermore, these liabilities are often by design underfunded. In other words, companies may only allocate funds equal to a portion of their anticipated future liabilities.

As an initial matter, we note that the qualified plan rules are generally intended to incentivize the formation and continuance of qualified plans by providing favorable tax treatment. Treating DB Plan Liabilities as giving rise to RBIL would operate contrary to this policy, as new owners after an ownership change would be less likely to continue an existing qualified defined benefit plan to the extent a contribution to that plan would constitute a limited RBIL. We also note that, for asset acquisitions, authorities support the treatment of contributions by the purchaser to a qualified plan formerly maintained by the target as deductible, even if the payments relate to services provided before the acquisition.115 This exception to capitalization


113 The amount of any contingent liabilities or income items should be reflected in the NUBIG/NUBIL computation.

114 We also note that the AFS frequently reflects as part of the liability amounts that are expected to be incurred in the future relating to future events and, therefore, is not an appropriate measure of current liabilities.

115 See, e.g., Tech. Adv. Mem. 8436002 (Mar. 23, 1984) (noting that “it is the position of the Service that an employee’s past service with a former employer may be taken into account by an employer making pension

(footnote continued on the next page)
(the normal rule for acquirer’s payment of target liabilities) supports the notion that qualified plan “liabilities” are distinguishable from liabilities more generally. Thus, consistent with the policy underlying the qualified plan rules and the distinction made in the asset acquisition context between qualified plan and other “liabilities,” it would be reasonable to conclude that no portion of the post-change contributions to a qualified defined benefit plan (with the possible exception of overdue minimum contributions) should be treated as RBIL.

If post-change contributions to a qualified defined benefit plan are treated as giving rise to RBIL, the amount of the built-in DB Plan Liability as of the change date also must be established. We understand that these liabilities are most commonly reported on GAAP-based AFS on the “projected benefit obligation method” or “PBO method,” which reflects the present value of vested and non-vested benefits earned by employees taking into account projected future increases in employee pay. An alternative is the “accumulated benefit obligation method” or “ABO method,” which is essentially a subset of the PBO method based on benefits without regard to future increases in employee pay. A third alternative, the “vested benefit obligation method” or “VBO method,” is a subset of the ABO method reflecting only the present value of vested benefits.

Although it is the most common measurement used on AFS, the PBO method may overstate the amount of built-in DB Plan Liabilities because it takes into account anticipated salary raises. Because an employer generally has the ability to freeze a plan at current participation rates, we suggest that the amount of liability associated with a plan that is treated as built-in on the change date be no more than the future costs assuming that the plan is frozen. Consistent with this point, we understand that, in the acquisition context, buyers sometimes value DB Plan Liabilities based on either the ABO method or the VBO method, which can be easily computed from workpapers, but which are not reflected on the AFS. Therefore, though we understand the desire to use AFS for most purposes, for purposes of calculating the amount of DB Plan Liabilities, we recommend that either the ABO method or VBO method be utilized.

Additionally, if post-change contributions to a qualified defined benefit plan are treated as giving rise to RBIL, a methodology would be necessary to determine the amount of the contributions that give rise to RBIL. As noted above, a qualified defined benefit plan will generally be underfunded to an extent by design. We understand that, in general, employers often attempt to maintain a consistent level of funding (but at a level below 100 percent). Taking into account these considerations, we recommend treating only a payment that results in an increase in the aggregate funding level as giving rise to RBIL. While we acknowledge that

contributions, and such employer may be allowed a Code section 404(a) deduction for such contributions”); see also Gen. Couns. Mem. 39274 (Aug. 16, 1984); Priv. Ltr. Rul. 7816063 (Jan. 23, 1978).

116 As noted above, under our proposal to determine the value of the loss corporation’s assets by adding the amount of liabilities to the stock value of the loss corporation, the amount used for DB Plan Liabilities should be largely irrelevant for purposes of the NUBIG/NUBIL computation, but still could be relevant for determining the amount of RBIL for a taxpayer in a NUBIL position.

117 For example, assume a taxpayer routinely contributes to its qualified defined benefit plan 80 percent of additional accrued liabilities. On the change date, assume the AFS accrual for DB Plan Liabilities is $500, while the funded amount of such liability is $400. In the first year following the change date, assume the AFS accrual for such contributions, and such employer may be allowed a Code section 404(a) deduction for such contributions”); see also Gen. Couns. Mem. 39274 (Aug. 16, 1984); Priv. Ltr. Rul. 7816063 (Jan. 23, 1978).

116 As noted above, under our proposal to determine the value of the loss corporation’s assets by adding the amount of liabilities to the stock value of the loss corporation, the amount used for DB Plan Liabilities should be largely irrelevant for purposes of the NUBIG/NUBIL computation, but still could be relevant for determining the amount of RBIL for a taxpayer in a NUBIL position.

117 For example, assume a taxpayer routinely contributes to its qualified defined benefit plan 80 percent of additional accrued liabilities. On the change date, assume the AFS accrual for DB Plan Liabilities is $500, while the funded amount of such liability is $400. In the first year following the change date, assume the AFS accrual for such contributions, and such employer may be allowed a Code section 404(a) deduction for such contributions”); see also Gen. Couns. Mem. 39274 (Aug. 16, 1984); Priv. Ltr. Rul. 7816063 (Jan. 23, 1978).
this solution may constitute an approximation,\textsuperscript{118} we do not believe it is appropriate to automatically treat any contributions to a pension fund as first satisfying pre-change unfunded pension liabilities and therefore as RBIL.

\textbf{D. \ The Proposed Regulations’ Underinclusive Approach to Liabilities}

By capturing only deductible liabilities that are deferred by an income or timing limitation, the Proposed Regulations fail to capture certain built-in items, discussed in greater detail below.

\textbf{1. Liabilities Giving Rise to Basis}

In certain instances, the Service has ruled that liabilities giving rise to basis are covered in the term “deductible liabilities.” For example, in Rev. Rul. 95-74,\textsuperscript{119} the Service concluded that liabilities that have not yet created or increased basis should be treated as deductible liabilities described in section 357(c)(3), and therefore excluded from section 357(c)(1). Similarly, although section 108(e)(2) literally applies to liabilities to the extent payment of the liability would have given rise to a deduction, section 108(e)(2) (and other principles under section 108) can be extended to cover liabilities that have not yet given rise to basis. Section 108(e)(2) is intended to exclude from COD expenses for which no tax benefit has been derived.\textsuperscript{120} Although the statutory language is limited to items of deduction, if section 108(e)(2) is intended to recognize the fact that a taxpayer has not yet recognized any tax benefit corresponding to the

\textsuperscript{118} In some cases, additional funding that does not increase the ratio can be associated with traditional built-in items. For example, if additional funding is needed because the value of the assets in the trust decreases, the additional funding could be tied to the pre-transaction contingent liabilities.

\textsuperscript{119} 1995-2 C.B. 36.

\textsuperscript{120} Specifically, the purposes of section 108(e)(2) is to place cash-method taxpayers and accrual-method taxpayers on the equal footing; that is, section 108(e)(2) is intended to prevent detriment to cash-method taxpayers where the cash-method of accounting has delayed their ability to deduct certain payment liabilities that have not been paid (\textit{i.e.}, “lost deductions”). H.R. REP. NO. 96-833, at 16 (1980); S. REP. NO. 96-1035, at 20 (1980); see also Pub. L. No. 96-589, Bankruptcy Tax Act of 1980.
otherwise deductible liability, liabilities that have not given rise to a tax benefit of additional basis may be excluded under the same rationale. 121

Given the conceptual similarity between deductible liabilities and liabilities that have not yet given rise to basis, we recommend that liabilities that will give rise to basis when properly taken into account should be taken into account in the same manner as deductible liabilities, i.e., as a reduction to NUBIG or increase in NUBIL. For purposes of RBIL, we note that the payment or accrual of these liabilities does not generally create an actual limited deduction, nor should it, since no immediate tax benefit is obtained by the creation of basis. To achieve neutrality between pre-change and post-change periods, and consistent with the five-year recognition period, we do not recommend that payment or accrual of a pre-change liability that gives rise to basis result in immediate RBIL. Rather, we recommend that, if basis is created in connection with such liabilities, the basis should be treated as pre-change basis for purposes of computing RBIG or RBIL on additional depreciation or amortization or on a later recognition event associated with the underlying asset.

2. Liabilities Associated with Off-Market Executory Contracts

Where a taxpayer is subject to an executory contract that requires the taxpayer to make above market payments, the excess of the obligation over the value to be received is generally thought of as a liability. For example, if a taxpayer has a rental obligation of $1,000 monthly on property whose fair market rental on the change date would be only $800 month, the first $800 of monthly rent represents payment for value received, while the excess $200 monthly obligation arguably represents a built-in loss. Similarly, if the contract requires the taxpayer to make below-market payments, the excess of the value to be received over the obligation is generally thought of as an asset.

We understand that there generally is no requirement to report under GAAP the extent to which an executory contract is above-market or below-market on an on-going basis. However, in the acquisition context, the acquirer’s GAAP AFS oftentimes will disclose (if material) the extent to which any executory contracts of the acquired target differ from the market rate. To the extent the AFS of a taxpayer or of its 50-percent or greater shareholder reflects a reasonably contemporaneous assessment122 of an off-market executory contract,123 we believe these amounts should be subject to the RBIG and RBIL rules.124 Although the Proposed Regulations

121 Cf. Treas. Reg. § 1.1001-2(a)(3) (“In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor’s basis for such property.”).

122 A workable standard for “reasonably contemporaneous” is if the AFS reflects a valuation that took place within one year leading up to the change date or if the next financial statement reflects a valuation done as a result of the ownership change.

123 Where the AFS shows the off-market component of an executory contract, the AFS generally will show both (i) the present value of the total payments to be made or received and (ii) the present value of the “asset” or “liability” resulting from the off-market component of the contract.

124 The amount of any asset or liability represented by above-market or below-market executory contracts should be incorporated into the NUBIG/NUBIL computation.
currently utilize AFS only to determine the amount of contingent liabilities, we recommend treating any contingent or non-contingent amounts relating to an above-market or below-market payment obligation pursuant to an executory contract and reflected on an AFS as follows:

- To the extent a taxpayer’s AFS reflects an “asset” resulting from an off-market executory contract, that asset should generate RBIG using an approach akin to the foregone amortization approach we describe below in Part IV. Thus, we recommend taking into account the value of this asset as RBIG ratably over the life of the contract.\(^{125}\)

- Alternatively, to the extent a taxpayer’s AFS reflects a “liability” resulting from an off-market executory contract, we believe that, consistent with our approach to an “asset” in the preceding bullet point, the value of that liability generally should be taken into account as RBIL ratably over the course of the payments made under the contract, with payments made by the taxpayer under the contract during the recognition period treated as RBIL to the extent of such amount.\(^{126}\)

- Furthermore, to the extent the AFS reflects an aggregate asset or liability related to off-market executory contracts (rather than contract-by-contract), we believe the treatment described above should apply on an aggregate basis (i.e., by treating all of the aggregated executory contracts akin to a single contract giving rise to a single asset or liability).

Inclusion on an AFS provides an administrable, objective measurement of the existence and amount of these items. While conceptually it would be appropriate to subject all executory contracts to the same treatment, it would be administratively burdensome to require a determination of the off-market component of all of a loss corporation’s executory contracts where such a determination did not already exist. Therefore, we recommend providing that off-market executory contracts give rise to RBIG or RBIL only where reflected on an AFS, as we believe that this approach offers a (much) more administrable rule.

**E. Bad Debt Deductions**

The Proposed Regulations diverge from the 1374 Approach for bad debt deductions in two material ways:

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\(^{125}\) For example, if a taxpayer is leasing property, and the taxpayer’s AFS reflected a $1,000 asset, representing below-market rental payments on a lease with five years remaining, the taxpayer would take into account $200 ($1,000 / 5 years remaining) of RBIG each year of the remaining lease period to the extent that period coincides with the recognition period.

\(^{126}\) For example, if a taxpayer is leasing property, and the taxpayer’s AFS reflected a $1,000 liability, representing above-market rental payments on a lease calling for 5 payments of $2,000, each $2,000 payment of rent by the taxpayer would generate $200 ($1,000 / 5 payments) of RBIL if the payment is made during the recognition period.

Conversely, we note that it may be problematic to apply RBIL concepts with respect to a lessor of property in a situation involving a below-market contract, as the lessor’s built-in loss is, in effect, taken into account through reduced income under the lease.
1. They dispense with the one-year limitation on bad debt deductions in favor of taking into account as RBILs relevant bad debt deductions in the full five-year period; and

2. They permit taxpayers to prove out of RBIL treatment if they can establish that the bad debt deduction was not attributable to an excess of basis over value on the change date.

With respect to the first point, we recommend that, for consistency purposes, the period during which bad debt deductions give rise to RBIL match the period during which COD can give rise to RBIG. Furthermore, we recommend that the period for both be the full recognition period. However, if the decision is made to retain RBIG treatment for COD for only one year, we recommend a similar treatment for bad debt deductions.

On the second point, we note the following example illustrates a potentially unintended result. Assume a lender with a portfolio of 10 loans outstanding with principal balance of $1,000 each, each of which, on the change date, has a 20 percent chance of defaulting and generating zero recovery. Furthermore, assuming that (i) there is an appropriate market rate of interest for each loan, and (ii) basis for each loan equal to the principal balance, the lender would have an aggregate basis of $10,000 in the loan portfolio, which would have an aggregate fair market value of $8,000. If, as anticipated, two of the loans default and result in zero recovery, the lender would recognize $2,000 of bad debt deductions. However, it appears that only $400 would be limited as RBIL. Accordingly, the full built-in loss could be recognized with only a fraction being treated as RBIL.

We acknowledge that the statutory language permits taxpayers to “prove out” of RBIL treatment on an asset-by-asset basis, but we suggest that consideration be given to including a rule requiring taxpayers in the business of lending money to treat certain categories of loans owned on the change date as a unitary asset for these purposes. Another way of phrasing a similar rule might be to dictate that, where a taxpayer reserves against a category of loans due to collectability concerns, the built-in loss in the category should be treated as attaching to any loan in the category, but that it cannot be accessed twice. Using the same example above, the loan portfolio would have an aggregate built-in loss of $2,000, which will attach to whichever loans become worthless. If only one loan becomes worthless, then the RBIL will be only $1,000. Moreover, if three loans become worthless, the RBIL will be capped at the $2,000 RBIL in the loan portfolio.

F. Recommended Treatment of Gain from the Sale of Stock and Dividends

The Proposed Regulations would add rules that exclude from RBIG certain items with respect to a loss corporation’s stock in another corporation, including stock of both a domestic corporation and a controlled foreign corporation (“CFC”).127 In particular, the Proposed Regulations would provide that a dividend paid to a loss corporation on stock it owns in another corporation (including gain on the sale of stock that is treated as a dividend under section 1248)

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127 Similar issues may arise with respect to a loss corporation’s stock in either a foreign corporation that is not a CFC or a domestic subsidiary that is not a member of the loss corporation’s consolidated group.
during the recognition period is not RBIG (the “Dividend Exclusion”), even if the loss corporation has a NUBIG and there is built-in gain in such stock immediately before the ownership change. On the other hand, gain recognized on the disposition of stock, other than gain recharacterized as dividend income under section 1248 (the “Section 1248 Exclusion”), generally would be treated as giving rise to RBIG to the extent of the built-in gain inherent in such stock on the change date.

The preamble to the Proposed Regulations reasons that the Section 1248 Exclusion is appropriate because such gain would give rise to a dividends-received deduction (a “DRD”) under section 245A equal to the amount of such gain, resulting in no net taxable income with respect to such amounts. Because no losses would be required to offset this item of income, Treasury and the Service determined that this income item should not give rise to RBIG. One might infer a similar rationale with respect to the exclusion of actual dividends from a CFC – section 245A generally would permit a DRD equal to the amount of such dividend, resulting in no net taxable income with respect to such amounts. The rationale supporting the Dividend Exclusion in other circumstances is not described in the preamble. However, Treasury and the Service requested comments regarding whether dividends paid on built-in gain stock should constitute RBIG, and whether final regulations should clarify the eligibility of other similar income items for RBIG treatment.

1. Gain on the Sale of Stock

We respectfully submit that the Section 1248 Exclusion from RBIG on the sale of CFC stock is inappropriate and should not be included in the final regulations. First, the assumption reflected in the preamble that such gain, once recharacterized as a dividend from the CFC to the loss corporation, would always give rise to a DRD in an equivalent amount is flawed. Second, the operative rule in the Proposed Regulations is not limited to circumstances where the DRD is available. Pursuant to section 246, certain limitations – including the holding period requirements in section 246(c) – will prevent certain “deemed dividends” pursuant to section 1248 from qualifying for the DRD. In such circumstances, the loss corporation will have taxable dividend income to the extent of its gain with respect to its sale of the stock of its CFC.

Where this DRD is unavailable for any portion of the deemed dividend under section 1248, we submit that such taxable income should be treated the same as any gain from the sale of an asset held on the change date notwithstanding that section 1248 would recharacterize this gain as dividend income. Consistent with the Neutrality Principle, such amounts should increase the loss corporation’s section 382 limitation to afford the loss corporation’s NOLs the same treatment as they would have if the stock of the CFC were sold prior to the change date. In circumstances where the DRD is available, it is appropriate that such


129 Presumably, the Section 1248 Exclusion would encompass a CFC’s sale of its stock in a subsidiary CFC that is recharacterized as a dividend from the subsidiary CFC to its parent CFC and taxed to the loss corporation as Subpart F income under section 964(e).
gain, which is effectively treated as tax-exempt income, should not increase the loss corporation’s section 382 limitation.\textsuperscript{130}

We also submit that this approach should apply to situations where the loss corporation recognizes Subpart F income under section 964(e) with respect to its CFC’s gain on the sale of lower-tier CFC stock. While this situation does not involve a sale of an asset directly owned by the loss corporation, it nevertheless involves an indirect sale of a portion of the loss corporation’s directly-held CFC stock. In this regard, it may be appropriate to consider the treatment of such amounts consistent with the discussion below regarding dividend distributions.

2. Dividends with Respect to Stock

Dividends may be distributed from either domestic or foreign corporations to a loss corporation following an ownership change with respect to stock that has a built-in gain on the change date. Domestic distributing corporations may be included in the distributee’s consolidated group, in which case a distribution would result in no income to the distributee and the basis of the distributor’s stock would be reduced.\textsuperscript{131} If the domestic distributing corporation is not included in the distributee’s consolidated group, the distributee may be entitled to a 100 percent, 65 percent, or 50 percent DRD under section 243, or no deduction at all (\textit{e.g.}, section 246 may deny the distributee corporation a DRD because the holding period requirement is not met). As described above, a dividend distribution from a CFC may entitle the distributee to a DRD, but that deduction will be unavailable in certain circumstances (\textit{e.g.}, the distributee does not satisfy the holding period requirements in section 246(c)). Otherwise, a dividend distribution from a foreign corporation may entitle the distributee to a 100 percent, 65 percent, or 50 percent DRD under section 245, or no deduction at all.\textsuperscript{132} Also, dividend distributions may cause the distributee’s basis in the distributor’s stock to be reduced under section 1059, including for non-pro rata redemptions under section 1059(e).

In all cases, where a dividend distribution from a distributing corporation to a loss corporation during the recognition period results in taxable income to the loss corporation (\textit{i.e.}, the dividend is not entirely offset by a DRD), the Neutrality Principle dictates that, to the extent of the sum of the distributing corporation’s pre-change earnings and profits (“E&P”) and its net pre-change gain in its assets, the taxable portion of the dividend results in RBIG in order to afford the same treatment with respect to the loss corporation’s NOLs for a dividend following the change date as the treatment afforded a pre-change dividend to the loss corporation.\textsuperscript{133}

Stated differently, one of the purposes of the NUBIG / RBIG regime is to avoid requiring a loss corporation to engage in self-help prior to the change date, such as causing the payment of a

\textsuperscript{130} Given that the built-in gain in the stock of the CFC is effectively included in the loss corporation’s NUBIG, it may be appropriate for Treasury and the Service to consider whether an adjustment in the remaining NUBIG is appropriate in an instance where that gain, when recognized, is effectively treated as tax-exempt income.

\textsuperscript{131} In this regard, separate rules in Treas. Reg. §§ 1.1502-91 through 1.1502-99 address these situations and are beyond the scope of the Proposed Regulations and these Comments.

\textsuperscript{132} See generally § 245(a), (b).

\textsuperscript{133} For a similar approach to an analogous problem, see section 1059(e)(2)(B).
pre-change dividend and/or the sale of the distributing corporation’s assets, in order to avail itself of its NOLs to offset such income. To the extent that post-change dividend distributions exceed the amount of pre-change E&P and net pre-change gain in the distributing corporation’s assets, such dividends should not result in RBIG, as that E&P could not be distributed to the loss corporation prior to the ownership change.

Further, assuming that the distribution reduces the value of the distributor’s stock, if the distributee is required to reduce its basis in the distributor’s stock by the full amount of the distribution, built-in gain in that stock would be preserved and a subsequent sale of the distributor’s stock would generate the same amount of gain (assuming no subsequent change in value of the stock). However, if the amount of the dividend is not entirely offset by a DRD, and the basis of the distributor’s stock is not reduced by the full amount of the dividend, the built-in gain may not be preserved in the distributor’s stock. There also may be certain circumstances where the loss corporation cannot force a pre-change dividend distribution with respect to its stock in another corporation (e.g., where the loss corporation owns a minority interest) and, therefore, the loss corporation’s only source of pre-change income is the gain on the sale of the stock. This outcome may suggest that the Neutrality Principle should limit the treatment of post-change dividends as RBIG to the pre-change gain in such stock.

Accordingly, we recommend that the final regulations provide that RBIG includes the taxed portion of a dividend (i.e., the dividend income that is not offset by a DRD) to the extent of the lesser of (i) the pre-change E&P of the distributing corporation, increased by the net built-in gain in the distributing corporation’s assets as of the change date, and (ii) the built-in gain with respect to the distributing corporation’s stock as of the change date.

IV. Foregone Amortization as a Proxy for an “Item of Income” for RBIG Purposes

As discussed in the preamble to the Proposed Regulations, under the 338 Approach, depreciation deductions on certain built-in gain assets give rise to RBIG, although actual recognition of gain or income may not have occurred.¹³⁴ This treatment follows from the premise that such built-in gain assets would have generated income in subsequent years as the asset wasted and, in the absence of an acquisition, such income could have been offset freely by the old loss corporation’s NOLs.¹³⁵ The 338 Approach prescribes a proxy for that excess income amount; specifically, the extent to which cost recovery deductions (disregarding bonus depreciation under section 168(k) in accordance with Notice 2018-30) under a hypothetical purchase of each asset at its current fair market value exceed actual allowable cost recovery deductions.¹³⁶ This proxy is commonly referred to as “foregone amortization.”

Although taxpayers have relied on the useful economic proxy provided through the treatment of foregone amortization as an item of RBIG for the last 16 years, Treasury and the

¹³⁵ Id. at 47464.
¹³⁶ Id.
Service have determined that this treatment of built-in gain assets is problematic for two reasons; specifically:

First, the schedules for cost recovery deductions were never intended to match the production of income from each asset; rather, they were intended to accelerate cost recovery to stimulate investment. Thus, this proxy is likely to, on average, overstate income created by those assets, further increasing NOL usage beyond the neutral baseline. Second, such an adjustment for income created by built-in gain assets is unnecessary, as it is already taken into account by section 382. Section 382 provides that the NOLs of the old loss corporation can be used by the new loss corporation up to the annual limit. This annual limit is equal to a prescribed interest rate multiplied by the value of the stock of the old loss corporation, and serves as a proxy for the income created by the assets of the old loss corporation. Thus, to the extent that the appreciated value of a built-in gain asset is reflected in the value of the stock, the general rule of section 382 allows for the NOLs of the old loss corporation to offset the flow of income created by that asset. Therefore, the treatment created by the 338 Approach creates a double benefit. By eliminating this treatment, the proposed regulations reduce the attractiveness of inefficient, tax-motivated acquisitions, which enhances economic efficiency.137

Consistent with the sentiment expressed in the preamble to the Proposed Regulations, Prop. Treas. Reg. § 1.382-7(d)(2)(i) provides as follows:

Except as otherwise provided in this paragraph (d)(2) and in paragraph (d)(4) of this section, subject to section 382(h)(1)(A)(ii), an item of income that is properly taken into account during the recognition period is a recognized built-in gain only if the item would have been properly included in gross income before the change date by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually elected that method). As a result, for example, cost recovery deductions on an appreciated asset claimed during the recognition period are not treated as generating recognized built-in gain.

As excerpted above, the preamble to the Proposed Regulations includes statements to the effect that (i) an adjustment for income created by built-in gain assets is unnecessary, as it is already taken into account by section 382, and (ii) to the extent that the appreciated value of a

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137 Id. (excerpted from Special Analyses, Part I.C.2, Economic Analysis of Proposed Regulations – Making the 1374 Approach Mandatory).
built-in gain asset is reflected in the value of the stock, the general rule of section 382 allows for the NOLs of the old loss corporation to offset the flow of income created by that asset. Significantly, these statements fail to account for the fact that the base limitation under section 382 reflects the perceived risk-free rate of return on assets, and, therefore, is not a proxy for the expected economic return on the assets.138 Rather, Congress intended to capture the economic return on the assets by way of section 382(h)(6)(A). Stated differently, if the base section 382 limitation were sufficient to account for the items of built-in gain and income, there would be no need for section 382(h). In this regard, it is important to note that the risk-free rate of return on the assets in question is not a component of the expected economic return. For example, if an asset with a zero basis and a fair market value of $100 wastes over five years, the foregone amortization uplift in the determination of RBIG would be $100; however, the asset would not have a fair market value of $100 unless the expectation was that the asset would generate $100, plus an amount of yield equal to prevailing returns. Thus, the overall economic return would be $100 plus the additional yield. Because that additional yield is not captured in the determination of RBIG, it follows that the risk-free rate of return, which would be part of that additional yield, is not duplicated.

A. Recommended Treatment of Foregone Amortization

For the reasons discussed below, we recommend that Prop. Treas. Reg. § 1.382-7(d)(2)(i) be amended to include foregone amortization as an “item of income” taken into account in the determination of RBIG.

1. Application of the Neutrality Principle Demands a Balanced Approach to the Determination of RBIG and RBIL

As we discussed above, in administering this area, Treasury and the Service have always sought to give full effect to the Neutrality Principle.139 Under the Neutrality Principle, the built-in gains and losses of a loss corporation, once recognized after an ownership change, generally are treated in the same manner as if they had been recognized before the ownership change. For example, the Neutrality Principle directs the outcome that RBIL be limited in the same manner as a pre-change NOL carryforward or net capital loss carryforward. Similarly, in the built-in gain context, the Neutrality Principle dictates that section 382-limited losses be freely usable against RBIG because, had the gain been taken into account before the ownership change, use of the loss would not have been subject to (that is, limited by) section 382. The Neutrality Principle further directs that built-in items of income and deduction be treated consistently, i.e., if a

138 See, e.g., H.R. REP. No. 99-426, at 258 (1985) (“The committee concluded that the use of the long-term rate for Federal obligations, converted to a tax-exempt rate, was justified as the maximum risk-free rate of return a loss corporation could obtain in the absence of a change in ownership.”); see also S. REP. NO. 99-313, at 233 (1986) (similar statement).

139 Notice of Proposed Rulemaking, Regulations Under Section 382(h) Related to Built-In Gain and Loss, 84 Fed. Reg. 47455, 47459 (Sept. 10, 2019) (“[I]n administering this area, the Treasury Department and the IRS have always sought to implement a guiding principle discussed in the section 382 legislative history, which is commonly referred to as the ‘neutrality principle.’”)

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deduction item is treated as RBIL, the mirror income item should be treated as RBIG, and vice versa.\textsuperscript{140}

As is the case for section 382(h) generally, the rules under section 382(h)(6) are intended to preserve neutrality between pre-change date and post-change date transactions. Income items recognized prior to the change date may have been freely offset with pre-change losses; thus, if those same income items were recognized after the change date, the Neutrality Principle requires that pre-change losses be allowed to freely offset it. RBIG treatment accomplishes this effect.\textsuperscript{141} Similar logic applies with respect to deduction items.

As presently drafted, the Proposed Regulations need greater balance between RBIG and RBIL determinations. A balanced approach to RBIG and RBIL determinations is grounded in the Neutrality Principle and previous guidance from the Service. For example, prior to Notice 2003-65, the Service addressed the application of section 382(h)(6) to a broad range of income and deduction items, including:

- COD not excluded under section 108 that arose in a transaction resulting in an ownership change (held attributable to the pre-change period);\textsuperscript{142}
- Deductions arising from the funding of retiree benefits (same);\textsuperscript{143}
- Deductions arising from the exercise of stock options issued before the change date (same);\textsuperscript{144}

\textsuperscript{140} \textit{Cf.} STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 320 and 320 n.36 (1987) (recognizing that, following the amendments made to section 382 by the Tax Reform Act of 1986: “Depreciation deductions cannot be treated as accrued deductions or built-in losses . . . . Similarly, section 382 does not provide relief for built-in income other than gain on disposition of an asset.”); Tech. Adv. Mem. 200217009 (Dec. 4, 2001) (“The juxtaposition of the footnote with the statement of Congressional position regarding depreciation deductions arguably suggests that income and deductions from wasting assets should be treated similarly.”); IRS Field Service Advice 1998-415 (July 8, 1993) (“Although Congress did not delineate the types of income subject to I.R.C. section 382(h)(6)(A), it did indicate, by enacting I.R.C. section 382(h)(2), in the flush language, that depreciation is a deduction treated as recognized built-in loss. Under I.R.C. section 382(h)(2), post-change depreciation that is attributable to pre-change built-in loss is treated as recognized built-in loss. \textit{The flip side to this situation is that post-change income attributable to pre-change depreciation, which generated the built-in gain, should be treated as recognized built-in gain.”} (emphasis added)), reprinted in 98 TNT 229-58 (LEXIS, FEDTAX Library, TNT File).

\textsuperscript{141} As noted in the preamble to the Proposed Regulations, “these rules exist to implement the ‘neutrality principle’ underlying the statute . . . . Under this principle, the built-in gains and losses of a loss corporation, if recognized during the recognition period, generally are to be treated in the same manner as if they had been recognized before the ownership change.” Notice of Proposed Rulemaking, Regulations Under Section 382(h) Related to Built-In Gain and Loss, 84 Fed. Reg. 47455, 47455 (Sept. 10, 2019).


\textsuperscript{143} \textit{See, e.g.}, Priv. Ltr. Rul. 8902047 (Oct. 28, 1988).

\textsuperscript{144} \textit{See, e.g.}, Priv. Ltr. Rul. 9444035 (Aug. 5, 1994).
• Prepaid income items that had been deferred pursuant to Rev. Proc. 71-21 (not attributable to the pre-change period);\(^{145}\) and

• Income derived from the licensing of software (attributable to the pre-change period where the corporation’s loss carryovers were attributable to expenditures incurred in the software’s development).\(^ {146}\)

Items of deduction or loss treated as RBIL under the approach of Prop. Treas. Reg. § 1.382-7(d)(3) provide a ready framework for identifying corresponding items of income or gain that ought to be treated as RBIG. In this regard, Prop. Treas. Reg. § 1.382-7(d)(3)(v) would direct that the payment of a contingent liability, i.e., a liability described in Prop. Treas. Reg. § 1.382-7(c)(3)(i)(D), is RBIL to the extent of the estimated amount of the liability immediately before the ownership change that is included in the loss corporation’s NUBIG/NUBIL computation. The analog to the treatment of contingent liabilities as RBIL would be to treat contingent income as RBIG. Contingent income is income that may be generated by built-in gain assets. That contingent income could be identified by tracing or, as described below, by foregone amortization. Taking into account foregone amortization as an item of RBIG is effectively the converse of the treatment that would be provided to contingent liabilities under Prop. Treas. Reg. § 1.382-7(d)(3)(v). In addition, this approach is symmetrical with the treatment afforded actual cost recovery deductions on depreciable, depletable, or amortizable assets that have an unrealized built-in loss on the change date.\(^ {147}\)

Importantly, our recommended approach also avoids the administrative burden associated with tracing income by presuming that an asset annually generates an amount of income equal to the cost recovery deduction that would have been allowed if the loss corporation had purchased the asset on the change date for its change-date value.\(^ {148}\) Notwithstanding the increased level of precision that a tracing approach may provide to the determination of RBIG, in our estimation, the necessary amount of time, additional expense, and other administrative considerations associated with an approach that applies a tracing mechanism to identify items of income that constitute RBIG makes such an approach appreciably less feasible than our recommended

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\(^{145}\) See, e.g., Tech. Adv. Mem. 199942003 (Oct. 22, 1999). Pursuant to Rev. Proc. 71-21, 1971-2 C.B. 549, the taxpayer had elected to defer reporting of the prepaid income until the time of performance. Although the Service’s rationale is not articulated, it may have believed the income was solely attributable to the post-change period because the services with respect to which the payments were received had been provided after the ownership change.

\(^{146}\) See, e.g., IRS Field Service Advice 1998-415 (July 8, 1993), reprinted in 98 TNT 229-58 (LEXIS, FEDTAX Library, TNT File). We refer to this Field Service Advice as the “1993 FSA.”

\(^{147}\) See § 382(h)(2)(B) (flush language); Prop. Treas. Reg. § 1.382-7(d)(3)(iii).

\(^{148}\) In addition to avoiding the burden of tracing, foregone amortization is focused on expectations regarding income generation at the time of the ownership change, which is the relevant time at which to create no tax incentives or disincentives, and is similar to the regime with respect to the determination of the annual section 382 limitation. The risk-free rate of return based on equity value on the change date may end up exceeding, or being less than, the actual return, but there is no requirement that taxpayers prove actual yields in order to use their section 382 limitation.
approach of treating foregone amortization as an item of RBIG. However, as discussed further below, we recommend specific modifications to the determination of foregone amortization in order to make such amount more reasonable from an economic perspective.

2. **Wasting Assets Do Not Have To Be Disposed of To Generate Income**

In general, a “wasting” asset is an asset that tends to decline in value over its expected life. As previously recognized by the United States Tax Court, “the gradually disappearing value of a wasting asset cannot be replaced except by periodic depreciation adjustments.” In keeping with this reasoning, the United States Court of Appeals for the Eighth Circuit has explained the rationale of the depreciation deduction as follows:

This allowance for depreciation is intended to provide a nontaxable fund to restore income-producing assets at the end of their useful life and their capacity to produce income has ceased or to allow a taxpayer to recoup his investment in wasting assets free of income tax.\(^{151}\)

We believe that it is appropriate to treat certain built-in gain assets as generating RBIG even if they are not actually disposed of during the recognition period. Specifically, in the case of a wasting asset, a “disposition” may be considered to occur through the use or consumption of the asset. For example, an asset’s value may decline on account of functional obsolescence or physical depreciation, such that, at the end of the asset’s economic life, its value is no more than salvage value. In addition, the Code may treat an asset as wasting – e.g., goodwill – and, therefore, allow cost recovery deductions for that asset.\(^{152}\) This phenomenon is illustrated by the example that follows below:\(^{153}\)

_Example._ Corporation S has one asset with a basis of $0 and a value of $100. Corporation P buys all the stock of S for $100, and P and S elect to file consolidated returns. S

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149 Cf. IRS Non-Docketed Service Advice Review dated Nov. 3, 2014 (“It is difficult to demonstrate that any income earned in the post-change period is directly attributable to an expense from a pre-change period. To do so, TAXPAYER would have to trace any income earned from the LOSS CORP I/P directly to expenses incurred in creating the I/P. This tracing methodology would require TAXPAYER to demonstrate that the PCT payment is only for the use of the I/P and that the payment accurately captures the expense of creating the I/P plus some profit margin. TAXPAYER has not presented any facts to support its position. Instead, because tracing is such a difficult exercise, the Service has allowed taxpayers to treat certain income earned from the consumption or wasting of assets as RBIG in Notice 2003-65.” (emphasis added)), available on Westlaw at 2015 WL 2296613.

150 Currier v. Commissioner, 7 T.C. 980, 984 (1946).


152 Principally for this reason, we believe that goodwill, (and, more generally, amortizable section 197 intangibles (as defined in section 197(c) and Treas. Reg. § 1.197-2(d))) should be treated as wasting assets for purposes of these rules.

uses the asset in business operations. The asset earns $20 and declines in value by $20 in each year over a five-year period. Under the investment adjustment rules, P’s basis in the stock of S is increased by S’s $100 of income to $200, but the value of S remains $100, and P may recognize a loss of $100 if P sells the S stock. Both in this fact pattern, and in a fact pattern where the asset is sold, disallowing P’s $100 loss eliminates the possibility that investment adjustments caused by S’s recognition of built-in gain, whether from dispositions or operations, results in elimination of the gain.

A comparable analogy exists for corporations in the services sector and the technology sector because they frequently possess significant intangible assets with high values and little or no tax basis due to the fact that the costs incurred in creating those intangible assets historically have been deductible (frequently contributing to a pre-change loss). In its technical explanation of the Tax Reform Act of 1986, the Staff of the Joint Committee on Taxation cited “special tax provisions that accelerate deductions or defer income” as among the reasons for a loss corporation with assets having an unrealized built-in gain to be permitted to offset that gain by pre-change losses. This fact pattern is common in the services sector and the technology sector. These companies do not typically dispose of their intangibles; rather, they generate income by exploiting those intangibles. Accordingly, the recognition of the income derived from those intangibles with pre-change losses is consistent with the policies of section 382(h) and, as discussed above, the reasoning applied by the Service in the 1993 FSA. In the 1993 FSA, the taxpayer generated significant NOLs based on expenses developing computer software. The taxpayer underwent an ownership change and then licensed the software, generating income. The taxpayer took the position that the income earned from the license of its software represented RBIG. The Service explained that:

[T]he software development costs essentially generated both the NOLs and the licensing income. Moreover, it is undeniable that pre-change value created by such software costs is being exploited (realized) by the licensing of such software. Finally, although licensing of the use of software may not be a disposition in a strict tax sense, in an economic sense it approaches being a disposition.

In addition, the 1993 FSA notes that, under section 382(h)(2), post-change depreciation that is attributable to pre-change built-in loss is treated at RBIL and that “the flip side to this

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155 See, e.g., Rev. Rul. 92-80, 1992-C.B. 57 (advertising costs are generally deductible); Treas. Reg. § 1.197-2(k), Ex. 1.
156 Tech. Adv. Mem. 2002-17009 (Dec. 4, 2001) distinguished (and arguably retreated from) the 1993 FSA by concluding that income attributable to wasting assets was not addressed by section 382(h)(6) and not properly treated as RBIG; however, Notice 2003-65 implicitly rejected the position expressed in Tech. Adv. Mem. 2002-17009.
157 1993 FSA.
situation is that post-change income attributable to pre-change depreciation, which generated the built-in gain, should be treated as [RBIG].”\textsuperscript{158} Based on that assertion, the Service concluded that “[a] court is likely to conclude that the income from the license agreements is attributable to the pre-change [NUBIG] and therefore should be treated as [RBIG] . . . .”\textsuperscript{159}

3. A Tracing Approach Would Be Difficult To Administer

Under a tracing approach, taxpayers would be required to identify specific items of income that were directly attributable to built-in gain assets. An easy example would be a licensable asset, where all costs required to monetize the value of the asset have occurred prior to the ownership change and no further expenses would be required after the change. More difficult would be a situation where, although the asset has significant built-in gain, additional expenses are incurred after the ownership change.

Although a tracing approach likely would be the most precise method to identify RBIG, Treasury and the Service have rejected the adoption of such an approach in other contexts because of the administrative burdens that tracing would place on both taxpayers and the Service. For example, in the preamble to the proposed regulations under Treas. Reg. § 1.1502-36, Treasury and the Service noted their difficulty in administering a tracing regime under Treas. Reg. § 1.337(d)-2 as follows:

[T]he IRS and Treasury Department have again, as in 1990, concluded that tracing is not a viable method for preventing the circumvention of GU repeal in consolidation. This conclusion, while arguably based on theoretical concerns in 1990, is now based on several years of administering § 1.337(d)-2 (in both its temporary and final form) as a tracing regime. The IRS found that the difficulties encountered, by taxpayers and the government alike, in administering § 1.337(d)-2 as a tracing-based rule were overwhelmingly greater than those encountered in administering it as a presumption-based rule.\textsuperscript{160}

The preamble to those proposed regulations also explains that:

The most problematic aspect of tracing, however, has typically been establishing the connection, or lack thereof, between items taken into account by the group and particular amounts of tainted appreciation. . . . If tainted appreciation is recognized as income earned through the wasting or consumption of the appreciation, instead of as gain on the disposition of the asset, there are

\begin{footnotesize}
\begin{enumerate}
\item[158] Id.
\item[159] Id.
\end{enumerate}
\end{footnotesize}
additional difficulties. In those cases, tracing is possible only if the tainted appreciation generates an identifiable stream of income. However, this is frequently not the case. For example, intangible assets, like patents or goodwill, are the source of significant tainted appreciation and they typically do not generate identifiable income streams.\textsuperscript{161}

Accordingly, because (i) we believe that it is appropriate to treat wasting assets as generating RBIG, and (ii) a tracing approach is very likely to prove unadministrable, we recommend allowing foregone amortization as a proxy for an item of income for RBIG purposes.

4. Ample Authority Supports the Treatment of the Consumption of Change Date Built-in Gain of a Wasting Asset as RBIG

The “loss disallowance rule” of Former Treas. Reg. § 1.1502-20 – the principal tenets of which have been embodied in the “unified loss rule” of Treas. Reg. § 1.1502-36 – directly supports treating foregone amortization as RBIG. The primary focus of the loss disallowance rule was to prevent investment adjustments attributable to RBIG from creating an “artificial” loss in the stock of a subsidiary and reflected Treasury and the Service’s attempt to distinguish economic losses from losses attributable to RBIG. As relevant here, the preamble to the temporary regulations concerning loss disallowance specifically addressed Treasury and the Service’s concern with RBIG in the context of the investment adjustment rules.\textsuperscript{162} For example, Example 2 in the preamble to those temporary regulations provides as follows:

Corporation S has one asset with a basis of $0 and a value of $100. Corporation P buys all the stock of S for $100 and P and S elect to file consolidated returns. S then sells the asset for $100 and recognizes gain of $100. Under the investment adjustment rules, P’s basis in the stock of S is increased to $200 because the sale of the asset generated $100 of earnings and profits to S. This basis increase permits P to recognize a loss of $100 if P sells the S stock, thus offsetting the gain on the sale of the asset.\textsuperscript{163}

The preamble to the temporary regulations then states that:

[T]he increase in the basis of P’s stock in S is inconsistent with the repeal of the General Utilities doctrine. The failure to require the P group to fully account for S’s recognized built-in gain in effect permits the elimination of corporate-level tax on this gain, because the increase in P’s basis for the S stock is attributable to S’s

\textsuperscript{161} Id.

\textsuperscript{162} T.D. 8294, Consolidated Return Regulations; Special Rules Relating to Dispositions and Deconsolidations of Subsidiary Stock, 1990-1 C.B. 66.

\textsuperscript{163} Id. at 68.
recognition of built-in gain (gain already reflected in P’s cost basis for the S stock) and not to earnings that increase S’s value. Moreover, P’s loss does not represent an economic loss of either P or S.164

The preamble to the temporary regulations further states that, “the problem is not limited to dispositions of built-in gain assets, **but also arises when built-in gain assets are consumed.**”165 The preamble next provides an example of how income from assets that are consumed in the operation of the business should be considered RBIG for purposes of the investment adjustment rules. Specifically, Example 3 states:

The facts are the same as in Example 2, except that S uses the asset in business operations rather than selling it. The asset earns $20 and declines in value by $20 in each year over a 5-year period. As in Example 2, P’s basis in the stock of S is increased by the earnings to $200, but the value of S remains $100 and P may recognize a loss of $100 if P sells the S stock.166

The preamble to those temporary regulations concludes by stating that, “in Examples 2 and 3, disallowing P’s $100 loss eliminates the possibility that investment adjustments caused by S’s recognition of built-in gain, **whether from dispositions or operations,** will result in elimination of the gain. Disallowing P’s loss therefore gives effect to General Utilities repeal by assuring that a corporate-level tax will be imposed on S’s recognized built-in gain.”167

Although Treasury and the Service withdrew the temporary loss disallowance regulations and, in their place, issued proposed regulations,168 the preamble to the proposed regulations plainly states that income from wasting assets would be treated as recognized built-in gain for purposes of the loss disallowance rules; specifically, the preamble provides as follows:

A number of commentators proposed that the loss disallowance rule be revised to disregard investment adjustments attributable to the consumption of built-in gain assets through operations ("wasting assets") . . . . The revised rules do not adopt this proposal, and all positive investment adjustments are taken into account (whether from dispositions or consumption of wasting assets). **Consumption of wasting assets is not outside the scope of General Utilities repeal because dispositions and consumption may produce identical investment adjustments, as illustrated by**

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164 *Id.*

165 *Id.* (emphasis added).

166 *Id.*

167 *Id.* (emphasis added).

Examples (2) and (3) in . . . [the temporary regulations’] preamble. Failing to take wasting assets into account would treat taxpayers in similar economic circumstances differently.169

The preamble to those proposed regulations further states that, “all positive adjustments are presumed to be attributable to built-in gain, including built-in gain recognized through the wasting of built-in gain assets.”170

The preamble to the final loss disallowance regulations provides that, “if an asset is amortizable or depreciable, its built-in gain may be recognized through consumption as well as disposition . . . . If E&P171 depreciation and amortization are not taken into account, the group that consumes assets through production would be in a better position than the group that sells assets.”172 This position, the treatment of income from wasting assets as RBIG, was incorporated into the loss disallowance rules in Former Treas. Reg. § 1.1502-20(c)(1)(ii).

Overall, Treasury and the Service have equated consumption with dispositions in the preamble discussions of multiple Treasury regulations. These discussions amply justify the treatment of foregone amortization as an item of income that constitutes RBIG.

Authority also exists to support the interpretation of the phrase “attributable to” in section 382(h)(6)(A) as treating income from the consumption of change date built-in gain of a wasting asset as RBIG. For example, in Lawinger v. Commissioner,173 the United States Tax Court determined the common meaning of the phrase “attributable to” in the following manner:

The term “attributable to” has no particular technical significance under the tax laws; nowhere in the Internal Revenue Code is such term defined. The phrase “attributable to” is used, and has been interpreted, in various tax and non-tax contexts. Under the definition of collapsible corporation under section 117(m) of the 1954 Code, the Supreme Court interpreted “attributable to”, in the phrase “attributable to such property”, as “merely [confining] consideration to that gain caused or generated by the property in question”. Braunstein v. Commissioner, 374 U.S. 65, 70 (1963). In interpreting the statutory language of section 165(i)(3) of the 1954 Code (prior to its repeal by Pub. L. No. 91-677) that governs the ability of taxpayers to claim refunds or credits for property expropriated by the Government of Cuba, the U.S. District Court for the Southern District of Mississippi held that the normal

169 Id. at 699 (emphasis added).
170 Id. (emphasis added).
171 In general, prior to 1995, the investment adjustment rules were linked to the subsidiary’s E&P.
meaning of one thing to be attributed to another is that one thing is caused or brought about by that other thing. Ogden v. United States, 432 F. Supp. 214, 216 (S.D. Miss. 1975) (citing Webster’s Third New World Dictionary), aff’d, 555 F.2d 134 (5th Cir. 1977). These interpretations are based on the conclusion that “attribute” or “attributable” connotes causation. See National Association of Greeting Card Publishers v. United States Postal Service, 462 U.S. 810, 823 (1983); Watson v. Employment S.E.C. Comm’n of North Carolina, 432 S.E.2d 399, 401 (N.C. Ct. App. 1993) . . . . Thus, the plain meaning of “attributable to” is simply due to, caused by, or generated by.\footnote{\textit{Ogden v. United States}, supra, 432 F. Supp. 214, 216.}

The interpretation of “attributable to” in this manner results in utilization of pre-change loss consistent with the policies of section 382 by affording taxpayers maximum ability to take into account the economic return on assets sought to be captured by section 382(h)(6)(A).

We also note that section 1374 contains the same “income attributable to a prior period” language that is used in section 382(h)(6)(A). In the context of “C” to “S” conversions, section 1374 addresses the issue of “recognized built-in gain” by imposing a tax on the income of an S corporation arising from pre-S election built-in gains recognized on the disposition of an asset provided certain conditions are met; specifically, section 1374(d)(5)(A) provides that:

\[
\text{[A]ny item of income which is properly taken into account for any taxable year in the recognition period but which is attributable to periods before the first taxable year for which the corporation was an S corporation is treated as a recognized built-in gain for the taxable year in which it is properly taken into account.}
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Notably, the legislative history describing this provision provides as follows: “Thus, the term ‘disposition of any asset’ includes not only sales or exchanges \textit{but other income recognition events that effectively dispose of or relinquish a taxpayer’s right to claim or receive income.}”\footnote{\textit{H.R. Rep. No. 100-795}, at 63 (1988) (emphasis added).}

While the section 1374 regulations ultimately adopted an accrual model to determine recognized built-in gain, the section 382 regulations do not need to follow this approach for several reasons:

- First, the preamble to the proposed regulations under section 1374 makes clear that the approach was based on administrability for both S corporations and the Service. Specifically, the preamble to those proposed regulations states that that “[t]he accrual method is used to implement section 1374(d)(5), because valuing items of income

\footnote{\textit{Id. at 435.}}

and deduction on the first day of the recognition period would be *unduly burdensome both for S corporations . . . and for the Service.*”

- In addition, the preamble to the final regulations under section 1374 provides that, “[t]he Treasury and the IRS believe that separately valuing each item of income and deduction for net recognized built-in gain purposes would be unduly burdensome both for taxpayers and for the IRS . . . . Accordingly, the final regulations . . . retain the accrual method rule in the proposed regulations.” That preamble further states that “[t]he accrual method rule in the proposed regulations was adopted as an administrable method for both taxpayers and the Service to determine the extent to which an amount included in income or deducted in the recognition period is attributable to the pre-recognition period.”

- Finally, the preamble to the proposed regulations under section 1374 states that, “[t]he Treasury Department and the Service *intend no inference regarding rules they may adopt in other regulations, such as under sections 382(h)(6) . . . which contain language similar to section 1374(d)(5).*”

5. **Allowing Foregone Amortization as a Proxy for an Item of Income for RBIG Purposes Is Intended To Prevent Taxpayers from Engaging in Self-Help**

In the absence of allowing foregone amortization as a proxy for an item of income for RBIG purposes, taxpayers are likely to engage in self-help in order to trigger RBIG. For example, we believe it likely that taxpayers will seek to recognize gains during the recognition period through transactions such as (i) sale-leaseback arrangements, (ii) structured sale transactions (inside and outside of consolidation), and (iii) taxable liquidations. Moreover, in bankruptcy settings, companies are likely to be forced by creditors to sell assets in “liquidating plans,” and will be more likely to execute “taxable” emergence transactions. This is contrary to the purpose of the rules under section 382(h)(6), which were intended to preserve neutrality between pre-change date and post-change date transactions so taxpayers did not have to engage in self-help.

6. **Conclusion**

In view of the foregoing discussion, we believe it is “necessary or appropriate” for Treasury and the Service to exercise their broad grant of regulatory authority under

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177 1995-1 C.B. 172.
178 *Id.*
179 1992-2 C.B. 595 (emphasis added). This statement appears to apply only to use of the accrual method.
180 In the context of a consolidated group, deferred intercompany gains that are recognized during the recognition period are treated as RBIG only if they are subsequently taken into account during the recognition period. See Treas. Reg. § 1.1502-91(h)(3); see, e.g., Treas. Reg. § 1.1502-13(c)(2)(ii), Ex. 10.
B. Method for Taking into Account Foregone Amortization as RBIG

We recommend that the method used to take into account foregone amortization as RBIG mirror the flush language of section 382(h)(2)(B) and the approach of Prop. Treas. Reg. § 1.382-7(d)(3)(iii); specifically, we recommend that the final regulations include a provision that reads as follows:

Foregone amortization.—With respect to any section 382 asset with an unrealized built-in gain on the change date, the loss corporation shall take into account recognized built-in gain for any taxable year during the recognition period to the extent that the loss corporation establishes that—

(A) The amount of the cost recovery deduction that would have been allowable with respect to such section 382 asset for that taxable year (disregarding any cost recovery provision that does not approximate the useful life of the asset, e.g., the additional first year depreciation allowed under section 168(k))—

(I) If the adjusted basis of the section 382 asset on the change date equaled its fair market value, and

(II) Taking into account the depreciation or amortization method (as applicable), the useful life, the recovery period or amortization period (as applicable), and the convention (cost recovery schedule) that would be used by the loss corporation if the section 382 asset were first placed in service on the change date, exceeds

(B) The greater of the amount of cost recovery deductions allowed or allowable for such section 382 asset with respect to the period.182

In order to compute the precise amount of foregone amortization, it is necessary to establish the amortization period that should be used in amortizing the built-in gain inherent in

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181 In this regard, we believe that section 382(m) affords Treasury and the Service full ability to direct this outcome by providing that: “The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section and section 383, including (but not limited to) regulations . . . .”

182 We also recommend that a corresponding annual approach to the determination of foregone amortization be adopted in the context of a consolidated group.
the change date assets of the loss corporation. Here, we believe that three reasonable methods could be used to determine the relevant amount of amortization: (i) using the applicable provision of the Code, i.e., “tax life;” (ii) using the depreciation schedule for E&P purposes under section 312(k); or (iii) determining the actual amount of wasting that has occurred. As relevant to the analysis of this issue, the Service made the following statements in the 1993 FSA:

We believe one reasonable method would to be to amortize the NUBIG over the life of the asset. This is analogous to the treatment that would be accorded a taxpayer making an election under IRC section 338 at the time of acquisition. The gain on the software recognized from such an election would have stepped up the basis of the software to its fair market value. This basis would then have been amortized over the life of the software.

In our estimation, this excerpt from the 1993 FSA underscores the approach to using “tax lives” and tax depreciation as the relevant measure of foregone amortization for two principal reasons:

- First, following a deemed asset sale, amortization would be determined under the applicable provision(s) of the Code.

- Second, the loss corporation’s income is computed under pertinent income tax accounting rules.

Additionally, compare two fact patterns, one where the corporation has goodwill with a zero basis and a fair market value of $10,000, and one where the corporation has goodwill with a basis and fair market value of $10,000. Assume that, in each case, the corporation will generate the same stream of income from the goodwill. In the latter case, the corporation’s income will be shielded in part through amortization. In the former case, the corporation’s income should be shielded by an equivalent amount of pre-change losses because such losses are likely attributable to expensing or prior amortization of the goodwill.

Accordingly, we believe that foregone amortization should be computed under the rules generally applicable to that system, using tax lives and tax depreciation.\(^{183}\) For example, section 197 provides for an amortization period of 15 years for certain intangible assets.\(^{184}\) Thus, in the case of an amortizable section 197 intangible, foregone amortization should be determined

\(^{183}\) Further, we have recommended that foregone amortization be determined by reference to the tax life that would be used by the loss corporation if the section 382 asset were first placed in service on the change date in order to address concerns associated with built-in gain assets that previously have been subject to depreciation, depletion, or amortization in the hands of the loss corporation and have little or no tax life remaining at the time of the ownership change.

\(^{184}\) Specifically, section 197(a) provides that a taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible.
by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which the change date occurs.185

Lastly, our approach to the determination of foregone amortization is not intended to impact the operation of any provisions of the Code that were added or amended by the Public Law 115-97 (the “Act”)186, e.g., sections 163(j), 172, 250, or 951A. Notably, the mechanism we have offered above does not utilize a deemed asset sale nor does it look beyond the intended treatment of foregone amortization as a proxy for an item of income for RBIG purposes. Thus, we do not believe that the narrow question we are seeking to resolve in this instance will have an immediate consequence beyond the contemplated impact on RBIG.

V. Treatment of Built-In COD

As discussed above, one of the primary changes in the Proposed Regulations is a fundamental reworking of the treatment of liabilities for purposes of calculating NUBIG, NUBIL, RBIG, and, in the case of contingent liabilities, RBIL. While the changes to the treatment of contingent liabilities are borne of broader concerns about ensuring that items treated as NUBIL are also treated as RBIL, the fundamental reworking of the treatment of liabilities appears to be primarily directed at loss corporations with liabilities in excess of the fair market value of the loss corporation’s assets, i.e., loss corporations with “built-in” COD.

As discussed in greater detail below, while we believe that the policy underlying the change in approach to built-in COD is justifiable, we believe that the better approach is to revert to the prior treatment of liabilities (with the modifications we suggest below). Overall, our recommended approach is intended to eliminate significant technical issues that arise under the Proposed Regulations. To the extent that our recommendation provides some benefit to troubled companies, it should be viewed as appropriately reflecting the generally more favorable approach section 382 applies to such companies.

A. Application of Statutory Language to Built-In COD

We acknowledge the Service’s focus on ensuring that there is a statutory basis for including any items, including built-in COD, in a determination of NUBIG or RBIG, and that the Proposed Regulations express concern that the treatment of built-in COD under Notice 2003-65 (described in further detail below) may be inconsistent with statutory authority. We submit that, even without the broad grant of statutory authority under section 382(m), the default position under the statute seems to include built-in COD – even COD that is excluded from taxable income under section 108(a).187 Further, because excluded COD can constitute an item of

185 However, we note that, as a general matter, section 197 intangibles decline in value faster than the 15-year amortization period afforded under section 197(a) (but for any replenishment in value through post-acquisition expenditures).


187 We agree with the conclusion in the preamble that COD that is not excluded from gross income under section 108(a) is an item of income for purposes of section 382(h)(6).
income under section 382(h)(6)(A), it can be included in the NUBIG/NUBIL computation pursuant to section 382(h)(6)(C).

Section 382(h)(6)(A) applies to an “item of income.” Section 61(a) defines gross income as “all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness.” Section 61(b) goes on to note that certain provisions of the Code, including section 108, contains “items specifically excluded from gross income,” and section 108(a) itself operates as an exclusion for items that “would be includable in gross income” by reason of cancellation of indebtedness. At first blush, the definition of gross income in section 61(a) may seem circular, but it is not. The only logical way to give effect to the distinction between “gross income” and “income” in these provisions is to acknowledge that “gross income” and “income” are distinct concepts, with “gross income” being a subset of “income.” Accordingly, section 382(h)(6) appears to at least contemplate taking into account items of “income” that are excluded from “gross income” as a result of another provision of the Code.

The Supreme Court has weighed in on the distinction between “gross income” and “income” in another context, and concluded that COD excluded under section 108(a) nevertheless constituted “income” for purposes of the S corporation basis adjustment rules.188 Congress subsequently amended section 108(d)(7)(A) to overturn the result in Gitlitz. However, Congress did not change anything about the statutory language that led to the Supreme Court’s nearly-unanimous decision, so it is difficult to avoid the conclusion that Gitlitz continues to control the general interpretative question of whether COD that is excluded from gross income pursuant to section 108(a) remains an “item of income” for other purposes of the Code.

Moreover, it is notable that COD that is excluded from gross income under section 108 is nevertheless treated as income for purposes of E&P calculations, unless the excluded COD reduces tax basis in assets.189 This treatment of excluded COD for E&P purposes is additional statutory evidence that excluded COD should be viewed as an economic item of income, despite the fact that Congress has chosen to assist bankrupt and insolvent companies through the enactment of section 108(a).

Accordingly, we believe that built-in COD that is excluded from taxable income can be treated as RBIG for purposes of section 382(h)(6)(A) and, accordingly, as increasing NUBIG (or reducing NUBIL) pursuant to section 382(h)(6)(C). In addition, this issue is not one merely of statutory authority; it is, more significantly, a policy issue. As we discuss below, we respectfully submit that neither Notice 2003-65 nor the Proposed Regulations has struck the right balance on this issue. We propose an approach that balances the “double benefit” concern expressed in the Proposed Regulations against administrability concerns and the appropriateness of providing insolvent companies with a modest non-economic benefit in this area.

189 See § 312(l).
B. **Treatment of Built-In COD Under Notice 2003-65**

As discussed above, Notice 2003-65 uses a straightforward methodology for purposes of the NUBIG/NUBIL computation; specifically, a sale of the loss corporation’s assets to a buyer assuming all of the loss corporation’s liabilities, followed by various adjustments to that baseline outcome. For loss corporations with liabilities in excess of the fair market value of the loss corporation’s assets, this approach resulted in a “floor” value equal to the loss corporation’s liabilities. This outcome followed even when the liabilities at issue were discharged in the transaction giving rise to the ownership change, and even when the built-in COD reduced pre-change tax attributes under section 108(b) or was eliminated as black-hole COD.

The treatment of built-in COD as RBIG did not mirror its treatment for NUBIG purposes. Under Notice 2003-65, COD that is included in income is treated as RBIG (subject to certain constraints), but excluded COD is not expressly treated as an amount of RBIG. Instead, Notice 2003-65 arguably created ambiguity regarding the inclusion of excluded COD in the RBIG calculation. Our recommended approach to built-in COD is intended to eliminate this ambiguity.

C. **Issues with the Approach to Built-In COD Under Proposed Regulations**

The Proposed Regulations adopt an approach to built-in COD that is much different than the approach set forth in Notice 2003-65 and appear to have two primary goals in mind: (i) consistency between NUBIG or NUBIL and RBIG or RBIL treatment of built-in COD items, consistent with the base-line statutory mandate in section 382(h)(6)(C); and (ii) avoiding undue “RBIG uplift” attributable to built-in COD, especially when excluded COD reduces pre-change tax attributes. Because the approach adopted by the Proposed Regulations has several technical deficiencies and is likely to lead to heavy administrative burdens, including valuation disputes,\(^\text{190}\) we believe that a change is warranted.

1. **Distinction Between Recourse and Nonrecourse Liabilities**

   As discussed above, the deemed sale construct that the Proposed Regulations apply to the NUBIG/NUBIL computation and the determination of RBIG draws a critical distinction between recourse and nonrecourse liabilities. For purposes of the NUBIG/NUBIL computation, assets that are subject to nonrecourse liabilities are essentially treated as having been foreclosed on, leading to a value equal to the amount of outstanding liabilities under *Tufts*.\(^\text{191}\) This approach leads to essentially the same result as Notice 2003-65 where only nonrecourse liabilities are involved, *i.e.*, the liabilities set a “floor” on value.

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\(^{190}\) Under Notice 2003-65, such valuation disputes arguably exist for contingent liabilities. However, as a practical matter, most contingent liabilities are taken into account when determining the amount realized in the deemed sale and then subtracted from NUBIG (or added to NUBIL) as a deductible item, eliminating the need to engage in a fact-intensive and highly subjective valuation exercise. We acknowledge that the valuation issues caused by the Proposed Regulations have always applied to non-deductible contingent liabilities. As a practical matter, this set of liabilities is fairly narrow and, from a dollars-at-issue perspective, usually comparatively minor.

This comparatively favorable treatment of nonrecourse liabilities is required to preserve neutrality. Under *Tufts* and Treas. Reg. § 1.1001-3, a pre-change foreclosure on assets subject to nonrecourse liabilities would, in fact, trigger taxable gain equal to the difference between tax basis and the amount of debt outstanding, without regard to the value of the asset. Any approach to built-in gain under section 382 must, therefore, permit a debtor to offset any such gain with pre-change losses on a post-change basis. However, the Proposed Regulations’ distinction between recourse and nonrecourse liabilities leads to several problems.

First, where a loss corporation has tax attributes other than tax basis that may be subject to reduction as a result of the application of section 108, the distinction incentivizes debtors that are facing a potential ownership change to cause their debts to be treated as nonrecourse debt for tax purposes. In this regard, the Service has issued guidance in recent years that seems to permit electivity between recourse and nonrecourse liabilities through the use of disregarded entity borrowers.

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192 We do not express a view, as a general matter, on this continued distinction in the law. Many commentators have advocated for a change in law more broadly on this issue, at least in the context of insolvent companies, and the distinction has been widely discussed. See, e.g., Henderson and Goldring, *Tax Planning for Troubled Corporations: Bankruptcy and Nonbankruptcy Restructurings* §§ 403.1.3, 404 (2017) (discussing consequences of recourse vs. nonrecourse distinction); Peaslee, *Disregarded Entities and Debt Modifications*, *Tax Notes* 1145 (Mar. 7, 2016) (evaluating the distinction between recourse and nonrecourse debt, particularly with respect to disregarded entities, in the context of the debt modification rules, and proposing specific regulatory changes); Levy and Hofheimer, *Bankrupt Partnerships and Disregarded Entities*, *Tax Notes* 1103 (June 7, 2010) (performing an extensive analysis of the legislative history of both the federal income tax code and the bankruptcy code to evaluate the distortive effects that current tax rules, including the treatment of recourse and nonrecourse liabilities, have in certain restructuring contexts); Hoffer, *Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities*, *Tax Notes* 327 (Apr. 18, 2005) (among other issues, discussing the treatment of debt of a disregarded entity, and the distinction between recourse and nonrecourse debt more broadly, in the context of section 108); Cuff, *Indebtedness of a Disregarded Entity*, 81 *Taxes* 303 (2003) (discussing, among other things, the distinction between recourse and nonrecourse indebtedness and many of the consequences of such distinction); Cummings, *The Disregarded Entity Is and Isn’t (Disregarded)*, *Tax Notes* 743 (May 5, 2003) (evaluating the treatment of debt of disregarded entities in the context of the significant modification rules; Geier, *Tufts and the Evolution of Debt-Discharge Theory*, 1 Fla. L. Rev. No. 3, 115 (1992) (evaluating history of the different treatment of recourse and nonrecourse debt and suggesting that the inconsistencies should be eliminated); Cunningham, *Payment of Debt with Property—the Two-Step Analysis After Commissioner v. Tufts*, 38 *Tax Lawyer* 575 (1985) (exploring history of treatment of dispositions of property in satisfaction of recourse and nonrecourse debt and arguing that distinction is justifiable on put/call option theory); Rosenberg, *Better to Burn Out than to Fade Away? Tax Consequences on the Disposition of a Tax Shelter*, 71 Cal. L. Rev. 87 (1983) (evaluating caselaw development between *Crane* and *Tufts* and proposing and evaluating various different approaches to the issue, including the tax benefit rule and treating certain amounts as COD); Simmons, *Nonrecourse Debt and Amount Realized: The Demise of Crane’s Footnote 37, 59 Or. L. Rev. 42 (1980) (discussing caselaw development from *Crane* to the lower court decisions in *Tufts* and exploring the theoretical bases for including the full amount of nonrecourse debt in amount realized). This issue, of course, goes far beyond the scope of section 382(h)(6), but our discussion is intended to illustrate the perils of expanding the relevance of this distinction to yet another part of the Code.

193 There is, of course, a meaningful economic difference between debts that are recourse or nonrecourse for state law purposes that otherwise could mitigate potential tax planning.

194 See, e.g., Priv. Ltr. Rul. 201644018 (Oct. 28, 2016) (holding that debt issued by disregarded entity that was not guaranteed by its regarded parent was nonrecourse debt and did not give rise to COD).
Second, there are many unsettled questions regarding the scope of what is a nonrecourse liability for federal tax purposes. If the distinction in the Proposed Regulations is preserved, disputes around these issues are inevitable. While a retroactive adjustment to the NUBIG/NUBIL computation could hypothetically address these issues, it would present significant administrability concerns and would be inconsistent with the direction of section 382(h)(6)(C) to complete the NUBIG/NUBIL computation at the time of the ownership change.

Example. A loss corporation (“LossCo”) has assets with a fair market value of $100 and tax basis of $200, subject to $200 of nonrecourse liabilities. LossCo has $100 of NOLs. In a bankruptcy workout, LossCo’s creditors receive 100 percent of the stock of LossCo (rather than foreclosing on LossCo’s assets), leading to $100 of COD. This COD will either (i) reduce LossCo’s NOLs by $100; or (ii) reduce the tax basis of LossCo’s assets by some amount in lieu of reducing attributes.

Under the Proposed Regulations, LossCo will not have any NUBIG or NUBIL, because the full $200 of liabilities are taken into account, without regard to whether NOLs or tax basis are reduced. That being the case, most rational taxpayers would not elect to reduce tax basis, because the above-fair-market-value tax basis will not be subject to any limitation under section 382. By contrast, if the liabilities were recourse, under the Proposed Regulations, LossCo would have a $100 NUBIL and the above-fair-market-value tax basis would be subject to limitation during the recognition period, unless LossCo elected to reduce tax basis in assets (in which case LossCo’s NOLs would be preserved, but still subject to permanent limitation).

Third, the Proposed Regulations do not function appropriately under numerous scenarios and appear to be based on two problematic operating principles: (i) nonrecourse liabilities are always addressed by a foreclosure or forced sale of assets that will give rise to Tufts gain; and (ii) where assets are subject to both recourse and nonrecourse liabilities, the nonrecourse liabilities will take precedence over the recourse liabilities. Neither of these operating premises

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195 A non-exhaustive list would include (i) the extent to which debt issued by a disregarded entity that is not guaranteed by its owner is “nonrecourse” if the owner owns nothing but the disregarded entity, and, if this type of debt is not nonrecourse debt, where the debt crosses over to being nonrecourse debt based on the amount of the owner’s other assets; (ii) the effect, if any, of section 1111(b) of the bankruptcy code, which transforms nonrecourse debt to recourse debt for purposes of a bankruptcy case, subject to certain exceptions; (iii) the extent to which a “bad boy” recourse provision, which typically provides that debt that is otherwise nonrecourse can become recourse (both to the issuer and to other parties) causes debt to be recourse rather than nonrecourse for these purposes; and (iv) the general treatment of “floating lien” nonrecourse debt, which encumbers all of an issuer’s assets as a practical matter but is not recourse as a technical matter, constitutes nonrecourse debt.

196 We understand that the Proposed Regulations’ 12-month limitation that has been imposed on the inclusion of COD in NUBIG / RBIG was driven by these concerns, and that the delay in finalizing the proposed modifications to Treas. Reg. § 1.1502-91(g) are driven by the same concerns. We agree that finding a solution that does not require retroactive redeterminations of NUBIG / RBIG is preferable, but it would be inappropriate to move forward with a rule that only addresses foreclosures occurring within 12 months of the ownership change.

197 Under Gershkowitz v. Commissioner, 88 T.C. 984 (1987), this transaction will give rise to COD, rather than Tufts gain.

198 See § 108(b)(5).
is true in all situations, and the Proposed Regulations lead to inappropriate outcomes where these operating premises are incorrect.

Example. LossCo has one asset with a fair market value of $100 and tax basis of $20. LossCo has $90 of nonrecourse debt secured only by the asset, and $30 of debt that is generally recourse on a secured basis to LossCo. In a debt workout, the debt is reduced pro-rata, resulting in a $15 reduction to nonrecourse debt and $5 reduction to the recourse debt. Under the Proposed Regulations, the nonrecourse debt does not constitute an “excess nonrecourse liability,” because that determination is made without taking LossCo’s recourse liabilities into account, so none of the $15 of COD can be included in RBIG, even though it will have the same result (attribute or tax basis reduction) as the recourse debt. In essence, the Proposed Regulations inappropriately assume that, in a situation like this example, rather than a pro rata debt reduction, LossCo’s recourse debt would be reduced from $30 to $10.

2. Valuation Issues

The Proposed Regulations’ general approach to liabilities – driven by the concern around built-in COD – leads to valuation problems, particularly for companies with contingent liabilities that have AFS amounts.

As discussed in greater detail above, recourse liabilities are not taken into account for purposes of determining the deemed sale value of assets in the initial step of the NUBIG/NUBIL computation. This outcome presents a basic dilemma for an insolvent company; specifically, if a loss corporation has $200 of liabilities and a stock market capitalization of $0.50 (representing option value in the stock), what are the loss corporation’s assets worth? Other provisions of the Code look to the trading value of debt in a circumstance like this example, at least where the debt is “publicly traded,” but that is for purposes of determining the “issue price” of debt, not directly determinative of the fair market value of assets. While we acknowledge that valuation issues are commonplace in the Code in general and section 382 in particular, the rule adopted by the Proposed Regulations would further expand those issues.

The valuation concerns raised by the Proposed Regulations will be particularly troublesome for loss corporations with meaningful contingent liabilities. As discussed above, the Proposed Regulations do not treat contingent liabilities as being assumed in the hypothetical asset sale, but contingent liabilities do reduce NUBIG (or increase NUBIL) if they are deductible. For companies with an AFS, the reduction is assumed to be equal to the amount of the recorded liability. This approach raises a serious problem, because AFS-recorded liabilities

199 Of course, these simple facts point to one of the potential disputes regarding the distinction between recourse and nonrecourse debt. If LossCo is a single purpose entity that will not, as a practical matter, acquire any other assets, there is no meaningful economic distinction between recourse and nonrecourse debt here.

200 LossCo has total liabilities of $120, 75 percent of which is the nonrecourse debt and 25 percent of which is the recourse debt. LossCo is insolvent by $120 and the total debt reduction agreed to is $20 (i.e., COD precisely equals insolvency). 75 percent of the reduction ($15) applies to the nonrecourse debt and 25 percent of the reduction ($5) applies to the recourse debt.

201 See Treas. Reg. § 1.1273-2; see also § 108(e)(10) (calculation of COD in debt-for-debt exchanges).
will typically overstate the economic effect that the relevant liability has on the value of a company’s assets.

*Example.* LossCo has assets with $0 of tax basis, a $0.50 overall stock market capitalization, $100 of long-term funded debt that has 80 percent “indicative quotes” but no identifiable actual trades, and a deductible contingent liability recorded on an AFS of $100. The true intrinsic value of LossCo’s assets is $120. Without factoring in collectability and “priority-of-claim” issues, the true long-term economic exposure of the AFS liability is $75.202

Under Notice 2003-65, the NUBIG/NUBIL computation in this situation would be straightforward; specifically, LossCo has a NUBIG of $100. LossCo would be treated as disposing of its assets to a party that assumes the funded debt of $100 and the contingent liability of an indeterminate value, and NUBIG then would be reduced by the same indeterminate amount for the contingent liability. Conversely, under the Proposed Regulations, there are numerous valuation and related problems; for example:

- An appraisal of LossCo’s assets would appear to be mandatory, because there are minimal market-based indicators of value.
- Even if the 80 percent quotes on the company’s long-term funded debt were in fact actual trades, the trades would not be directly translatable to a full value for LossCo’s assets. The 80 percent trades would factor in the risk of non-collection, uncertainty regarding future events, potentially limited liquidity, and the uncertain dilutive effect that the company’s contingent liabilities would have on recovery.
- For a company that may be restructured in the future, where the AFS liability may be subject to a capped recovery, it appears to be particularly inappropriate for the AFS liability to reduce NUBIG or increase NUBIL by the full amount despite that possibility.

We have been unable to identify any solutions for these issues within the liability construct utilized in the Proposed Regulations. Importantly, however, if our proposal for liabilities more generally is not adopted, we believe that the Proposed Regulations would lead to distortive results by requiring reliance on AFS-recorded contingent liabilities.

**D. Recommendation**

As noted above, we appreciate the concerns expressed by Treasury and the Service regarding the arguably inappropriate benefits obtained by taxpayers taking into account built-in COD under section 382(h)(6). However, we believe the approach adopted by the Proposed Regulations raises difficult issues of administrability and causes distortive results. To balance these considerations, we reiterate our recommendation to revert to the general approach taken to

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202 The distinction between the AFS-recorded amount and the actual economic exposure would likely be attributable to multiple factors, including many potential disconnects between GAAP liability accounting principles and actual value.
liabilities by Notice 2003-65 for purposes of the NUBIG/NUBIL computation, i.e., a sale of assets to a third party that assumes all of the liabilities of the loss corporation, and, further, we recommend that the following approach be utilized:

- COD that is recognized at any point in the recognition period (not just in the 12-month period following the change) that is included in taxable income be treated as an RBIG item and, accordingly, increase the annual section 382 limitation.

- COD that is recognized at any point during the recognition period that is excluded from gross income and that results in black-hole COD or the reduction of attributes other than tax basis in section 382 assets be treated as utilizing available NUBIG (i.e., like an item of RBIG). We describe this approach as “charging-off” the NUBIG cap. Whether the excluded COD results in RBIG depends upon whether pre-change attributes are reduced (no RBIG) or post-change attributes are reduced (RBIG). The results are summarized as follows:
  
  - Excluded COD that results in black-hole COD or the reduction of pre-change attributes (other than tax basis in section 382 assets): charge-off of NUBIG cap; no RBIG.
  
  - Excluded COD that reduces tax basis in section 382 assets: no charge-off of NUBIG cap; no RBIG (except as realized through disposition or foregone amortization of built-in gain assets, for this purpose treating the basis reduction as having occurred immediately before the ownership change).

  - Excluded COD that reduces post-change attributes (including tax basis in assets acquired after the ownership change): charge-off of NUBIG cap; RBIG.

Further, we recommend that language be added to the final regulations providing that any foregone amortization calculation does not permit reliance on liabilities in excess of asset fair market value.

This proposal does preserve a benefit for insolvent companies; specifically, liabilities in excess of fair market value may result in a non-economic increase to NUBIG or reduction to NUBIL. However, this potential benefit is significantly limited by the proposed “charge-off” of NUBIG for excluded COD that reduces pre-change attributes, without RBIG. Two other economic benefits remain.

First, companies with economic NUBILs will be able to avoid some or all of the RBIL limitation that they otherwise would incur. We are unaware of any legislative history that specifically supports, or refutes, permitting this modest benefit.

Example. LossCo has a single asset with tax basis of $150, fair market value of $100, liabilities of $200, and NOLs of $150. Creditors receive 100 percent of LossCo’s stock in exchange for their claims in a transaction that gives rise to an ownership change, which generates $100 of COD. Under Notice 2003-65, LossCo has a NUBIG of $50 (liabilities of $200 less tax basis of $150), even though economically LossCo has a NUBIL of $50 (fair market value of
$100 less tax basis of $150). Assuming LossCo does not make an election to reduce tax basis, LossCo’s NOLs will be reduced to $50, and be usable under the section 382 limitation, while LossCo’s economic built-in loss will be preserved without limitation. Under the Proposed Regulations, (i) if LossCo did not elect to reduce tax basis in its assets, it would have a NUBIL of $50, and a portion of its depreciation deductions would be subject to limitation as RBIL during the recognition period; or (ii) if LossCo elected to reduce asset tax basis, it could avoid NUBIL status if it further elects to take tax basis into account in redetermining NUBIG or NUBIL.  

Under our recommendation, LossCo would have a NUBIG of $50. If LossCo did not elect to reduce tax basis in assets and the excluded COD instead reduced NOLs, LossCo would not be treated as incurring RBIG of $50, and the $50 reduction of LossCo’s pre-change NOLs would be a charge-off with respect to the NUBIG cap. Accordingly, the benefit obtained by LossCo would be avoiding NUBIL status, but no additional benefits are obtained under section 382. Alternatively, if LossCo elects to reduce tax basis in assets, LossCo still would have a NUBIG of $50, but (i) it would have no immediate RBIG uplift, and LossCo would have moved from having an economic built-in loss of $50 in its assets to an economic built-in gain of $50 in its assets (which would be treated as RBIG if the asset is disposed of or, if our recommendation regarding wasting assets is accepted, through foregone amortization) and (ii) LossCo would have no depreciation deductions that would be treated as RBIL.

The above example illustrates that our proposal eliminates the various problems we have identified with the approach adopted by the Proposed Regulations. Overall, we believe that any trade-off in this instance is reasonable and appropriate as a matter of policy, deference to 16 years of Congressional silence in the face of Notice 2003-65, and the benefits achieved from avoiding the complex approach in the Proposed Regulations.

Second, under rare circumstances, companies with a mix of assets with economic built-in gains and built-in losses may achieve an “RBIG uplift.” As an example, LossCo has two assets. Asset A has a tax basis of $100 and a value of $75 (i.e., built-in loss of $25). Asset B has tax basis of $0 and a value of $75 (i.e., built-in gain of $75). LossCo has $200 of liabilities. Under our proposal, LossCo would have a NUBIG of $100, compared to LossCo’s economic NUBIG of $50. LossCo has $75 of NOL. Presume there is an ownership change in a transaction that does not discharge the liabilities (e.g., as a result of a shareholder claiming a worthless stock deduction that results in an ownership change pursuant to section 382(g)(4)(D)). If LossCo sells Asset B during the recognition period, it will recognize $75 of taxable income, all of which would be RBIG, and LossCo would be able to utilize all $75 of its pre-change NOLs to offset such taxable income – at least to the extent of the available section 382 limitation and to the extent that the NOLs in question are not subject to limitation under another provisions of the

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204 Reducing asset basis instead of NOLs would not be a rational choice under these facts.
205 As we discussed above, we believe that this result is permitted by the statutory language of section 382(h)(6)(A) and (C).
Code such as section 172(a)(2) – even though LossCo only had $50 of economic NUBIG on the change date.

It is important to note that, in our experience, many scenarios involving an ownership change of an insolvent company involve a simultaneous COD recognition event. In those situations, this fact pattern would not arise. We also would highlight that, in this example, no additional gain has been offset by pre-change losses compared to what would have occurred if LossCo’s assets had been sold on a pre-change basis. However, we acknowledge that, in this example, following a sale of Asset B, LossCo would still have a built-in loss of $25 in Asset A that would not be limited. The above fact pattern does not, in fact, violate the Neutrality Principle; if Asset B had been sold before the change, LossCo’s pre-change losses all would have been available to offset the associated taxable income. Accordingly, we do not believe this fact pattern invalidates our proposal.

VI. Clarification of the Recognition Period and Related Considerations

These comments consider and address how items incurred or otherwise experienced on the change date should be taken into account in the NUBIG/NUBIL computation and whether they should be treated as RBIG or RBIL. Change date items present a particularly nettlesome problem because of the items’ potential treatment as being taken into account in NUBIG or NUBIL and potential treatment (or non-treatment) as RBIG or RBIL and the interaction of three different timing rules in the statute: (i) the moment immediately before the ownership change (relevant for the NUBIG/NUBIL computation), (ii) the period ending at the close of the change date (relevant for determining whether items are in the pre-change period, and (iii) the period beginning on the change date (relevant for determining whether items are in the recognition period). The interaction of these rules create some anomalies that appear to be inconsistent with the purposes of the statute unless Treasury and the Service provide additional guidance interpreting or modifying the rules to produce rational results.

As discussed in greater detail below, we recommend that final regulations clarify that:

- The “recognition period” begins at the end of the “change date”;

- Items recognized on the change date that are built-in items immediately before the ownership change (including items that occur simultaneously with the ownership change) be included in an initial, tentative NUBIG/NUBIL computation;

- Items recognized on the change date that would be RBIG if recognized on a subsequent date in the change year be treated as RBIG and allocated under section 382(h)(5)(A) to the post-change period (or items that would be RBIL if recognized on a subsequent date in the change year be treated as RBIL and similarly allocated to the post-change period);

- Items not allocated under section 382(h)(5)(A) be allocated under the general rules of Treas. Reg. § 1.382-6;
• The initial, tentative NUBIG/NUBIL computation be revised by removing built-in items taken into account in the change year that are allocated to the pre-change period;

• Items recognized simultaneously with the ownership change be treated as built-in items taken into account in the NUBIG/NUBIL computation and as RBIG or RBIL, as appropriate; and

• Regardless of the approach that Treasury and the Service take with respect to includible items of income or deduction that occur simultaneously with an ownership change, the approach in the two sets of proposed regulations under section 382(h) and Treas. Reg. § 1.1502-76 does not apply to built-in COD that is excluded from gross income.

A. Overview of the Relevant Provisions

Under section 382(h)(3)(A)(i), NUBIG or NUBIL is, before adjustment under section 382(h)(6)(C) for potential items of built-in income or deduction, “the amount by which the fair market value of the assets of such corporation immediately before an ownership change is more or less, respectively, than the aggregate adjusted basis of such assets at such time.” At first blush, the reference to “immediately before an ownership change” suggests that the relevant moment for this determination is at the particular point in the day that the ownership change occurs. However, Temp. Treas. Reg. § 1.382-2T(a)(1) effectively provides that an ownership change occurs at the close of a testing date.\(^{206}\) Notwithstanding the rule in the regulations regarding when during the day an ownership change occurs, NUBIG or NUBIL should be measured at the particular point in the day that an ownership change occurs. If NUBIG or NUBIL were not measured at that point, then items that are built-in items at the moment an ownership change occurs and are recognized immediately afterwards on the same day would not be taken into account in NUBIG or NUBIL, would not be RBIG or RBIL, and would be subject to allocation under the rules of Treas. Reg. § 1.382-6.

Section 382(h)(2)(A) provides that RBIG from an asset is any gain recognized during the recognition period to the extent the loss corporation proves that it held the asset “immediately before the change date” and to the extent the gain does not exceed the amount of unrealized built-in gain “on the change date.” Similarly, section 382(h)(2)(B) provides that RBIL from an asset is any loss recognized during the recognition period unless the loss corporation proves that it did not hold the asset “immediately before the change date” or it proves that the loss did not exceed the unrealized built-in loss “on the change date.” In addition, section 382(h)(6)(A) and

\(^{206}\) See Temp. Treas. Reg. § 1.382-2T(a)(1) (“An ownership change occurs with respect to a corporation if it is a loss corporation on a testing date and, immediately after the close of the testing date, the percentage of stock of the corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of such corporation owned by such shareholders at any time during the testing period.”); Treas. Reg. § 1.382-2(a)(4)(i) (“All computations of increases in percentage ownership are to be made as of the close of the testing date and any transactions described in this paragraph (a)(4) that occur on that date are treated as occurring simultaneously at the close of the testing date.”); see also Temp. Treas. Reg. § 1.382-2T(a)(2)(i)(B), (c)(1).
(B) provides that items of income or deduction taken into account during the recognition period, but attributable to periods “before the change date,” are treated as RBIG or RBIL. Thus, the RBIG/RBIL rules refer to periods before the change date, immediately before the change date, and on the change date, none of which correspond (at least literally) with the reference in the NUBIG/NUBIL rules to immediately before the ownership change.

Section 382(h)(7) defines the recognition period as the five-year period beginning on the change date. Thus, the recognition period as defined in the statute can include a portion of the pre-change period, as discussed below.

Under sections 382(b)(3)(A) and 382(d)(1), income of the loss corporation for the year in which the ownership change occurs must be allocated to the periods before and after the ownership change (the pre-change and post-change periods). If income is allocated to the pre-change period, that income may be offset by pre-change losses without limitation. If loss is allocated to the pre-change period, the loss is a pre-change loss the utilization of which is limited under section 382. Both statutory rules provide that the pre-change period is the period in the year ending on or before the change date. Treas. Reg. § 1.382-6 provides more detailed rules on how the loss corporation’s income or loss for the year may be allocated (whether ratably under the default method or under an elective “closing-of-the-books” approach) and specifically defines the pre-change period as “the portion of the change year ending on the close of the change date.”

Section 382(h)(5)(A) provides one critical exception to the general allocation rules in section 382(b)(3)(A) and Treas. Reg. § 1.382-6. That rule reads as follows:

> In applying . . . [section 382(b)(3)(A)], taxable income shall be computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year (or recognized built-in losses to the extent such losses are treated as pre-change losses), and gain described in paragraph (1)(C), for the year [the latter relating to section 338 elections made in connection with an ownership change].

Unfortunately, section 382(h)(5)(A) does not answer the question of whether an item that is a built-in item at the time of the ownership change that is recognized on the change date increases the limitation (if there is a NUBIG and the item is a built-in gain)

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207 Section 382(b)(3) states that “[i]n the case of any post-change year which includes the change date — [the section 382 limitation] shall not apply to the portion of the taxable income for such year which is allocable to the period in such year on or before the change date.” Section 382(d)(1) states that “[t]he term ‘pre-change loss’ means . . . 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.”

208 Treas. Reg. § 1.382-6(g)(2).
because such item is in the pre-change period and arguably subject to allocation under the general allocation rules. 209

B. Illustrative Examples

The following examples serve to illustrate the inappropriate potential detriment or benefit as a result of the interactions between the various definitions in sections 382(h)(1)(A) and (B), section 382(h)(6), section 382(h)(7)(A), and section 382(b)(3)(A).

For purposes of illustrating the potential detriment, assume that, on S’s change date, S (i) has a NUBIG, (ii) has a deduction item that meets the definition in section 382(h)(6)(B), and (iii) has elected to close its books for purposes of Treas. Reg. § 1.382-6(b). Because S has elected to close its books under Treas. Reg. § 1.382-6(b), the deduction item is allocated to the pre-change period, which (i) subjects the deduction to the section 382 limitation, but only if the deduction gives rise to an NOL in the pre-change period, and (ii) decreases S’s NUBIG under section 382(h)(6)(C). Thus, the potential detriment here is the possibility of subjecting the deduction to a section 382 limitation and the reduction of S’s NUBIG.

Similarly, for purposes of illustrating the potential benefit, assume that, on S’s change date, S (i) has a NUBIL, (ii) has an income item that meets the definition in section 382(h)(6)(A), and (iii) has elected to close its books for purposes of Treas. Reg. § 1.382-6(b). Because S has elected to close its books under Treas. Reg. § 1.382-6(b), the income item is allocated to the pre-change period, which (i) allows the income to be freely offset by pre-change losses that otherwise would be subject to the section 382 limitation and (ii) decreases S’s NUBIL under section 382(h)(6)(C). Thus, the potential benefit here is the possibility of allowing the income to be freely offset by pre-change losses and the reduction of S’s NUBIL.

In both examples, a similar problem exists if the loss corporation uses ratable allocation, though only to the extent that the item is allocated to the pre-change period under that method.

C. The Recognition Period Should Begin at the End of the Change Date

We recommend that the recognition period begin at the end of the change date. Thus, items that occur on the change date are allocated under Treas. Reg. § 1.382-6 either to the pre-change period under the closing-of-the-books method or between the pre-change period and the post-change period under the ratable allocation method. 210 This recommendation arguably removes built-in items that are recognized on the change date from the recognition period because they occur before the end of the change date. However, the principles of section 382(h)(5)(A) should apply to built-in items that are recognized on the change date. If section 382(h)(5)(A) did not apply, the recognized built-in items would be allocated under the general rules, and, for NUBIG companies, the amount of pre-change losses that could offset a

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209 The question would be the same if there is a NUBIL and the item is a built-in loss.

210 We recognize that not all items occurring in the pre-change period are strictly allocated to the pre-change period under the closing-of-the-books method in Treas. Reg. § 1.382-6(b) because of the implicit ceiling rule. See, e.g., Treas. Reg. § 1.382-6(f), Ex. 1.
D. Recommended Treatment of Change Date Items

Taking into account the preceding discussion, we recommend that, if section 382(h)(5)(A) would have applied were an item recognized on a later date in the recognition period, then section 382(h)(5)(A) should apply to such change date item. Thus, if the loss corporation has a NUBIG, and it sells an asset on the change date that it held with an unrealized built-in gain immediately before the ownership change, the gain should be RBIG and should be allocated solely to the post-change period. Similarly, if the loss corporation has a NUBIL, and it sells an asset on the change date that it held with an unrealized built-in loss immediately before the ownership change, the loss should be RBIL and should be allocated solely to the post-change period. However, if the loss corporation has a NUBIG, and it sells an asset on the change date that it held with an unrealized built-in loss immediately before the ownership change, section 382(h)(5)(A) should not apply to the loss, and the loss may be allocated under the general rules. Similarly, if the loss corporation has a NUBIL, and it sells an asset on the change date that it held with an unrealized built-in gain immediately before the ownership change, section 382(h)(5)(A) should not apply to the gain, and the gain may be allocated under the general rules.

Built-in items recognized on the change date that have a different character than the NUBIG or NUBIL (i.e., a built-in gain item of a NUBIL company or a built-in loss item of a NUBIG company) that are allocated to the pre-change period distort the amount of NUBIG or NUBIL. Accordingly, any recognized built-in items that are allocated to the pre-change period should be removed from the NUBIG/NUBIL computation. Thus, our recommendation is to apply the following steps:

- First, compute a tentative NUBIG/NUBIL;
- Then, allocate change year items under section 382(h)(5)(A) and Treas. Reg. § 1.382-6; and
- Finally, revise the tentative NUBIG/NUBIL computation by removing built-in items taken into account in the change year that are allocated to the pre-change period.

This approach reflects the intent of the “consistency” rule in Prop. Treas. Reg. § 1.382-7(c)(2)(i). Because this recommendation would require a recomputation of NUBIG or NUBIL at the end of the year, our recommendation could be further refined by removing those

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211 We acknowledge that, in this circumstance, a loss corporation may want to make a closing-of-the-books election to allocate the item to the pre-change period. However, a closing-of-the-books election may not be beneficial in all circumstances. Similarly, for NUBIL companies, the amount of pre-change losses subject to limitation would be lower if a built-in loss item recognized on the change date is allocated to the post-change period. In this circumstance, a loss corporation may want to use ratable allocation.

212 We illustrate this distortion in the examples set forth above in Part VI.B. of this letter.
items recognized on the change date in their entirety from the NUBIG/NUBIL computation (rather than determining what part of those items are allocated to the pre-change period).

This recommendation is a change from the Section’s prior recommendation with regard to change date items.213 This recommendation also is superficially inconsistent with the approach in Prop. Treas. Reg. § 1.382-7(b)(9), which merely defines recognition period by cross-reference to section 382(h)(7)(A). However, this recommendation has some similarity to the approach found in Prop. Treas. Reg. § 1.382-7(c)(2) and Prop. Treas. Reg. § 1.1502-76(b),214 each of which deal with the interaction of the “end of the day” and the “next day” rule with section 382.

E. **Recommended Treatment of Items Recognized Simultaneously with the Ownership Change**

We also recommend that items recognized simultaneously with the ownership change be treated as built-in items taken into account in the NUBIG/NUBIL computation and as RBIG or RBIL, as appropriate. The most common items that occur simultaneously with ownership changes are deductions that arise from the issuance of stock (e.g., deductions from the contribution of stock to a section 468B qualified settlement fund, deductions from the payment of employee compensation with stock, or COD from the satisfaction of liabilities with stock).215 We believe that these income or deduction items exist up until the moment of the ownership change and thus exist “immediately before the ownership change” (and, correspondingly, should be taken into account in the NUBIG/NUBIL computation and as RBIG or RBIL). Nevertheless, we acknowledge that this recommendation is inconsistent with the proposed treatment of such items when a loss corporation’s change in status as a member of a consolidated group is also the date of an ownership change.216

Regardless of the approach that Treasury and the Service take with respect to includible items of income or deduction that occur simultaneously with an ownership change, we

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213 As noted above, the Section previously provided comments to Treasury and the Service concerning Notice 2003-65 on April 29, 2005. That comment letter is available on the Section’s website at: https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/2005/050429corp.pdf

The aspects of that prior comment letter that are relevant to this discussion are found on pp. 9-11 and 21-22.

214 See Notice of Proposed Rulemaking, Guidance Regarding Reporting Income and Deductions of a Corporation That Becomes or Ceases To Be a Member of a Consolidated Group, 80 Fed. Reg. 12097 (Mar. 6, 2015).

215 For another example, consider the transfer of appreciated property to a shareholder in redemption of the shareholder’s stock.

216 See Prop. Treas. Reg. § 1.382-7(c)(2)(ii) (“For example, if income from the discharge of indebtedness is includable in the taxable year that ends as a result of S’s change in status, that income is neither treated as taken into account during the recognition period nor included in the determination of net unrealized built-in gain or net unrealized built-in loss.”); see also Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2) (“The next day rule does not apply to any extraordinary item that becomes includible or deductible simultaneously with the event that causes the change in S’s status.”); Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(D) (“Accordingly, if the day of S’s change in status is also a change date, the determination of net unrealized built-in gain or loss will reflect the application of both the end of the day rule and the next day rule, to the extent each applies.”).
recommend that the approach in the two sets of proposed regulations under section 382(h) and Treas. Reg. § 1.1502-76 not apply to built-in COD that is excluded from gross income. In our view, excluded COD is different from includible items because (i) it is not allocated between pre-change and post-change periods and (ii) the consequences of such excluded COD as resulting in black-hole COD, the reduction of pre-change attributes other than tax basis, the reduction of tax basis in section 382 assets, or the reduction of post-change attributes is not known until a later date.

VII. Effective Date Considerations

A. The Proposed Regulations

The Proposed Regulations are proposed to be effective for ownership changes occurring after the date the Treasury decision adopting such regulations as final regulations is published in the Federal Register. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), are permitted to apply the Proposed Regulations to any ownership change that precedes the date of finalization, for which the statute of limitations period of section 6511(a) has not expired, so long as the taxpayers and all of their related parties consistently apply the rules of the Proposed Regulations to such ownership change and all subsequent ownership changes that occur before the applicability date of final regulations. The preamble to the Proposed Regulations further notes that taxpayers may continue to apply the approaches of Notice 2003-65 to ownership changes that occur prior to finalization.

B. Effective Date Transition Recommendations

As noted above, the final regulations would apply to ownership changes that occur after the effective date of the regulations. As described further below, we believe there are at least two types of loss corporations that should be permitted to apply the approaches of Notice 2003-65, if desired, even if the ownership change occurs after the effective date of final regulations. As to such corporations, the effective date exceptions would effectively “grandfather” their continued application of the approaches of Notice 2003-65, which would shield such corporations from an abrupt change in deal terms / valuation if the Proposed Regulations were finalized before the transaction had closed (i.e., the change date).

The first type of loss corporation that we recommend for grandfathering is a loss corporation whose ownership change is subject to a binding agreement (e.g., to acquire the stock of such company) that is in place on the date that the Proposed Regulations are finalized. For this purpose, we would expect an agreement to be considered “binding” even though subject to customary closing conditions. Typically, the terms of an agreement reflect months of negotiations and financial modelling, which often includes assigning a value to the loss corporation based in part upon expected recovery of its tax attributes. While a pending acquisition of the stock of a loss corporation would be the archetypal transaction for such a rule, we also would expect the effective date exception to apply to out-of-court debt restructurings and other ownership changes arising from negotiated agreements as well.

Providing transition rules of this sort would be consistent with the approach that Treasury and the Service have followed in other instances in which a finalized regulation might have a
disruptive effect on pending transactions in the marketplace. For example, the language of such rule could be modeled after the effective date of the Treasury regulations under section 7874 providing certain rules that disregard affiliate-owned stock. While such regulatory provisions generally apply to domestic entity acquisitions completed on or after May 20, 2008, a special rule provides that “[t]his section shall not, however, apply to a domestic entity acquisition that was completed on or after May 20, 2008, provided such acquisition was entered into pursuant to a written agreement which was (subject to customary conditions) binding prior to May 20, 2008, and at all times thereafter (binding commitment).”

Similarly, with respect to insolvent or bankrupt loss corporations, oftentimes there is a significant amount of time between the point at which a troubled company first files a voluntary petition with the bankruptcy court and the subsequent ownership change that typically arises upon confirmation of the bankruptcy plan. The initial bankruptcy filing often occurs after a significant period of out-of-court negotiations among the debtor and its stakeholders. These discussions universally take expectations regarding debtors’ tax attributes into account, and negotiations regarding a plan may go on for months after a bankruptcy filing is made. Throughout all of these pre-filing and post-filing negotiations, financial modeling, including with respect to expectations with respect to, and the value of, a debtor corporation’s tax attributes, including NOLs, is critical. This focus on a loss corporation’s tax attributes is unsurprising, because such tax attributes are considered property of the bankruptcy estate. A more traditional “binding commitment,” which may be best analogized to a bankruptcy plan of reorganization “confirmed” by the court, may not arise until relatively late in this process, and a necessary predicate to such a confirmed plan is a potentially lengthy consent solicitation process and, potentially, litigation regarding the terms of the plan. Within that context, a post-bankruptcy-filing, pre-bankruptcy-emergence finalization of the Proposed Regulations could

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217 See, e.g., T.D. 9729, Basis in Interests in Tax-Exempt Trusts, 80 Fed. Reg. 48249 (Aug. 12, 2015) (final rules for determining a taxable beneficiary’s basis in a term interest in a charitable remainder trust (CRT) upon a sale or other disposition of all interests in the trust to the extent that basis consists of a share of adjusted uniform basis; generally applicable on date proposed regulations were proposed except for sales or disposition occurring pursuant to a binding commitment entered into before date of proposal); Treas. Reg. § 1.7874-1(e)(1)(i).

218 See Treas. Reg. § 1.7874-1(i).

219 Treas. Reg. § 1.7874-1(i)(1); cf. Former Prop. Treas. Reg. § 1.368-1(e)(9) (2011) (continuity of interest rules dealing with “collars” and similar arrangements were proposed to apply to transactions occurring on or after the date the regulations are published as final regulations “unless completed pursuant to a binding agreement that was in effect immediately before the date such final regulations are published and at all times afterwards”).

220 See, e.g., 11 U.S.C. § 1121(b) (generally providing for exclusive 120-day period for debtor to file bankruptcy plan).

221 During the pendency of the bankruptcy proceeding, there usually are negotiations on a variety of different issues and (significant) progress may be made on some or all of those issues well before resolving a formal plan that is then confirmed by the court. Thus, if the Proposed Regulations were finalized during pendency of a bankruptcy proceeding, but before confirmation, that outcome is very likely to delay a loss corporation’s emergence, as different aspects of the plan likely will need to be re-negotiated (and, ultimately, may cause a completely different structure to be given effect).

deeply unsettle negotiated positions, potentially invalidate plans that are “mid-solicitation” or “mid-approval process,” and otherwise result in significant additional cost and expense for bankrupt companies. Thus, we recommend that final regulations similarly provide an exception to the effective date provision with respect to an ownership change of a loss corporation that is in, or is emerging from, a case under title 11 of the United States Code or a receivership, foreclosure, or similar proceeding in a federal or state court, where the initial court petition (or other similar formal written request) has been filed prior to the effective date of any final regulations promulgated under section 382(h).\textsuperscript{223}

Lastly, we request that, in the final regulations, Treasury and the Service explicitly confirm that taxpayers experiencing ownership changes prior to the publication of the final regulations in the \textit{Federal Register} will continue to be able to rely on Notice 2003-65 for purposes of their previous NUBIG/NUBIL computations with respect to those ownership changes and, further, their RBIG and RBIL determinations following those ownership changes.

\textsuperscript{223} \textit{Cf.} H.R. REP. NO. 99-841, at II-196 (1986) (Conf. Rep.) (providing that, with respect to the amendments made to section 382 by the Tax Reform Act of 1986, “[i]n the case of a reorganization that occurs as part of a Title 11 or other court-supervised proceeding, the amendments do not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986”; the amendments to section 382 otherwise were generally applicable to ownership changes that occur on or after January 1, 1987).