December 19, 2019

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Re: Notice of Proposed Rulemaking Regarding Section 382(h) Related to Built-in Gain and Loss [REG-125710-18]

Dear Sir or Madam:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS or "Service") to address the need for guidance related to the changes to section 382[1] as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA or "the Act").

On September 10, 2019, Treasury and the IRS issued notice of proposed rulemaking REG-125710-18 (the "proposed regulations"). This letter is in response to the proposed regulations.

Specifically, the AICPA submits comments and recommendations in the following areas related to the proposed regulations:

I. Retain Section 338 Approach or Similar Forgone Amortization Approach

II. Cancellation of Indebtedness Income

III. Definition of Recognized Built-in Gain and Recognized Built-in Loss
   1. Uniformity between Income and Deduction Items Generally
   2. Contingent Liabilities
   3. Linked Income and Deduction Items
   4. Dividends
   5. Bad Debt Deductions

IV. Proposed Effective Date

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Julie Allen, Chair, AICPA Corporations & Shareholders Tax Technical Resource Panel, at (703) 965-9353, or Julie.allen@pwc.com; Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Mr. Krishna Vallabhaneni, Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Mr. Brett York, Associate International Tax Counsel, Department of the Treasury
Mr. Christopher W. Call, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
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Notice of Proposed Rulemaking Regarding Section 382(h) Related to Built-in Gain and Loss [REG-125710-18]

December 19, 2019

BACKGROUND

In General

Section 382 limits the ability of a "loss corporation" to use certain losses to offset its taxable income after an ownership change when the losses relate to the pre-change period. The limitation is value-based and generally equal to the value of the loss corporation multiplied by the long-term tax-exempt rate, with certain adjustments (section 382 limitation).[2] In general, a loss corporation is defined as a corporation that is: (i) entitled to use a net operating loss (NOL) carryforward, a carryforward of disallowed business interest expense under section 163(j), and certain other carryforward losses and credits; (ii) having an NOL or certain losses and credits in the taxable year in which the ownership change occurs; and (iii) except as provided in regulations, having a net unrealized built-in loss (NUBIL) as of the ownership change.[3] The items above are generally referred to as "pre-change losses." An ownership change generally refers to a shift in the ownership of the stock of the loss corporation by more than 50 percentage points during a specified testing period, by reference to ownership of stock held by 5% shareholders.[4]

Built-in Gains and Losses

Section 382(h) provides for special rules related to built-in gains and losses of a loss corporation, and their impact on the section 382 limitation. In general, if a loss corporation has a net unrealized built-in gain (NUBIG) as of the change date, the section 382 limitation is increased by the amount of recognized built-in gains (RBIG) during the 5-year recognition period (recognition period) following the change date.[5] A NUBIG refers to the excess of the fair market value of a loss corporation's assets over its adjusted basis in such assets, immediately before an ownership change.[6] An RBIG is generally defined as gain recognized during the recognition period, to the extent the loss corporation can show that the gain is attributable to an asset held on the change date, and such gain does not exceed the built-in gain on the asset on the change date.[7]

The concept of a NUBIL is similar to that of a NUBIG, but with a contrasting effect on the section 382 limitation. In general, if a loss corporation has a NUBIL as of the change date, a recognized built-in loss (RBIL) during the recognition period is subject to the section 382 limitation as if it

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[2] *See generally* section 382(b).
[3] *See generally* section 382(k)(1) and section 383.
[4] *See generally* section 382(g).
[5] Section 382(h)(1)(A).
[6] Section 382(h)(3)(A).
[7] Section 382(h)(2).

were a pre-change loss.[8] A NUBIL refers to the excess of a loss corporation's adjusted basis in its assets over the fair market value of such assets, immediately before the ownership change.[9] An RBIL refers to any loss recognized during the recognition period except to the extent the loss corporation establishes that the loss is not attributable to an asset held on the change date, or such loss exceeds the built-in loss of the asset on the change date.[10]

Section 382(h)(6) provides special rules related to built-in items. Specifically, section 382(h)(6)(A) provides that "[a]ny item of income which is properly taken into account during the recognition period, but which is attributable to periods before the change date shall be treated as [an RBIG] for the taxable year in which it is properly taken into account." For deduction items, section 382(h)(6)(B) similarly provides that "[a]ny amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the change date shall be treated as [an RBIL] for the taxable year in which it is a deduction." Section 382(h)(6)(C) provides that the amount of NUBIG or NUBIL is properly adjusted for the amount which would be treated as RBIG or RBIL if such amounts were properly taken into account (or allowable as a deduction) during the recognition period.

Notice 2003-65 provided interim guidance on the identification of the built-in items described in section 382(h). The notice provided a safe harbor for such identification under two alternative approaches: (i) the 1374 approach; and (ii) the 338 approach. In general, both approaches calculate NUBIG and NUBIL by reference to a hypothetical sale of the loss corporation's assets immediately before the ownership change. The treatment of RBIG and RBIL differs depending on which approach is adopted.

Under the 1374 approach, RBIG and RBIL are identified at the time of a disposition of an asset, relying on the accrual method of accounting to identify built-in items at the time of the ownership change, with certain exceptions. The 1374 approach does not apply the tax accrual rule as an exception to the general rule, for amounts allowable as depreciation, amortization, or depletion, treating such amounts as RBIL (unless the loss corporation establishes that such amount is not attributable to a built-in loss on the change date) regardless of whether such amounts accrued for tax purposes before the change date. The 1374 approach generally treats any cancellation of indebtedness income (COD income) or a bad debt deduction under section 166 as RBIG or RBIL, respectively, if taken into account during the first 12 months of the recognition period and if the item rises from debt owed to or by a loss corporation at the beginning of the recognition period.

Under the 338 approach, RBIG and RBIL are identified by comparing the loss corporation's actual items of income, gain, deduction, and loss recognized during the recognition period with those items that would have been recognized if an election under section 338 (section 338 election) were made with respect to the loss corporation. For a loss corporation with a NUBIL, the 338 approach treats as RBIG an amount equal to the excess of the cost recovery deductions that would have been allowable with respect to an asset had a section 338 election been made over the loss corporation's

[8] Section 382(h)(1)(B).
[9] Section 382(h)(3)(A).
[10] Section 382(h)(2)(B). The flush language of section 382(h)(2)(B) further provides that any amount allowable as depreciation, amortization, or depletion during the recognition period is included as RBIL, except to the extent the loss corporation establishes that the amount is not attributable to the built-in loss in the asset at the time of the ownership change.

actual allowable cost recovery deduction. For depreciation, depletion, and amortization, a loss corporation with a NUBIG would treat as RBIL the excess of the loss corporation's actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable to the loss corporation with respect to such asset had a section 338 election been made. For contingent liabilities, the 338 approach would treat a deduction for the payment of a liability as RBIL to the extent of the estimated liability on the change date. The 338 approach would treat COD income attributable to pre-change debt of the loss corporation as RBIG, not to exceed the adjusted issue price of the debt over the fair market value of the debt on the change date. The key assumption underlying application of the 338 approach to depreciable assets is the "wasting asset" theory, which is premised upon the notion that the "wasting" (e.g., depreciation and amortization) of a hypothetically purchased asset approximates the income to be generated by such asset.[11]

COMMENTS

I. Retain Section 338 Approach or Similar Forgone Amortization Approach

Overview

In Notice 2003-65, the IRS and Treasury provided taxpayers two available methods of identifying items of RBIG and RBIL: (i) the 1374 approach; and (ii) the 338 approach.

The proposed regulations did not incorporate the 338 approach, in part because the IRS and Treasury believe that the 338 approach "lacks sufficient grounding in the statutory text of section 382(h),"and "the continued application of the 338 approach likely would not be tenable after the changes to the Internal Revenue Code (IRC or "Code") enacted by the TCJA."

If the 338 approach is eliminated, a loss corporation with a NUBIG immediately prior to a relevant ownership change generally will no longer be able to take into account items of RBIG attributable to a built-in gain asset without selling or disposing such asset in a taxable transaction during the 5-year recognition period.

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations retaining the section 338 approach for purposes of identifying a loss corporation's items of RBIG and RBIL.

Alternatively, if the IRS and Treasury chose not to retain the section 338 approach, we request that the final regulations provide that taxpayers may apply a similar forgone amortization approach for purposes of identifying a loss corporation's items of RBIG and RBIL.

Analysis

The preamble to the proposed regulations ("the preamble") lists several reasons why the IRS and Treasury chose not to incorporate the 338 approach as follows:

[11] REG-125710-18, 84 FR 47455, 47458 (Sept. 10, 2019).

- Lacks sufficient grounding in the statutory text of section 382(h);
- Can result in overstatements of RBIG and RBIL;
- As a result of TCJA, would require substantial modifications to eliminate increased uncertainty and ensure appropriate results; and
- Is inherently more complex than the accrual-based 1374 approach.

Statutory Text of Section 382(h)

In relevant part, section 382(h)(2) states that RBIG means "any *gain* recognized during the recognition period on the *disposition* of any asset." Section 382(h)(6)(A) states that RBIG includes "any item of *income* which is properly taken into account during the recognition period, but which is *attributable to* periods before the change date." Analogous definitions are provided with respect to items of RBIL, including any amounts of deduction (e.g., amortization or depreciation on built-in loss assets) attributable to the pre-change period are treated as RBIL.[12]

Through differences in these definitions, Congress established two separate categories of RBIG: (i) the disposition of assets resulting in the recognition of gain; and (ii) the generation of income in a post-change year that was attributable to the loss corporation's activities in a pre-change year.

The statutory text does not explicitly contemplate the 338 approach. However, such language does not belie the 338 approach. The language also does not imply that a strict interpretation is warranted. Rather, Congress has left such language broad and subject to interpretation. It is reasonable to presume that, in drafting Notice 2003-65, the IRS and Treasury were confident that the 338 approach had sufficient grounding in the statutory text of section 382(h); otherwise, it seems unlikely that such an approach would have been prescribed. Alternatively, the IRS and Treasury could have believed that the broad regulatory grant of section 382(m) permitted the application of the 338 approach. Regardless of the historical rationale to permit such an approach, the preamble does not expound upon why the IRS and Treasury have shifted their view.

Further, it could be argued that the legislative history underlying section 382(h) supports the 338 approach. In 1986, Congress recognized that:[13]

> "Built-in gains are often the product of special tax provisions that accelerate deductions or defer income (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 such gains had the gains been recognized before the change in ownership occurred."

Congress was aware that certain assets generally have cost recovery periods that disassociate such assets' deductions from their production of income (e.g., research and development costs and

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[12] The discussion in the remainder portion of this section is from the perspective of identifying items of RBIG, as it is believed taxpayers generally only apply the section 338 approach when a loss corporation has a NUBIG as of immediately prior to its ownership change.

[13] Sections 382(h)(2)(B) & (h)(6)(B). *See also* JCS-10-87, *General Explanation of the Tax Reform Act of 1986*, at 298 (May 4, 1987).

licensing income). Absent the rules related to items of RBIG, Congress was concerned that NOL carryforwards (all or a portion of which are presumably comprised of these accelerated deductions) would be too limited in their ability to offset the items of RBIG generated by these assets, even though the NOL carryforwards would have been fully available to offset these items of RBIG if such items were recognized in the pre-change period. The 338 approach alleviates these Congressional concerns by treating an asset's built-in gain as an approximation of the income to be generated by such asset over the duration of its useful life.[14] The 338 approach strives to connect the accelerated deductions to the production of income – an approach that appears consistent with Congress' objective in implementing the "special" RBIG rules.

Two years later, in 1988, Congress amended section 382(h)(6), stating:[15]

> "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."

The IRS, in a 1993 Field Service Advisory (FSA),[16] interpreted this passage as indicating that "Congress was concerned with matching pre-change built-in gain with its associated income whether or not there was an actual disposition of the asset containing the built-in gain." In the context of the FSA, where a loss corporation self-produced software in a pre-change year and then licensed it during the recognition period, the IRS found that:

> [T]here is an undeniable close relationship between the software development costs that created the NOLs and the licensing income flowing from that software. That is, the software development costs essentially generated both the NOLs and the licensing income. Moreover, it is undeniable that pre-change value created by such software development 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.

We agree with this interpretation and assessment for purposes of section 382(h). The preamble provides that a guiding principle underlying section 382 is the "neutrality principle," which generally intends to treat a loss corporation's items of RBIG the same, regardless of whether they were recognized before or after an ownership change. In situations similar to the FSA's (of which there are many), there is a clear economic relationship between the pre-change costs giving rise to the NOL and the post-change income produced by the assets that the pre-change costs created (or obtained). Elimination of the 338 approach would appear to violate the neutrality principle in

[14] Arguably this estimate understates the income to be generated by an asset, as generally, the purchaser of an asset expects to earn a return on its investment. An asset that produces an amount of income equal to its purchase price (or production cost) generally would not be viewed as having a fair market value equal to such amount. In addition, the 338 approach may understate income because it restarts the depreciable/amortizable life of an asset. In many cases, (e.g. the 15-year life of intangible property), the asset may be deemed to waste over a longer period than it actually wastes.

[15] S. Rep. 100-445, 100th Cong., 2d Sess. 48 (1988).

[16] 1993 W.L. 1625453 (July 8, 1993).

situations similar to these and place disproportionate burdens on pre-change NOLs produced in sectors where business exigencies preclude the disposal of income-producing, built-in gain assets.

In addition, it is arguable that the definition of RBIL lends support to the "wasting" asset theory employed by the 338 approach. In sections 382(h)(2)(B) and 382(h)(6)(B), amounts of depreciation and amortization deducted by a loss corporation during the recognition period can be treated as an item of RBIL. Underlying such rule is the principle that, with respect to a loss corporation's built-in loss depreciable and amortizable assets, a portion of the loss corporation's post-change amortization and depreciation deductions represent a loss that was economically accrued in the pre-change period, but that is taken into account during the post-change recognition period.[17] Accordingly, the statute requires such items to be identified as an item of RBIL. The logical corollary to this rule seemingly would allow gain that has economically accrued during a pre-change period, but for which deductions are not available during the post-change recognition period, to be treated as an item of RBIG under a reasonable method of identification.

Lastly, the preamble states that "the Treasury Department and the IRS have determined that, historically, most acquiring corporations behave as if section 382 will limit the ability to utilize substantially all pre-change NOLs."[18] Assuming such determination is correct, this heuristic behavior seems to imply that, even with the 338 approach as an available method for identifying items of RBIG, acquiring corporations tend to behave as though a loss corporation's pre-change NOLs are of limited value. This implication would indicate that the Congressional intent underlying section 382 (i.e., NOLs should not be more valuable to an acquirer than to the going concern that created them) has not been frustrated by the utilization of the 338 approach.

Overstatement or Understatement of RBIG

The preamble states that the 338 approach's treatment of built-in gain assets is problematic for the following two reasons:

- 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.

- 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.

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[17] This statement assumes the loss corporation had a non-*de minimis* amount of NUBIL as of immediately prior to the relevant ownership change.

[18] The 338 approach has been in existence for 16 of the 33 years since section 382 was overhauled by the Tax Reform Act of 1986. Presumably, the "history" that such statement refers to includes all or a portion of this 16-year period.

With respect to the government's first contention, the government's concern is understandable.[19] However, it is unclear why this contention should result in the elimination of the 338 approach, rather than targeted modification of it. Further, it appears that only the cost recovery schedules related to depreciable property were formulated to provide investment stimulus. With respect to intangible assets (i.e., the wasting asset category that, in our experience, has the largest amount of built-in gain), the legislative history to section 197 supports that the 15-year cost recovery period was established to reduce ongoing controversies between taxpayers and the IRS – it was not for economic stimulus.[20] The 15-year period was not selected to accelerate the amortization of the tax basis in an intangible asset: "[i]t is recognized that the useful lives of certain acquired intangible assets to which the bill applies may be shorter than 14 years, while the useful lives of other acquired intangible assets to which the bill applies may be longer than 14 years."[21]

In addition, the cost recovery periods for depreciable assets and intangible assets have not materially changed since 2003.[22] Thus, it is unclear why these cost recovery periods are no longer an appropriate approximation of the items of RBIG produced by wasting assets; the government's use of such recovery periods under Notice 2003-65 would seem to imply their prior affirmation of the same recovery periods for the same purpose. Moreover, if the IRS and Treasury have recently determined that, specifically, the cost recovery periods associated with depreciable assets are unacceptable because of the legislative focus on incentivizing investment, it is unclear why a

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[19] The Joint Committee on Taxation (the "JCT") has helpfully summarized the legislative background with respect to depreciation schedules:

> In 1981, the prior-law ADR and useful life systems were replaced by a new system, the accelerated cost recovery system ("ACRS"), which permitted "recovery of capital costs for most tangible depreciable property using accelerated methods of cost recovery over predetermined recovery periods generally unrelated to, but shorter than, [prior] law useful lives." The Senate Finance Committee Report with respect to the provision explained the rationale for the change: "[t]he committee believes that the present rules for determining depreciation allowances . . . need to be replaced because they do not provide the investment stimulus that is essential for economic expansion. The real value of depreciation deductions allowed under present rules has declined for several years due to successively higher rates of inflation. . . . The committee therefore believes that a new capital cost recovery system is required which provides for the more rapid acceleration of cost recovery deductions . . . ."

These rules were tightened somewhat in 1982, and modified more substantially in 1986, when the modified accelerated cost recovery system ("MACRS") was adopted. The 1986 legislation enacting MACRS further accelerated the rate of recovery of depreciation deductions from the 150% declining balance method to the 200% declining balance method for those tangible assets with the shortest class lives.

See JCX-19-12, *Background and Present Law Relating to Cost Recovery and Domestic Production Activities* 20-21 (Feb. 27, 2012).

[20] *See* H.R. Rep. 103-111,103rd Cong., 1st Sess. 256 (1993):

> The Federal income tax treatment of the costs of acquiring intangible assets is a source of considerable controversy between taxpayers and the Internal Revenue Service. … It is believed that much of the controversy that arises under present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets and by treating acquired goodwill and going concern value as amortizable intangible assets. … Accordingly, the bill requires the cost of most acquired intangible assets, including goodwill and going concern value, to be amortized ratably over a 14-year period.

[21] *Id.* The final version changed the 14-year amortization period to 15 years.

[22] *See* JCX-54-05, *Present Law and Legislative Background Relating to Depreciation and Section 179 Expensing,* at 6 (July 20, 2005). *See also* JCX-19-12, *Background and Present Law Relating to Cost Recovery and Domestic Production Activities*, at 20-24 and 37-38 (Feb. 27, 2012).

different depreciation regime could not be utilized for these purposes, instead of the complete elimination of the 338 approach.[23]

With respect to the government's second contention, we do not believe that the annual limit serves as a proxy for the income generated by a loss corporation's equity-funded assets. The long-term tax-exempt rate is based upon the average long-term marketable obligations of the United States (U.S.) government.[24] However, during 1986, long-term marketable obligations of the U.S. government contained interest rates that were considerably higher than current rates.[25] Congress made it known that the rate prescribed was "higher than the average rate at which loss corporations actually absorb NOL carryforwards … [but] may be too restrictive for loss corporations that out-perform the average."[26] From such comparisons, it appears evident that Congress considered contemporaneous interest rates when deciding the "objective rate of return on the value of the corporation's equity."[27] Given that current interest rates have materially decreased relative to the interest rates contemporaneous to Congress's statement, it is arguable that the long-term tax-exempt rate no longer accomplishes Congress's original purpose of objectively providing a rate of return on the value of the corporation's equity. Given the broad regulatory grant of section 382(m), it would seem reasonable for Treasury to retain the 338 approach as an "appropriate" mechanism to carry out the purposes of section 382.

Lastly, we note that the elimination of the 338 approach may lead to the understatement of RBIG in industries where items of built-in gain comprise the majority of a company's value, but the disposition of which is precluded because of business exigencies. For example, companies in the technology and services sectors may have value that is substantially driven by their intellectual property, trade name, and/or skilled workforce.

As a Result of TCJA, Would Require Substantial Modifications to Eliminate Increased Uncertainty and Ensure Appropriate Results

The TCJA changed the corporate tax landscape, with ripple effects reaching section 382. In May 2018, the IRS and Treasury acted to mitigate one of these ripple effects: the TCJA's modification of section 168(k) permitted, in certain cases, a loss corporation to accelerate a significant portion of its hypothetical depreciation deductions into the first year of the recognition period. As a result, the IRS issued a notice providing that, under the 338 approach, in determining items of RBIG or RBIL, the hypothetical cost recovery deductions (that would have been made had an election under

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[23] For example, the JCT has stated that the Alternative Depreciation System (ADS) was based on "early estimates of economic depreciation." *See* JCX-19-12, *Background and Present Law Relating to Cost Recovery and Domestic Production Activities*, at 69 (Feb. 27, 2012).

[24] JCS-10-87, *General Explanation of the Tax Reform Act of 1986,* at 296 (May 4, 1987).
Specifically, "the long-term tax-exempt rate is to be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years." JCS-10-87, *General Explanation of the Tax Reform Act of 1986,* at 317 (May 4, 1987).

[25] For example, the long-term tax-exempt rate for January 1987 was 6.41%. *See* Rev. Rul. 86-158, 1986-2 C.B. 149. Meanwhile, the long-term tax-exempt rate for October 2019 is 1.77%.

[26] JCS-10-87, *General Explanation of the Tax Reform Act of 1986,* at 296 (May 4, 1987).

[27] *Id.*

section 338 been made) are determined without regard to section 168(k).[28] The method, applied by notice, appears to suitably prevent the 338 approach from causing this result.

The preamble provides two examples of additional, TCJA-related issues: (i) the reliance under section 163(j) and section 382 upon variants of taxable income; and (ii) income inclusions under section 951A.[29] It is unclear why these issues would lead to the elimination of the 338 approach. With respect to section 163(j), while these rules change the determination of taxable income, it is unclear that they have any impact on the determination of post-change income items attributable to the pre-change period. In addition, it is unclear why income inclusions under section 951A are particularly problematic when income inclusions by U.S. shareholders of controlled foreign corporations (CFCs) under section 951 have existed for the entirety of Notice 2003-65.[30]

As a result, these complications do not appear to require the elimination of the 338 approach or the provision of a forgone amortization approach similar to the 338 approach.

II. Cancellation of Indebtedness Income

Overview

The proposed regulations provide rules that limit the extent that COD income is treated as RBIG. The preamble states that Treasury and the IRS determined that the failure of Notice 2003-54 to distinguish between includable and excludable COD income results in: (i) the overstatement of RBIG (or understatement of RBIL); and (ii) a duplicated benefit under section 382(h) in certain cases.

First-year Recourse COD Income

In general, Prop. Reg. § 1.382-7(c)(3)(ii)(A) provides that no amount of income from COD recognized during the recognition period is added to the computation of the loss corporation's NUBIG or NUBIL.[31] However, Prop. Reg. § 1.382-7(c)(3)(ii)(B) provides an exception that a loss corporation may apply certain specified adjustments to the amount computed under Prop. Reg. § 1.382-7(c)(3)(i) to determine NUBIG or NUBIL (the NUBIG-NUBIL Amount) for a loss corporation's first-year recourse COD income.[32] If a loss corporation chooses to apply the

[28] Notice 2018-30, 2018-21 I.R.B. 610.

[29] "For example, the limitation on a loss corporation's interest deduction under amended section 163(j) and the modifications to the NOL deduction rules under amended section 172 are each based on variants of taxable income. However, a hypothetical sale of a loss corporation's assets under section 338 upon an ownership change would result in different taxable income computations than before the TCJA. Unanswered questions related to sections 163(j) and 172 would further complicate application of the 338 approach. Further, income inclusions under section 951A may increase existing concerns (including as a result of potential changes in hypothetical QBAI basis from deemed tiered section 338 elections) arising under the 338 approach." REG-125710-18, 84 FR 47458 (Sept. 10, 2019).

[30] One can presume the government distinguishes income inclusions under section 951A from income inclusions under section 951 due to the breadth of a CFC's income that is considered to be "tested income." However, without understanding the government's specific concerns and prior deliberations on the issue, it is not clear why the government finds solutions to these issues "untenable."

[31] Proposed Reg. § 1.382-7(c)(3)(ii)(A).

[32] Proposed Reg. § 1.382-7(c)(3)(ii)(B).

provisions in Prop. Reg. § 1.382-7(c)(3)(ii)(B), the amounts in Prop. Reg. § 1.382-7(c)(3)(ii)(B)(1) and (2) are treated as RBIG on the date recognized.[33] Otherwise, no COD income attributable to recourse liabilities is RBIG.[34]

The preamble states:

> The proposed regulations also provide that COD income recognized during the post-change period generally would not be treated as RBIG. However, these proposed regulations would provide taxpayers with the option to treat certain COD income recognized during the first 12 months of the recognition period as RBIG (and consequently to make adjustments to the taxpayer's NUBIG/NUBIL computation).

First, the proposed regulations provide that the NUBIG-NUBIL Amount is increased by the amount of all first-year recourse COD income that is included in gross income under section 61(a)[(11)].[35] This amount of first-year recourse COD income is treated as RBIG.[36]

Second, the proposed regulations provide that the NUBIG-NUBIL Amount is increased by the amount of first-year recourse COD income that is excluded under section 108(a) to the extent that section 108(b) reduces attributes that are not pre-change losses nor basis of the loss corporation's section 382 assets, which would include the reduction under section 1017(a) of the basis of loss corporation's assets that were not held at the time of the ownership change.[37] This amount of first-year recourse COD income is also treated as RBIG.[38]

Lastly, a loss corporation decreases the amount of basis in determining its NUBIG-NUBIL Amount by the amount of first-year recourse COD income that is excluded under section 108(a) to the extent that section 1017(a) reduces the basis of the loss corporation's section 382 assets.[39] The definition of "section 382 asset" means any asset that the loss corporation owns immediately before the ownership change, including goodwill and other intangible assets, but excluding cash and cash items described in section 382(h)(3)(B)(ii).[40]

The term "first-year recourse COD income" means any COD income 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.[41]

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[33] Proposed Reg. § 1.382-7(d)(2)(iii).
[34] *Id.*
[35] Proposed Reg. § 1.382-7(c)(3)(ii)(B)(1).
[36] *Id.*
[37] Proposed Reg. § 1.382-7(c)(3)(ii)(B)(2).
[38] *Id.*
[39] Proposed Reg. § 1.382-7(c)(3)(ii)(B)(3).
[40] Proposed Reg. § 1.382-7(b)(10).
[41] Proposed Reg. § 1.382-7(b)(4).

The amount of COD income that is first-year recourse COD income is limited to the loss corporation's "pre-change excess recourse liabilities." A loss corporation's pre-change excess recourse liabilities are defined as an amount equal to the excess, if any, of: (i) the aggregate adjusted issue price of the loss corporation's liabilities immediately before the ownership change excluding: (a) recourse liabilities to the extent that they would not be included in the determination of whether the loss corporation is insolvent under section 108(d)(3); and (b) nonrecourse liabilities; over (ii) the sum of the fair market value of the assets that the loss corporation owns immediately before the ownership change, reduced, but not below zero, by the amount of nonrecourse liabilities that is secured by such assets immediately before the ownership change.[42] If the loss corporation is under the jurisdiction of a court under Title 11 of the United States Code on the change date, the loss corporation's pre-change excess liabilities are the amount of all of the loss corporation's liabilities immediately before the ownership change (excluding nonrecourse liabilities) that are discharged by order of the court in an action that results in a discharge of the loss corporation's recourse liabilities.[43]

The total amount of increases to the NUBIG-NUBIL Amount related to first-year recourse COD income is limited to the loss corporation's liabilities immediately before the ownership change (excluding nonrecourse liabilities) to the extent of its pre-change excess liabilities.[44]

If a loss corporation chooses to apply the adjustments in Prop. Reg. § 1.382-7(c)(3)(ii)(B) to its first-year recourse COD income, it must apply the adjustments to all of its first-year recourse COD income subject to the timing rules in Prop. Reg. § 1.382-7(c)(3)(iii)(D).[45] The timing rules in Prop. Reg. § 1.382-7(c)(3)(iii)(D) require the loss corporation to make the adjustments in Prop. Reg. § 1.382-7(c)(3)(ii)(B) in their entirety as of the change date, and that a loss corporation may make these adjustments only if: (i) the statement described in Treas. Reg. § 1.382-11 reflects such adjustments; or (ii) the loss corporation files an amended return for the taxable year that includes the change date and includes an amended statement described in Treas. Reg. § 1.382-11.[46]

First-year Nonrecourse COD Income

In general, Prop. Reg. § 1.382-7(d)(2)(iv)(A) provides that no COD income attributable to nonrecourse liabilities is RBIG.[47] However, Prop. Reg. § 1.382-7(d)(2)(iv) provides exceptions which provide that first-year nonrecourse COD income is RBIG under certain circumstances.

The term "first-year nonrecourse COD income" means any COD income 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 inadequately secured nonrecourse liabilities.[48] The term "inadequately secured nonrecourse liabilities" means any nonrecourse liability of which,

[42] Proposed Reg. § 1.382-7(b)(8).
[43] *Id.*
[44] Proposed Reg. § 1.382-7(c)(3)(iii)(C).
[45] Proposed Reg. § 1.382-7(c)(3)(ii)(B).
[46] Proposed Reg. § 1.382-7(c)(3)(iii)(D).
[47] Proposed Reg. § 1.382-7(d)(2)(iv).
[48] Proposed Reg. § 1.382-7(b)(3). Collectively, we refer to first-year recourse COD income and first-year nonrecourse COD income as "first-year COD income."

immediately before the ownership change the adjusted issue price of the nonrecourse liability exceeds the fair market value of the property which secures such nonrecourse liability.[49]

First, Prop. Reg. § 1.382-7(d)(2)(iv) provides all first-year nonrecourse COD income that is included in gross income under section 61(a)[(11)] is RBIG on the date recognized.[50] In addition, all first-year nonrecourse COD income that is excluded under section 108(a) is RBIG to the extent that section 108(b) reduces attributes that are not pre-change losses under Prop. Reg. § 1.382-7(d)(2)(iv)(A); however, it does not apply to amounts of first-year nonrecourse COD income corresponding to debt whose discharge results in reduction of basis under section 1017(a).[51]

First-year nonrecourse COD income that is excluded under section 108(a) and reduces the basis of the loss corporation's assets that the loss corporation owned immediately before the ownership change is not RBIG. (The basis reduction is treated as occurring pre-change. However, future gain on disposition of the asset can be RBIG.)[52] However, first-year nonrecourse COD income that is excluded under section 108(a) and reduces the basis of the loss corporation's assets that the loss corporation did not own immediately before the ownership change is RBIG.[53]

The amount of first-year nonrecourse COD income treated as RBIG is limited to the excess of the adjusted issue price of debt over the fair market value of property measured under Prop. Reg. § 1.382-7(b)(5).[54] The computation of the NUBIG-NUBIL Amount is not adjusted to reflect RBIG amounts for first year nonrecourse COD income.[55] Nonetheless, the adjusted basis of the loss corporation's section 382 assets reflects the reduction, if any.[56]

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations providing that all built-in COD income is included in the NUBIG-NUBIL Amount (i.e., that all liabilities are deemed assumed).

Analysis

Although we acknowledge Treasury's policy concerns, we have identified significant issues that can arise when all liabilities are not deemed assumed in the NUBIG/NUBIL calculation. Consequently, the final regulations should revert to the formulation in Notice 2003-65, whereby all liabilities of the loss corporation are deemed assumed in the NUBIG/NUBIL calculation. We believe this action is supportable under the statute.

A technical reading of section 382(h)(6) supports that all built-in COD income should be taken into account in NUBIG/NUBIL. The proposed regulations recognize that COD income can be

[49] Treasury Reg.§ 1.382-7(b)(5).
[50] Proposed Reg. § 1.382-7(d)(2)(iv)(A).
[51] *Id.*
[52] Proposed Reg. § 1.382-7(d)(2)(iv)(B).
[53] *Id.*
[54] Proposed Reg. § 1.382-7(d)(2)(iv)(C).
[55] Proposed Reg. § 1.382-7(d)(2)(iv)(D).
[56] *Id.*

RBIG. For COD income to be capable of qualifying as RBIG, it must qualify as an "item of income… attributable to periods before the change date" under the requirements of section 382(h)(6)(A). Section 382(h)(6)(A) provides that, "[a]ny item of income which is properly taken into account during the recognition period, but which is attributable to periods before the change date shall be treated as a recognized built-in gain." Once it has been established that COD income is described in section 382(h)(6)(A), it follows that such amounts should be included in the NUBIL/NUBIG calculation, pursuant to section 382(h)(6)(C).

To qualify as RBIG, gain must be: (i) an "item of income"; (ii) that is "properly taken into account during the recognition period"; and (iii) that is "attributable to periods before the change date."[57] By treating COD as RBIG in certain cases, Treasury and the Service are implicitly acknowledging that COD is an item of income that can be attributable to periods before the change date.

The eventual tax effect of the COD income should not affect this conclusion. The Supreme Court held that exclusion of COD from gross income does not change its essential character as an "item of income."[58] In *Gitlitz,* the Supreme Court explained that "mere exclusion of an amount from gross income does not imply that the amount ceases to be an item of income."[59] Elsewhere in the regulations, Treasury and the Service likewise have acknowledged that exclusion from gross income does not affect characterization as an item of income. Treasury Reg. § 1.1502-13 defines an intercompany "item" as "income, gain, deduction, and loss from an intercompany transaction."[60] It then defines "attributes" of an intercompany item, providing that "attributes include character, source, *treatment as excluded from gross income* or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384."[61] In other words, exclusion from gross income is an attribute of an intercompany item of income, rather than an event that causes an item to cease to be an item of income. Consequently, built-in COD should be characterized as a built-in "item of income" for the purposes of section 382(h)(6), irrespective of whether such income may later be excluded from gross income.

Once it is established that COD income is an item of income that can be properly taken into account during the recognition period, and attributable to periods before the change date (i.e., COD income can be RBIG), section 382(h)(6)(C) necessitates including that item in NUBIG/NUBIL. Section 382(h)(6)(C) provides that the amount of NUBIL/NUBIG "shall be properly adjusted" for "amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period."[62] By acknowledging that COD income is described in section 382(h)(6)(A), it should follow that NUBIL/NUBIG are adjusted by such amounts.

Again, the fact that COD income may not give rise to an income item in the post-change period in all cases does not change this conclusion. It would appear that the "proper adjustment" referred

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[57] Section 382(h)(6)(A).
[58] *See* Gitlitz v. Comm'r, 531 U.S. 206 (2001) (holding that excluded COD under section 108(a) is an "item of income" for purposes of section 1366, which increases the shareholders' bases in the S corporation stock under section 1367).
[59] *Id*. at 213.
[60] Treasury Reg. § 1.1502-13(b)(2).
[61] Treasury Reg. § 1.1502-13(b)(6) (emphasis added).
[62] Section 382(h)(6)(C).

to in section 382(h)(6) is a simple mathematical adjustment (i.e., NUBIG should be increased or a NUBIL should be decreased to account for the built-in income items). The term "properly adjusted" does not appear to broadly require a taxpayer to analyze whether the particular adjustment at issue is a "proper" application of any underlying policy objectives. Indeed, the Code contains many uses of the phrase "properly adjusted," which serve merely to require that the appropriate mathematical adjustment be made.[63] Regulations interpreting section 1374(d)(5)(C), a provision with similar wording to section 382(h)(6)(C) and which is used as a reference in the 1374 approach, appear to reflect the conclusion by Treasury and the Service that the proper adjustment at issue is purely mathematical; an example therein shows a purely mathematical adjustment for built-in income and built-in deduction items.[64]

Furthermore, this application is consistent with the general application of NUBIG/NUBIL, wherein built-in gain or loss in the assets of a loss corporation held on the change date is presumed to affect future taxable income, regardless of whether recognition of such gain or loss would be included in gross income or deductible. For example, the NUBIL of a loss corporation may be increased by subsidiary stock that has a tax basis in excess of its fair market value, even if a loss realized on the sale of such stock would be disallowed under the loss disallowance rules.

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations that provide that excludable COD income is absorbed by NUBIG to the extent that it reduces a pre-change attribute under section 108(b) other than pre-change property basis under section 1017(a).

Analysis

We acknowledge the government's concern stated in the preamble related to a duplicative benefit under an approach that does not distinguish between includible and excludable COD income.[65] Therefore, to lessen a duplicative benefit, we propose allowing NUBIG to be absorbed to the extent that excludable COD income reduces a pre-change attribute of the loss corporation other than the reduction under section 1017(a) of the basis of the loss corporation's assets held immediately before the ownership change, despite the reduction not producing an RBIG item post-change. We believe that this approach would sufficiently mitigate any duplicative benefit.

Notice 2003-65 does not distinguish between includible and excludable COD income in the same manner as the proposed regulations. In the Notice, excludable COD income is not itself RBIG

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[63] *See,* e.g., sections 1019, 1272(a)(3)(A)(ii), 1374(d)(5)(C).

[64] *See* Treas. Reg. § 1.1374-3(b), ex. 1 (net unrealized built-in gain of cash basis C corporation converting to S corporation status mathematically adjusted for accounts payable balance and section 481(a) adjustment to determine net unrealized built-in gain). *Cf.* First Chicago Corp. v. Comm'r, 842 F.2d 180 (7th Cir. 1988) (court held for taxpayer that the tax benefit rule of former Section 58(h) should apply, noting that the phrase "properly adjusted" in former section 58(h) should be read in light of the Congressional intent).

[65] The preamble states:

> "After administrative experience under Notice 2003-65 and as highlighted by commentators, the Treasury Department and the IRS have determined that this failure 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."

when it reduces the basis of the loss corporation's assets that were held at the time of the ownership change (however, the basis reduction is treated as occurring pre-change, such that a later disposition of that asset can be RBIG). In this respect, the Notice and the proposed regulations are consistent. However, the proposed regulations go further to provide that excluded COD income is not NUBIG/NUBIL, or RBIG, to the extent that section 108(b) reduces pre-change attributes that are not basis of the loss corporation's section 382 assets. We believe that all built-in COD should be taken into account in the NUBIG/NUBIL for the aforementioned reasons. However, we recognize that there could be a double-benefit to a loss corporation that includes an amount of built-in COD income in its NUBIG, which is eventually excluded under section 108(a) during the recognition period, resulting in the reduction of a pre-change loss or the reduction of another pre-change attribute besides basis in section 382 assets.

Example 1

LossCo has one asset with a value of $200, basis of $200, and subject to $300 of recourse debt. In Year 1, COD of $100 is triggered, but excluded under section 108, which applies to reduce pre-change NOLs. The $100 of excluded COD need not be treated as an RBIG in Year 1 because there is no gain to offset at such time. It is applied against pre-change NOLs, just as it would have been if triggered pre-change. Under the logic of the proposed regulations, built-in COD should not be taken into account in NUBIG/NUBIL with respect to the recourse debt because it does not produce an RBIG item.

Our proposal will mitigate the double-benefit because a loss corporation's NUBIG would be absorbed to the extent that excluded COD income reduces such a pre-change attribute. Said differently, excluded COD income that reduces such a pre-change attribute would not constitute RBIG but would still reduce the amount of potential increases to the section 382 limitation under section 382(h)(1)(A)(i).

Example 2

Applying our proposal to the above example, LossCo would have a NUBIG of $100 ($300 liabilities assumed minus $200 basis). In Year 1, when the COD income is triggered, our proposal would treat the entire $100 of NUBIG as absorbed by the COD, despite the fact that there is no actual RBIG item. Consequently, LossCo will not be able to increase its section 382 limitation for future gains, which is appropriate, since no other gains were built-in at the time of the ownership change.

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations that provide that built-in COD income includes COD income that is recognized during the entire recognition period under section 382(h)(7).

Analysis

The adjustments to the NUBIG/NUBIL Amount and RBIG should not be limited to first-year COD income. We believe that COD income that the loss corporation recognizes (including income that is excluded from gross income under section 108(a)(1)) during the recognition period under section 382(h)(7) (i.e., the 5-year period beginning on the change date) should qualify as an adjustment to the NUBIG/NUBIL Amount and RBIG if it would otherwise qualify.

We recognize the importance of promulgating rules that are more administrable; however; administrative ease is only one factor. The preamble reiterates the intent to preserve the neutrality principle.[66] The legislative history of section 382(h)(6) indicates that it was a clarification that income properly taken into account during the recognition period but is attributable to periods before the change date is treated as a recognized built-in gain.[67]

Importantly, section 382(h)(6) applies to *any* item of income that is properly taken into account during the recognition period that is attributable to periods before the change date. There is nothing in the statute or the legislative history that distinguishes COD income from other types of income for purposes of section 382(h)(6). Furthermore, section 382(h)(7) provides the only definition for the recognition period for purposes of section 382 (i.e., the 5-year period beginning on the change date). There is also nothing in the statute or the legislative history that modifies the recognition period for this type of income for the purposes of section 382(h)(6). Thus, it is our view that COD income should have the same recognition period as other income for purposes of section 382(h)(6). While the Secretary has the authority under section 382(m) to prescribe regulations as may be necessary or appropriate to carry out the purposes of section 382, we do not believe it is necessary, or appropriate, to have a different recognition period for COD income for the purposes of determining NUBIG, NUBIL, and RBIG.

The preamble does not state a policy reason to limit an increase to RBIG to first-year COD income. The preamble solely states that the proposed regulations adopt the 1374 approach under Notice 2003-65, perhaps as a matter of convenience.[68] The 1374 approach in Notice 2003-65 adopts the same rule as in Treas. Reg. § 1.1374-4(f), which has a different objective than section 382. First, the rule in Treas. Reg. § 1.1374-4(f) does not measure the extent that COD income is built-in on the date of reference (i.e., the change date). Thus, the Notice only seeks to capture COD income

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[66] The preamble states:

> "[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 principal.' Under this principle the built-in gains and losses of a loss corporation, once recognized after an ownership change, generally are to be treated in the same manner as if they had been recognized before the ownership change. . . . 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."

[67] *See* S. Rep. No. 100-445, 48 (1988) stating, "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 recognized built-in gain for the taxable year in which it is properly taken into account."

[68] The preamble states, "[T]hese proposed regulations would provide taxpayers with the option to treat certain COD income recognized during the first 12 months of the recognition period as RBIG (and consequently to make corresponding adjustments to the taxpayer's NUBIG/NUBIL computation). The 12-month limitation on RBIG treatment is adopted from the 1374 approach under Notice 2003-65."

that is proximate to the change date. As noted above, the proposed regulations already attempt to measure the amount of built-in COD income on the change date by limiting the total adjustment to the NUBIG-NUBIL Amount and RBIG to pre-change excess recourse liabilities and inadequately secured nonrecourse liabilities respectively. Therefore, the rules should allow taxpayers to treat COD income as adjustments to NUBIG/NUBIL and RBIG for the entire recognition period in section 382(h)(7) provided such COD income does not exceed pre-change excess recourse liabilities and inadequately secured nonrecourse liabilities, as applicable.

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations providing a safe harbor for determining "built-in COD income" immediately before the change date.

Analysis

The proposed regulations limit the amount of COD income that may be subject to section 382(h)(6) to pre-change excess recourse liabilities and inadequately secured nonrecourse liabilities respectively. These limits are generally measured by the excess of the adjusted issue price of recourse liabilities and non-recourse liabilities, respectively, over the fair market value of the property subject to such liabilities determined immediately before the change date. There is a special rule for determining the pre-change excess recourse liabilities of a loss corporation under the jurisdiction of Title 11 on the change date under Prop. Reg. § 1.382-7(b)(8).

We understand that it is necessary to measure such "built-in COD income" potentially subject to section 382(h)(6) if taken into account during the recognition period on the change date. However, the determination of such amount based on the fair market value of property on the change date could be administratively burdensome for taxpayers because it would require taxpayers to separately value their assets. In order to reduce this burden on taxpayers, we recommend providing a safe harbor to measure built-in COD income for specific debt instruments rather than an aggregate approach.

A safe harbor could be applied to an issue of debt instruments that are traded on an established market under Treas. Reg. § 1.1273-2(f) (publicly traded). Taxpayers are already required to determine the fair market value of debt instruments that are publicly traded for other purposes (e.g., section 1273). The regulations under section 1273 provide that the fair market value of property that is publicly traded, including debt instruments, is presumed to be equal to such property's sales price or quoted price under Treas. Reg. § 1.1273-2(f)(2) through (4).[69] Thus, if debt is publicly traded immediately before a change date, a sales price, firm quote, and/or indicative quote will be available proximate to the change date.

A safe harbor which determines the amount of built-in COD income immediately before the change date based on the fair market value of publicly traded debt under Treas. Reg. § 1.1273-2(f) is preferable. The safe harbor amount of built-in COD income could be measured by the excess of: (i) the adjusted issue price of a debt instrument; over (ii) the fair market value of such debt instrument immediately before the change date determined under Treas. Reg. § 1.1273-2(f). COD

[69] Treasury Reg. § 1.1273-2(f)(5).

income recognized during the recognition period with respect to such debt instrument could qualify as RBIG to the extent that the adjusted issue price of a debt instrument exceeds its fair market value immediately before the change date.

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations clarifying how COD income affects NUBIG/NUBIL of a consolidated group.

Analysis

The proposed regulations do not indicate how the rules set forth therein should apply in consolidation.

The sections relating to consolidated groups in general, and the sections applying section 382 to consolidated groups in particular, generally seek to treat a consolidated group as a single entity.[70] Therefore, final regulations should be applied to a loss group in a manner that results in aggregate NUBIL or NUBIG that matches the NUBIL or NUBIG that a single corporation with the same assets and liabilities would have. In the absence of any mechanism to achieve this result, the current rules will not always apply in this manner, (e.g., where one member of a loss group is liable on "External Liabilities," i.e., liabilities other than debt owed to other members of the consolidated group and deductible liabilities while the majority of assets are held by another member of a loss group).

Example 3

Parent of a loss group (P) owes $300 to a bank and its only assets are stock in two subsidiaries: (i) S1, which owns an asset worth $70 with a basis of $50; and (ii) S2, which owns an asset worth $30 with a basis of $50. If the indebtedness of P is not allocated to the assets of the group, and the NUBIG/NUBIL calculation is applied to each corporation separately, the results would be as follows:

- P would have zero NUBIL/NUBIG (because gain or loss on stock of an included member is not included in the group calculation);
- S1 would have $20 of NUBIG, and
- S2 would have $20 of NUBIL, which would aggregate to zero NUBIL/NUBIG for the group.

Contrast this result with the NUBIL/NUBIG calculation of a single entity with the same indebtedness and assets, which would have a NUBIG of $200 ($300 assumption of liability minus $100 aggregate basis), reflecting the $200 of built-in COD at the parent level.

[70] *See*, e.g., T.D. 8597, 1995-2 C.B. 147 ("The Treasury and the IRS believe that single entity treatment of both timing and attributes generally results in a clear reflection of consolidated taxable income.").

Final regulations should adopt a mechanism to achieve a single-entity result. One method to address this issue in the consolidated context would be to allocate External Liabilities pro rata to the assets of the loss group. Such an allocation would result in proper single-entity treatment of the loss group and would properly reflect the principles of section 382(h). Applying this mechanism to Example 3, P's $300 of indebtedness should be allocated $210 to S1 and $90 to S2. Applying the NUBIG/NUBIL calculation to this adjusted fact pattern, P would have zero NUBIL/NUBIG, S1 would have $160 of NUBIG, and S2 would have $40 of NUBIG, which would aggregate to a $200 NUBIG for the group, (i.e., the proper result from a single-entity standpoint).[71]

In addition to creating a mechanism through which a loss group can achieve single-entity treatment, the allocation of External Liabilities of the loss group to the assets of the loss group properly reflects the principles of section 382(h). As with a single insolvent corporation, a loss group will have built-in COD to the extent the loss group's External Liabilities exceed the fair market value of the assets held by the loss group. This result occurs since the ability of the holder of the External Liabilities to repay them will be limited to such value. Essentially, the allocation mechanism treats as built-in COD an amount equal to the loss group's External Liabilities that would remain unpaid if all of the assets of the loss group were sold on the change date for fair market value, and the proceeds were used to repay the External Liabilities to the extent possible. This treatment is consistent with section 382(h) and the proposed regulations, which seek to identify items of income, including COD that are built-in on the change date.

Alternatively, Treasury and the Service could adopt the methodology that was applied in PLR 201051019.[72] In that PLR, the Service ruled:

> "[E]xcept as otherwise modified by Notice 2003-65, the Parent Consolidated Group may apply the principles for computing and allocating the aggregate deemed sale price under §§ 1.338-4 and 1.338-6 to determine its amount realized on the hypothetical sale of all of its assets to a third party that assumed all of its liabilities. Liabilities immediately before the ownership change should be taken into account at their adjusted issue price regardless of whether they were subsequently discharged in whole or in part during the recognition period (which includes the change date) or thereafter. Amounts realized should be allocated to the stock and obligations of members of the Parent Consolidated Group notwithstanding that gain or loss might not be taken into account under Treas. Reg. § 1.1502-91."

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[71] Note that the example is simplified, because it may also be the case that the subsidiaries also have External Liabilities, but the formula applies equally effectively in those circumstances. For example, if each of S1 and S2 also had $25 of External Liabilities, the aggregate External Liabilities of $350 would be allocated $245 to S1 and $105 to S2. In that case, S1 would have NUBIG of $195 and S2 would have NUBIG of $55. In aggregate, the group would have a NUBIG of $250, appropriately reflecting the additional $50 of built-in COD at P, given the value of P's assets (i.e., the stock of its two subsidiaries would be $50 less because of the liabilities at the subsidiary level).
Note also that the pro rata allocation methodology does not put a premium on correct determination of relative fair market value, since the net effect on the NUBIL/NUBIG calculation will stay the same even if the valuation varies. If, for example, P in the above example allocated all $300 of debt to S1 and $0 to S2, P would have zero NUBIL/NUBIG, S1 would have $250 of NUBIG, and S2 would have $50 of NUBIL, which would still aggregate to a $200 NUBIG for the group.

[72] September 14, 2010.

Treasury Reg. § 1.338-4 provides that the amount realized in a section 338 sale is allocated among the acquired corporation's assets in accordance with Treas. Reg. § 1.338-6 to determine the amount for which each asset is deemed to have been sold.[73] Generally, Treas. Reg. § 1.338-6 provides that aggregate deemed sale price (ADSP) is allocated among six asset classes, Class I through Class VI, to the extent of the fair market value of the assets in each class.[74] Any remaining ADSP (i.e., the residual amount) is then allocated to Class VII, comprised of goodwill and going concern value.[75]

Example 4

P, the parent of a consolidated group, has liabilities of $100. P owns the stock of S, which is worth $60. S owns one asset with a value of $60 and a basis of $80. If our recommendation is adopted to allow all liabilities to be treated as assumed in calculating NUBIG/NUBIL (which will also simplify calculations in the consolidated context), P's amount realized on a deemed sale of its assets would be $100. Under Treasury Reg. § 1.338-6, $60 is allocated to its S stock and $40 is allocated to goodwill. P would have a $40 NUBIG on a separate company basis, equal to its $40 amount realized with respect to hypothetical goodwill minus $0 basis in that goodwill (gain or loss on stock in members is still ignored for this purpose). S would have a $20 NUBIL, equal to its $60 amount realized on its sale of its asset minus $80 of basis. Together, the P-S group would have $20 NUBIG, which is equal to the NUBIG/NUBIL that would be recognized by a single entity with the same assets and liabilities ($100 amount realized minus $80 basis).

If this methodology is adopted, Treasury and the IRS should clarify that allocation of excess ADSP to goodwill does not create or raise the fair market value of goodwill and, therefore, does not give rise to an item for which forgone amortization can give rise to RBIG (even if a general forgone amortization concept is adopted).

III. Definition of Recognized Built-in Gain and Recognized Built-in Loss

1. Uniformity Between Income and Deduction Items Generally

Overview

The 1374 approach under the Notice is restrictive. It generally only treats an item as built-in if the item would already have given rise to a deduction by an accrual-method taxpayer before the change date, except that, for purposes of determining whether an item is RBIL, the economic performance rules of section 461(h)(2)(C) and Treas. Reg. § 1.461-4(g) do not apply. In other words, with certain limited exceptions, if anything other than the economic performance requirement would cause the item not to be taken into account, that item does not give rise to RBIG or RBIL under the Notice. The Notice notes explicitly 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

[73] Treasury Reg. § 1.338-4(a).
[74] *See generally* Treas. Reg. § 1.338-6.
[75] *Id.*

accrue before the change date. The proposed regulations state they will adopt the 1374 approach; however, they deviate from the 1374 approach in significant ways.

In the proposed regulations, the definition of RBIG generally provides:

> "…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."[76]

The definition of RBIL generally provides:

> "any deduction properly allowed during the recognition period is treated as recognized built-in loss if an accrual-method taxpayer would have been allowed a deduction for the item against gross income before the change date (taking into account any additional methods of accounting actually used by the loss corporation). For purposes of this [definition of RBIL], in determining whether an accrual-method taxpayer would have been allowed a deduction before the change date, no taxable income or timing limitation applies."[77]

A "taxable income or timing limitation" is defined as:

> "(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)." [78]

The proposed regulations also include as RBIL a deduction for the payment of a deductible liability, to the extent of the amount or the estimated amount of the liability. [79] The proposed regulations exclude from RBIG items such as: prepaid income; certain inclusions of COD; dividends paid on stock (including gain taxable as a dividend under section 1248); and inclusions of income with respect to stock, for example under section 951(a) and 951A(a).[80]

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[76] Proposed Reg. § 1.382-7(d)(2).
[77] Proposed Reg. § 1.382-7(d)(3).
[78] Proposed Reg. § 1.382-7(b)(12).
[79] Proposed Reg. § 1.382-7(c)(3)(D), and (E).
[80] Proposed Reg. § 1.382-7(d)(2)(ii), (iii), and (vi).

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations that harmonize the definitions of RBIG and RBIL, such that principles apply consistently to items of income and deduction.

Analysis

The proposed regulations state they will adopt the 1374 approach from Notice 2003-65. Because the 1374 approach in Notice 2003-65 narrowly defines built-in items, historically it has been viewed as favorable to taxpayers in a NUBIL position (where limiting RBIL is desirable) and unfavorable to taxpayers in a NUBIG position (where maximizing RBIG is desirable). The approach adopted in the proposed regulations fundamentally departs from the 1374 approach of the Notice. The proposed regulations expand what can be captured as RBIL, while adhering to a fairly strict accrual method with respect RBIG. We see no justification for this inconsistent treatment; therefore, we suggest the approach to RBIG and RBIL be harmonized.

For example, the proposed regulations would take into account in NUBIG/NUBIL, and capture as RBIL, contingent liabilities. However, the proposed regulations decline to treat forgone amortization from wasting assets as RBIG. Forgone amortization and contingent liabilities both represent amounts that are economically built-in based on expected future income or deduction, respectively. If Treasury and the Service choose to adopt an economic approach in the case of deductions, the approach in the case of income should also be adopted.

Furthermore, the proposed regulations include as RBIL items that would be taken into account by an accrual method taxpayer but for a "taxable income or timing limitation." There is no similar expansion of the asserted 1374 approach to capture as RBIG income items that would have been taken into account prior to the ownership change but for a timing limitation[81] as RBIG. If Treasury and the IRS decide to include this concept on the deduction side, it should not apply on the income side as well. Therefore, items of income that are deferred due to a timing limitation should be taken into account in NUBIG/NUBIL and as RBIG.

Finally, the initial clauses in the definitions of RBIG and RBIL, which seem to be intended to arrive at the same point, use different phrasing. The RBIG definition refers to "…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)."[82] The RBIL definition refers to "any deduction properly allowed during the recognition period is treated as recognized built-in loss if an accrual-method taxpayer would have been allowed a deduction for the item against gross income before the change date (taking into account any additional methods of accounting actually used by the loss corporation)." Unless Treasury and the IRS intend that

[81] Generally, income items will not be deferred by a taxable income limitation as described in clause (i), thus expansion primarily would relate to timing items on the income side.
[82] Proposed Reg. § 1.382-7(d)(2).

these phrases apply differently (which we would not suggest), parallel language should be used to avoid any uncertainty created by the dissimilar language.

2. Contingent Liabilities

Overview

Under the Notice, the estimated value of contingent deductible liabilities (as of the change date) was subtracted as part of the NUBIG/NUBIL calculation. However, the ultimate payment of such liabilities did not give rise to RBIL. The preamble notes that this asymmetry violates the neutrality principle. Therefore, the proposed regulations treat payments on a contingent liability as RBIL to the extent of the estimated value of the contingent liability as of the change date.

Recommendations

The AICPA recommends that the IRS and Treasury issue final regulations generally retaining the rule that would treat contingent liabilities as RBIL, subject to our more specific recommendations below, in conjunction with our recommendation that wasting assets should be taken into account as RBIG.

If the decision is made not to incorporate the wasting assets concept, we recommend that contingent liabilities not be taken into account in NUBIG/NUBIL or as RBIL.

Analysis

There are arguments for and against treating contingent liabilities as "attributable to the pre-change period" within the meaning of section 382(h). In certain instances, such as where a taxpayer anticipates future tort claims based on actions already taken by the taxpayer, the deduction could appear attributable to the pre-change period.[83] In other instances, such as liabilities attributable to cost to perform a future service or liabilities attributable to future payments of underlying insurance claims, the connection is less clear.[84]

Nevertheless, as noted above, we view contingent liabilities as representing a similar economic approach on the deduction side as forgone amortization on the income side. Therefore, to take a consistent approach, both features should be retained. However, to the extent contingent liabilities continue to be treated as RBIL and factored into NUBIG/NUBIL in the final regulations, we note certain complexities and aberrations can arise based on the approach taken in the proposed regulations, addressed below.

[83] Although in that case, income from an anticipated settlement should likewise be captured in RBIG.

[84] The logic previously espoused by the Service would indicate that such items are not attributable to the pre-change period. *See supra* note 92 and accompanying text.

Applicable Financial Statements

Overview

The proposed regulations provide if any contingent liability is reflected on the face of the most recently issued applicable financial statement (AFS) within the meaning of section 451(b)(3) and the regulations thereunder, the estimated value of a liability is the amount of such liability reflected on the most current AFS as of the change date. The estimated value of any liability is not adjusted to reflect the actual amount of liability that is established on removal of the contingency.

Recommendations

The AICPA recommends that the IRS and Treasury issue final regulations retaining the AFS measure provided for in the proposed regulations, subject to our recommendation related to relinking liabilities and amounts realized below.

We further recommend that the final regulations clarify if a taxpayer files an AFS and a liability is not reflected on that AFS (i.e., because it is too contingent), it is not taken into account as a contingent liability.

Analysis

AFS may not match market value for various reasons. For example, GAAP accounts for breach-of-contract liabilities based on the amount asserted by a contract without regard to any potential reduction to the amount as a result of settlement (i.e., if a contract asserts a $1 million payment if certain terms are breached, GAAP would book $1 million as liability, even though a breach of contract claim is likely to be settled for a lesser amount). Furthermore, GAAP measures loss contingencies without regard to any expected insurance recoveries. As another example, pension liabilities can be valued on the AFS assuming certain actions going forward (i.e., that employees will receive certain percentage raises every year), which the buyer could choose not to take. Further, there is significant subjectivity in determining amounts reflected on the AFS. Consequently, different loss corporations may have different amounts reflected on the AFS, even with respect to the same liability.

Although an AFS may not accurately capture the market value of contingent liabilities, we recognize the benefit of having an administrable rule. Therefore, retaining this feature is optimal in most cases.[85] However, to minimize the significant issues that could arise from this potential deviation from market value, relinking liabilities and the amount realized should occur, as discussed below.

[85] We recommend departing from AFS in determining built-in items with respect to cost to perform in connection with prepaid income.

Relinking Liabilities and Amount Realized

Overview

Under Notice 2003-65, NUBIG or NUBIL is determined by calculating the net amount of gain or loss that would be recognized if the loss corporation sold all of its assets at fair market value to a third party that assumed all of its liabilities: (i) decreased by the sum of: (a) any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale; and (b) the loss corporation's aggregate adjusted basis in all of its assets; (ii) increased or decreased by the corporation's section 481 adjustments that would be taken into account on a hypothetical sale; and (iii) increased by any RBIL that would not be allowed as a deduction under sections 382, 383 or 384 on the hypothetical sale.

Because all liabilities of the loss corporation are deemed assumed in this calculation, it is not necessary to precisely value contingent liabilities because the liabilities would be taken into account both in amount realized and as a reduction to the formula, such that the amounts offset.

The proposed regulations would modify the calculation of NUBIG/NUBIL, such that only nonrecourse liabilities are treated as assumed in the hypothetical sale. This adjustment stems from the desire of Treasury and the IRS to modify the treatment of built-in COD income under the formula, as discussed in the cancellation of indebtedness income section of this letter. However, by delinking the amount realized from liabilities, this adjustment also creates complexities with respect to the valuation of contingent liabilities.

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations reverting back to the formulation of NUBIG/NUBIL in Notice 2003-65, where a third party is deemed to assume all the liabilities of the loss corporation.

Analysis

Treating all liabilities of the loss corporation as assumed in a hypothetical sale allows the amount realized and deductible liabilities to offset, which reduces issues that can arise based on valuations of the contingent liabilities.[86] Because contingent liabilities are "in-and-out" of the NUBIG/NUBIL calculation set forth in the Notice, it is not necessary that contingent liabilities be valued precisely for the purposes of the NUBIG/NUBIL calculation. While valuation is still necessary for RBIL purposes, RBIL only applies to items recognized in the five years after the ownership change, which is a more limited subset of items.

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[86] Congress was concerned with complexities of valuation and took steps to reduce burdens. See H.R. REP. NO. 99-426, 1986-3 (PART 2) C.B. 1 (1985) ("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 *minimis* 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.").

Example 5

> Assume ProfitCo purchases 100% of the stock of LossCo for $100 cash. LossCo has assets valued at $125. LossCo has no non-contingent liabilities, and a contingent deductible recourse liability which is reflected at $50 on AFS. LossCo has zero basis in its assets. If a third party is willing to pay $100 for the stock of a corporation with assets worth $125, it indicates that the market values the contingent liability at $25. Under the Notice, LossCo would have $100 NUBIG ($125 realized reduced by $25 deductible liability). However, this formulation does not consistently correctly value the contingent liabilities. If instead the contingent liabilities are deemed to be valued at $50, as reflected on the AFS, the amount realized on a sale to a third party that assumed all the liabilities must be $150 (a third party that values the stock at $100 would only assume $50 of liabilities if receiving $150 of assets). The NUBIG/NUBIL calculation would result in $100 NUBIG ($150 amount realized reduced by $50 deductible liability). Because deductible liabilities are accounted for both in amount realized and as a reduction to the calculation, capturing the precise value of the deductible liabilities correctly is inconsequential; the amounts offset in any case.

Because the proposed regulations do not deem the hypothetical third party to assume recourse liabilities of the company in the deemed asset sale, this offsetting mechanism does not function in the same manner under the proposed regulations. Applying the proposed regulations to the example above, the amount realized on the sale of assets to a third party that did not assume liabilities would be $125, but that amount must be reduced by $50 to account for the amount of deductible liability reflected on AFS, resulting in a $75 NUBIG. We are unaware of any policy reason for the $25 difference (between the result under the Notice and the apparent result under the proposed regulations); it merely reflects that AFS may not always accurately capture the market value of the contingent liability, and that the proposed regulations provide no mechanism to link the amount realized to the amount of reduction.

3. Linked Income and Deduction Items

Overview

The disparate approach to RBIL and RBIG can produce inconsistent results particularly in situations where income and deduction items are inexorably linked. For example, the proposed regulations provide that any amount received prior to the change date that is attributable to performance occurring on or after the change date (prepaid income) is not RBIG.[87] Alternatively, it appears that contingent liabilities associated with the cost to perform that service (cost to perform) would be included as RBIL. This treatment can lead to inappropriate results.

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[87] The IRS and Treasury previously addressed the treatment of deferred revenue under section 382(h) in Treas. Reg. § 1.382-7 which provides: "For purposes of section 382(h), prepaid income is not recognized built-in gain. The term prepaid income means any amount received prior to the change date that is attributable to performance occurring on or after the change date." *See also* TAM 199942003 (Oct. 25, 1999) (same conclusion reached in a prior technical advice memo).

Example 6

> At the time of an ownership change, LossCo has an asset worth $50, which it purchased with $50 cash received as an advanced payment for services to be provided in the future. LossCo deferred inclusion of the payment into gross income pursuant to Revenue Procedure 2004-34. The market estimated cost to perform those services is $30. LossCo does not have any other assets or liabilities. LossCo does not have any section 481 adjustments that would be taken into account on a hypothetical sale, or any RBIL that would not be allowed as a deduction under sections 382, 383 or 384 on a hypothetical sale.

In this example, policy would dictate that LossCo should have a $20 NUBIG. LossCo will recognize net income of $20 after the ownership change ($50 of prepaid income taken into account offset by $30 cost to perform), which is attributable to items that were built-in prior to the ownership change. At the time of the ownership change, an arm's length buyer would pay $20 for LossCo because LossCo has $50 of assets and a $30 liability. Then, if all items of LossCo that were built-in on the change date were recognized during the recognition period, LossCo would have $20 of net income. The $20 of net income would be generated without LossCo increasing in value or generating any new return after the ownership change.

It is appropriate for the $20 to be treated as RBIG because if that revenue had been recognized prior to the ownership change, rather than being deferred into the post-change period, pre-change NOLs would have been available to offset that income. Thus, as a policy matter, it is appropriate to not limit the $20 of NOL after the ownership change.

However, one could read the proposed regulations to calculate NUBIG/NUBIL in this example as follows: $50 amount realized - $50 basis - $50 deductible liabilities[88] = $50 NUBIL. This application seems inappropriate since LossCo does not have a net built-in loss. This example also illustrates the issues raised by delinking the amount realized and deductible liabilities. However, even if cost to perform is included at its market value of $30, the taxpayer would have $30 NUBIL, which is inappropriate.

Recommendations

The AICPA recommends that the IRS and Treasury issue final regulations providing for one of the following outcomes (in order of preference):

- Prepaid income be taken into account in the NUBIG/NUBIL calculation, and net against cost to perform to determine RBIG and RBIL;
- Prepaid income be taken into account in NUBIG/NUBIL and the full amount recognized as RBIG, while the full amount of cost to perform is recognized as RBIL; or

[88] Deferred revenue is booked on AFS equal to the full value of the contract, on the theory that if services are not performed, the amount would be refunded to the other party to the contract. This example also illustrates the issues raised by delinking the amount realized and deductible liabilities. However, even if cost to perform is included at its market value of $30, the taxpayer would have $30 NUBIL, which is inappropriate].

- Cost to perform not be taken into account in NUBIG/NUBIL or as RBIL.

The AICPA also recommends that the final regulations take a similar approach with other linked items of income and deduction.[89]

Analysis

Accelerated prepaid income should be taken into account as an additional item in the NUBIG/NUBIL formula. For example, under the facts of Example 1 (assuming our relinking suggestion is adopted),[90] the calculation would be \$70 amount realized (assets must be deemed to be worth \$70 if third party would assume a \$50 liability and the stock is worth \$20) + \$50 prepaid income - \$50 basis - \$30 deductible liabilities = \$20 NUBIG.

With respect to RBIL and RBIG, any excess of prepaid income over cost to perform should be treated as RBIG (i.e., \$20 in Example 1), and any excess of cost to perform over prepaid income be treated as RBIL. For this purpose, the cost to perform should be based on market liability, rather than the amount of deferred revenue booked as a liability on AFS. Deferred revenue is booked at the amount of the prepaid income; therefore, generally there would not be any net RBIG or RBIL if the AFS amount of deferred revenue is deemed to represent the liability for cost to perform. Therefore, it is appropriate to diverge from that standard for this purpose. This approach deviates from the general treatment recognized built-in in losses and recognized built-in gain as separate items, with the former only taken into account when the taxpayer is in a NUBIG position, and the latter only taken into account when the taxpayer is in a NUBIL position. However, we believe this approach most accurately captures built-in items in similar cases, where the income and the deduction item are linked.

If the IRS and Treasury do not apply a netting approach, prepaid income should still be taken into account in NUBIG/NUBIL and be treated as RBIG. We are unaware of any policy reason for treating cost to perform as RBIL and not treating prepaid income as RBIG. The items are equally attributable to the pre-change period. Furthermore, including prepaid income in NUBIG/NUBIL and as RBIG is consistent with Congress' vision of section 382(h). In legislative history, Congress described the purpose of section 382(h) as follows:

> "The committee bill also provides relief for loss corporation having built-in gain assets. Built-in gains are often the product of special tax provisions that accelerate deductions *or defer income* (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

[89] For example, a similar issue can occur to the extent an insurance company is required to include as contingent deductible liabilities the future unaccrued insurance claims of the insurance company less the present value of future premiums (i.e., contingent claim liabilities), but not the income from the associated release of tax reserves.

[90] We illustrate in text the result if AFS is deemed to be the amount of the liability, but the same result is obtained if market liability is taken into account. In that case, the formula would be \$50 amount realized (assets valued at \$50 if third party would assume \$30 and stock is worth \$20) plus \$50 accelerated prepaid income minus \$50 basis minus \$30 deductible liability = \$20 NUBIG. This example illustrates how relinking solves numerous issues.

> carryforwards would have been fully available to offset such gains had the gains been recognized before the change in ownership occurred."[91]

Thus, Congress explicitly contemplated that deferred income would be captured.

Including the full amount of prepaid income as RBIG and cost to perform as RBIL has the appeal that it is consistent with the general operation of section 382(h), and with Treasury's decision to include contingent liabilities as RBIL. However, it is arguably inappropriate from a policy perspective because it fails to take into account the linked nature of the income and deduction items, which will result in overstatement of both RBIG and RBIL.

As a third option, Treasury and the IRS could apply the logic they previously have put forth in concluding that prepaid income should not be treated as RBIG to determine that cost to perform should not be treated as RBIL or taken into account in NUBIG/NUBIL. The preamble to prior temporary Treas. Reg. § 1.382-7 which, similar to the proposed regulations, contained a provision that prepaid income is not RBIG, explained that the IRS and Treasury believe that prepaid income is attributable to the period on or after the change date (post-change period) rather than the pre-change period because the post-change period is the period in which performance occurred and expenses were incurred to earn the income.[92] Thus, according to the IRS and Treasury, treating prepaid income as RBIG is inconsistent with the purposes of section 382(h). Under this logic, then cost to perform likewise should not be treated as RBIL or taken into account in NUBIG/NUBIL. Just as the performance does not occur until the post change period for prepaid income, the expenses associated with cost to perform are not incurred until the post change period.

The NUBIG/NUBIL calculation under this alternative formulation would result in $0 NUBIG ($50 amount realized - $50 basis). If it is the view of Treasury and the IRS that prepaid income and cost to perform are not attributable to the pre-change period, then the result is correct: there are no items built-in; therefore, nothing is captured in the NUBIG/NUBIL formula. However, this approach appears inconsistent with the legislative history referenced above, as well as the general inclusion of contingent liabilities as RBIL and in NUBIG/NUBIL.

4. Dividends

<u>Overview</u>

The proposed regulations indicate that dividends, including gain taxable as a dividend under section 1248, will not be treated as RBIG, even if the taxpayer is in a NUBIG position. According to the preamble states:

> "[T]hese proposed regulations would add a rule clarifying that certain items do not constitute RBIG. For example, the proposed regulations provide that dividends paid on stock during the recognition period are not RBIG, even if the loss corporation has a NUBIG and there is gain built into the pertinent stock immediately before the ownership change. On the other hand, gain recognized on

[91] SEN. REP. NO. 99-313, 1986-3 (VOL. 3) C.B. V, 1986-3 (PART 3) C.B. 1 (emphasis added).

[92] 72 FR 32792-01. *See also* TAM 199942003 (applying this same logic in a PLR).

the disposition of stock generally would be treated as giving rise to RBIG. However, gain taxable as a dividend under section 1248 would generally give rise to a deduction under section 245A, with no net income being generated. Because no losses would be required to offset this item of income, the Treasury Department and the IRS have determined that this income item should not give rise to RBIG."

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations providing that income recognized on a distribution of pre-change earnings and profits (E&P) be treated as RBIG to the extent the income is not offset by a dividends received deduction (DRD) or excluded from income under Treas. Reg. § 1.1502-13(f)(2) (i.e., where the dividend gives rise to taxable income that is not offset by post-change deduction).

Analysis

The neutrality principle that underlies section 382(h) necessitates that a distribution of pre-change E&P in the recognition period put the loss corporation in same position in which it would have been had the distribution happened pre-change. Based on this language in the preamble, the logic of excluding dividends from RBIG treatment is that dividends generally can be offset by a DRD; therefore, there is no income that pre-change losses need be used to offset. However, there are many situations in which a full DRD is not available. Sections 243 through 246 impose a number of requirements and limitations on the ability of a corporation to take a DRD with respect to dividends received. If a taxpayer received a taxable dividend for which there was no offsetting deduction pre-change, it would have been able to offset the dividend with pre-change losses. Therefore, the same result should occur if a dividend is received in the recognition period. Otherwise, the regulations could incentivize self-help and uneconomic transactions. Taxpayers would be incentivized to distribute all of their E&P in advance of an ownership change, which may not be consistent with the business needs of the corporations. Taxpayers who are unable to effect a distribution (e.g., minority owners) would be disadvantaged.

Furthermore, the proposed regulations would treat gain on the disposition of stock as RBIG, and built-in gain on stock is taken into account in NUBIG/NUBIL. When E&P is distributed out of a corporation, it reduces the value of the corporation without a corresponding reduction in basis.[93] In effect, the distribution is a realization event with respect to that existing built-in stock gain.

Example 7

LossCo forms S with $100 cash. S uses the $100 to purchase assets and begins to generate E&P. Immediately prior to an ownership change of LossCo, S has $100 of E&P, and its value has increased to $200. In computing its NUBIG/NUBIL, LossCo takes into account the $100 built-in gain with respect to its S stock. Then, in the recognition period, S distributes $100 to LossCo. Assume no DRD is available. LossCo has $100 taxable income, which it cannot use pre-change NOLs to offset. Had S distributed that same $100 immediately before the ownership

[93] Section 301(c)(1).

change, LossCo would have been allowed to use pre-change NOLs against that income. In addition, the value of S has decreased to $100. Therefore, if LossCo sells the stock of S, it will not recognize any gain, or have an RBIG.

5. Bad Debt Deductions

Overview

The 1374 approach under Notice 2003-65 treated as RBILs only those bad debt deductions taken in the first twelve months of the recognition period. This method mirrored the approach to COD income, which could give rise to RBIG only if recognized in that period. Under the proposed regulations, bad debt deductions, to the extent attributed to built-in loss on the change date, are treated as RBILs if recognized at any time during the five-year recognition period.

Recommendation

We recommend that the IRS and Treasury issue final regulations providing for the coordination of the COD income and bad debt deduction rules (i.e., if COD income is not allowed to be recognized in the full recognition period, bad debt deductions should likewise be limited to the first 12 months after the ownership change).

Analysis

As noted in the cancellation of indebtedness income section of this letter above, the rule that would limit the extent that COD income is treated as RBIG is inconsistent with the proposed treatment of COD income, which can only give rise to a benefit if recognized in the first 12 months of the recognition period.

IV. Proposed Effective Date

Overview

The proposed regulations provide that the rules apply to any ownership change occurring after the date of publication of the Treasury decision adopting the proposed regulations in the *Federal Register*.[94] For ownership changes occurring on or before that date, taxpayers are referred to the existing provisions of the regulations regarding built-in gains and losses.[95] However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the proposed regulations to any ownership change occurring during a taxable year with respect to which the period of limitations described in section 6511(a) has not expired, as long as such persons consistently apply all of the proposed rules to the ownership change and all subsequent ownership changes that occur before the applicability date of final regulations.[96]

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[94] Proposed Reg. §§ 1.382-2(b)(4) and 1.382-7(g)(1).

[95] Treasury Reg. § 1.382-7 currently contains only a brief, narrowly focused regulation on the treatment of prepaid income for purposes of section 382(h), applicable to ownership changes on or after June 11, 2010.

[96] This formulation of the proposed effective dates is virtually identical in both of the sections proposed to be amended. However, there appears to be an inadvertent error in the drafting of Prop. Reg. § 1.382-7(g)(1). The effective date

Recommendation

The AICPA recommends that the IRS and Treasury issue final regulations which adopt transitional effective date rules to permit loss corporations to use the provisions of existing guidance, including Notice 2003-65, for ownership changes that occur after the date of publication of the final regulations in the *Federal Register*, provided that certain concrete steps have been completed before the date of publication. Exceptions should be provided for ownership changes occurring pursuant to binding commitments in place, or bankruptcy proceedings commenced, prior to the date of publication.

The effective date of the final regulations should contain at least two transitional rules. The final regulations should not apply to an ownership change that occurs pursuant to a written binding contract in effect before the date of publication of the Treasury decision in the *Federal Register*, and at all times thereafter before the ownership change. In addition, the final regulations should not apply to an ownership change that occurs pursuant to a reorganization or other transaction in a title 11 or similar case (within the meaning of section 368(a)(3)), if a petition in such case was filed with the court before the date of publication of the Treasury decision.

We also recommend that the provisions for obsoleting Notice 2003-65 mirror the effective date provisions, including transition rules, which will ultimately be adopted in the final regulations.

Analysis

With few exceptions, the ability of a loss corporation (or any acquiror or successor) to use its NOLs and other tax attributes following an ownership change is a vital consideration in determining the nature and structure of any transaction, the price to be paid for the stock, other terms of the transaction, and whether a transaction should be treated (for federal income tax purposes) as an actual or deemed purchase and sale of assets or a transfer of the corporation's stock. Acquisitions of loss corporations may be subject to an agreement with customary terms and conditions that take months to complete.[97] In addition, an ownership change often occurs when a loss corporation emerges from a bankruptcy case. While the ownership change normally occurs upon consummation of the plan of reorganization, this step is often one of the last in the bankruptcy process, and may occur months (if not a year or more) after the commencement of the case.

Affected taxpayers had more than 16 years to apply the alternative safe harbor approaches set forth in Notice 2003-65, which were generally viewed as favorable to taxpayers compared with the guidance in effect prior to the issuance of the Notice. Under the terms of that Notice, taxpayers may rely on the approaches set forth therein for purposes of applying section 382(h) to an ownership change that occurred prior to the effective date of temporary or final regulations under section 382(h).[98] Consistent with transitional rules provided for other changes under section 382 and the regulations thereunder, exceptions should be provided for ownership changes occurring

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provisions in this paragraph should provide that taxpayers must "consistently apply the rules of this section and § 1.382-2(a)(9) through (13)," rather than the rules of "this section and § 1.382-7(a)(9) through (13)."

[97] *See*, e.g., Treas. Reg. § 1.382-4(d)(7)(i), which provides that an agreement to acquire stock is an option that is not treated as having been exercised under the income, control, and ownership tests if, among other conditions, it is closed within one year after it is entered into.

[98] Notice 2003-65, Part V.

pursuant to binding commitments in place, or bankruptcy proceedings commenced, prior to the date of publication. In contrast, if the proposed regulations are adopted without modification, the application of those regulations to a post-publication ownership change would generally be less favorable to affected taxpayers.

The provisions for obsoleting Notice 2003-65 mirror the effective date provisions, including transition rules, which will ultimately be adopted in the final regulations. Thus, for example, if a loss corporation has entered into a binding commitment prior to the date of publication that will result in an ownership change after the date of publication, such a taxpayer should be permitted to use the provisions of the notice in their entirety. A loss corporation should not find itself in a position where it is not subject to the final regulations because of a transitional rule but is also not able to rely on the provisions of the notice because it has become obsolete.

Moreover, inasmuch as the proposed regulations reflect significant changes from existing guidance under section 382(h), particularly Notice 2003-65, there can be no assurance that the final regulations will not reflect further modifications based on the comments received in response to the proposed regulations. If there are no transitional rules along the lines set forth above, affected taxpayers may have committed themselves to transactions, or commenced bankruptcy proceedings, without being able to assess the effect of final rules that are not known to them at the time they take these crucial first steps.