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Awaiting the New Change-of-Control Built-In Gain Rules

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In this report, Nugent analyzes several issues that the IRS is considering for anticipated new proposed regulations regarding built-in gains and losses after an ownership change under section 382, including rules on the treatment of liabilities and the consumption of "wasting" assets, and he offers views regarding the possible treatment of wasting assets under section 384.

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I. Introduction

Section 382 imposes a significant annual limit on a loss corporation's ability to use its net operating loss carryforward and other tax assets following an ownership change. One of the cardinal rules of section 382 is the neutrality principle embodied in section 382(h), which generally mandates equivalent treatment for a loss corporation's built-in gains (and losses) whether recognized before (or after) an ownership change. Since 2003, taxpayers admittedly have enjoyed a quite favorable landscape in using their tax assets following an ownership change.

As discussed in detail below, Notice 2003-65, 2003-2 C.B. 747, established two different safe harbors and gave taxpayers electivity in their approach. Taxpayers that have a net unrealized built-in loss (NUBIL)[1] in their assets at the time of an ownership change typically elect the section 1374 approach (as defined below), which generally allows taxpayers following an ownership change to avoid treating contingent

[1]A NUBIL is the excess, if any, of the aggregate adjusted basis in the loss corporation's assets over the fair market value of those assets as determined immediately before the ownership change, *i.e.*, the opposite of a NUBIG (as defined below). Section 382(h)(3).

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losses as recognized built-in loss (RBIL)[2] because the loss had not yet accrued under general tax principles at the time of the ownership change. On the other hand, taxpayers that have a net unrealized built-in gain (NUBIG)[3] in their assets at the time of an ownership change generally elect the section 338 approach (as defined below), which gives them the opportunity to increase the their NOL utilization for recognized built-in gain (RBIG)[4] without actually having to sell or otherwise dispose of any assets.

Although the government had long signaled that it would abandon this dual approach, the proposed Treasury regulations released in September 2019 swung the pendulum too far in the opposite direction. Admittedly, eliminating dual approaches that invite taxpayer electivity and clarifying the built-in item (or accrual) standard associated with the section 1374 approach are logical ways to improve section 382(h)'s administrability. However, as detailed below, the proposed regulations would go well beyond those more modest aims and make wholesale revisions to how NUBIG and NUBIL (collectively or alternatively, NUBIG/L) are calculated and substantially restrict how RBIG is measured.

The proposed regulations were not favorably received by commentators, who urged the government to rethink substantial aspects of the regulatory project. In January 2020 the government alleviated some of the tension caused by the initial proposed regulations when it announced new transition rules for eventual final regulations, which would allow taxpayers to apply Notice 2003-65 to certain future ownership changes.[5]

Eventually, officials indicated publicly that the government would not finalize the proposed regulations but instead would issue new proposed regulations on calculating built-in gains and losses following an ownership change.[6] The issues addressed in the proposed regulations are critical to many taxpayers (distressed and non-distressed alike). Accordingly, it is welcome news that the government is reconsidering its thinking on these issues.[7]

In anticipation of new proposed regulations, the principal recommendations of this report are:

- The NUBIG/L computation under section 382(h) should include all of a loss corporation's liabilities.
- The recognition period should begin at the end of the change date immediately after the ownership change.
- Loss corporation items recognized on the change date should be allocated to the pre-change period and excluded from the NUBIG/L computation, other than excluded cancellation of indebtedness (COD) income realized under section 108(a), which effectively does not have an impact until the end of the tax year (that is, in the recognition period), and therefore should be included in the NUBIG/L computation. The same result should still attain if the loss corporation deconsolidates from a consolidated group on the change date.
- The government should address the treatment of liabilities in computing NUBIG/L in the consolidated group context, either as part of the same package as the expected new proposed regulations under section 382(h) or separately.
- During the recognition period, a loss corporation should be permitted to treat a portion of its built-in gain in "wasting" assets at the time of an ownership change as RBIG, even though the loss corporation does

[2] Section 382(h)(1)(B) and (2)(B).

[3] A NUBIG is defined as the excess, if any, of the aggregate FMV of a loss corporation's assets over its aggregate adjusted basis in those assets, as determined immediately before the ownership change. Section 382(h)(3)(A). A NUBIG is limited to zero unless it exceeds a certain threshold. Section 382(h)(3)(B). The threshold under current law is the lesser of 15 percent of the FMV of the loss corporation's assets as of immediately before the ownership change and $10 million. *Id.* The version of section 382 enacted in 1986 set the threshold at 25 percent of the FMV of the loss corporation's assets as of immediately before the ownership change, but this was reduced to the current threshold in 1989. *Compare* Internal Revenue Code of 1986, P.L. 99-514, *with* the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239.

[4] Section 382(h)(1)(A) and (2)(A).

[5] *See* preamble to REG-125710-18, 85 F.R. 2061, 2062 (Jan. 14, 2020).

[6] *See, e.g.*, Chandra Wallace, "Section 382 Loss Limitation Regs to Be Reproposed," *Tax Notes Federal*, May 23, 2022, p. 1282.

[7] In 2022 Congress enacted the Inflation Reduction Act, which adopted a corporate alternative minimum tax and an excise tax on stock repurchases. *See* H.R. 5376, section 10201 (2022). Guidance implementing this new legislation presumably accounts for a significant portion of the government's focus. *See, e.g.*, Notice 2023-64, 2023-40 IRB 1 (corporate alternative minimum tax guidance).

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not sell or otherwise legally dispose of the asset (forgone amortization).[8]

- If final regulations under section 382(h) define RBIG to include a forgone amortization construct, it would be logical for the government to consider a separate regulatory project regarding whether to import a similar forgone amortization construct in measuring the recognition of built-in gain under section 384(c).[9]

II. Section 382 Background

This section discusses the status of section 382(h)[10] and the concepts of NUBIG/L, as well as RBIG and RBIL (collectively or alternatively, RBIG/L) under current law (excluding the proposed regulations).

A. Prior Law

Acquisitions of corporations for the purpose of using their tax attributes were subject to significant scrutiny before the enactment of section 382. The government's primary early tool in challenging those transactions was section 129 of the 1939 code (the predecessor to modern section 269), which disallowed deductions, credits or other allowances secured through acquisitions of control of a corporation, or acquisitions by a corporation of property of another corporation, with the principal purpose of tax avoidance.[11] Although the government was successful in applying this provision in some cases,[12] in others the requirement to demonstrate that a taxpayer had the principal purpose of tax avoidance was too great a threshold to clear, and taxpayers successfully engaged in tax-motivated acquisitions of corporations with significant loss attributes.[13]

Congress enacted section 382 (old section 382) in its original form in 1954 to provide a further barrier to acquisitions that monetize the NOLs of loss corporations. The legislative history of the provision identifies a goal of restricting such acquisitions without requiring the government to prove the existence of a tax avoidance purpose, as section 129 required.[14] This initial version of section 382 differed significantly from the modern version. For a taxable purchase, old section 382 applied only to a corporation experiencing both (1) a prohibited 50 percent change in ownership resulting from purchases by its top 10 shareholders and (2) a contemporaneous prohibited change in business.[15] For some acquisitions qualifying as tax-free reorganizations, old section 382 generally applied if historic shareholders retained less than 20 percent stock ownership.[16] Constructive ownership rules and other exceptions applied to make the actual determination of whether old section 382 applied more complex. Some similar acquisitive transactions were not subject to old section 382 at all. For instance, old section 382 did not apply to the acquisition of the stock of a loss corporation in a section 368(a)(1)(B)

[8] This report uses the term "forgone amortization" to refer to the deemed recognition of built-in gain taken into account as RBIG under the section 338 approach in Notice 2003-65 regardless of whether the underlying asset is tangible property generally subject to depreciation or intangible property generally subject to amortization.

[9] Although beyond the scope of this report, the application of section 382 to controlled foreign corporations also involves important issues that require guidance, and this topic is on the priority guidance plan. *See* New York State Bar Association Tax Section, "Report on the Application of Section 382 to Foreign Corporations," No. 1457 (Jan. 18, 2022) (discussing relevant issues).

[10] The analyses and examples in this report assume that, except as otherwise indicated, (1) the referenced transactions are subject to sections 382 and 384; (2) the referenced transactions are not subject to other potentially applicable legal regimes, such as section 269 or the separate return limitation year rules, or to generally applicable threshold exclusions such as section 382(h)(3)(B) in each case; (3) all legal entities referenced are U.S. corporations; and (4) other than stock, all assets referenced are business assets used in the United States.

[11] Former section 129(a).

[12] *See, e.g.*, *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960) (real estate development was created for the principal purpose of tax avoidance and therefore was denied a corporate surtax exemption and excess profits credit).

[13] *See, e.g.*, *Hawaiian Trust Co. v. United States*, 291 F.2d 761 (9th Cir. 1961) (parent corporation acquired subsidiary for business reasons and therefore was permitted to use the subsidiary's NOL in consolidation).

[14] IRC of 1954, P.L. 83-591; S. Rep. No. 83-1622, at 4684 (1954) ("Under present law where a controlling interest in a corporation is acquired for the purpose of avoiding or evading tax liabilities the Internal Revenue Service may disallow the benefits of a deduction, credit, or allowance which would otherwise be enjoyed by the acquiring person or corporation. This provision has proved ineffectual, however, because of the necessity of proving that tax avoidance was the primary purpose of the transaction. It has also been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions.").

[15] Former section 382(a)(1) and (2).

[16] Former section 382(b).

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reorganization followed, after an interval, by the liquidation of the loss corporation.[17]

The effect of old section 382 depended on which kind of acquisition occurred: Taxable acquisitions resulted in total disallowance of NOL carryovers from prior years,[18] while acquisitive reorganizations resulted in a percentage reduction — not a limitation — in the target loss corporation's existing NOL carryforwards.[19] Old section 382 did not have an analog to current section 382(h) and did not use concepts related to the limitation or partial allowance of NOL carryovers, such as NUBIG and RBIG, because they were not relevant to that scheme given the complete disallowance of the NOL carryover.

In 1957, after the enactment of old section 382, the Supreme Court decided *Libson Shops*, which applied the 1939 code to the 1949 mergers of 16 non-consolidated corporations operating retail apparel businesses into a 17th, which had provided management services to the other 16.[20] The same persons owned all the corporations in the same percentages. Following the mergers, the surviving corporation operated the combined businesses of all the merged corporations and tried to claim NOL carryovers reflecting losses of some of them. The government denied the resulting deductions under several theories, and the Supreme Court affirmed this denial on the specific theory that a taxpayer's use of an NOL from a different entity in a prior year was permissible under the NOL carryover rules only if the taxpayer continued the business of the prior entity. In *Libson Shops*, the resulting business was not "substantially the same" as the businesses that produced the losses, and therefore could not offset its income with those losses. The decision appeared to introduce an additional business continuity requirement not present in the plain text of old section 382, and the potential application of that standard under the 1954 code was debated, notwithstanding the enactment of old section 382.[21]

B. 1986 Change in Law

The 1986 code entirely revised and restated old section 382 and implemented most of the modern rules that section 382 now applies, including the special rules for built-in gains and losses in section 382(h).[22] The full range of changes made in 1986 and the full range of rules of modern section 382 are beyond the scope of this report. However, some key rules, concepts, and changes are described below, especially to the extent they relate to section 382(h).

According to the legislative history, the drafters of the 1986 code had three general concerns with old section 382: (1) They considered the complete disallowance of NOLs overly harsh, especially when some continuity of shareholder ownership of the loss corporation remains; (2) they believed that taxable and tax-free acquisitions should be subject to the same general rules; and (3) some aspects of old section 382, including the exclusion of certain transactions, presented a tax avoidance risk.[23] In addition, Congress clearly intended to prevent *Libson Shops* from applying to any transaction subject to new section 382.[24]

[17] *See* former section 382(b)(1) (applying solely to asset reorganizations described in section 381(a)(2)).

[18] Former section 382(a).

[19] Former section 382(b).

[20] *Libson Shops Inc. v. Koehler*, 353 U.S. 382 (1957). The 1939 code did not contain provisions equivalent to section 381 or section 382. Thus, it was not entirely clear that the NOLs of a target that merged out of existence in a reorganization carried over to its acquirer, and there was no direct prohibition on trafficking in NOLs.

[21] *See, e.g.*, *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965) (reversing a Tax Court decision that applied the *Libson Shops* doctrine to deny use of corporation's NOLs when a transaction involved new investors' contribution of cash representing approximately 40 percent of the issuer's prior value as well as the subsequent issuance of nonvoting preferred stock not cognizable under old section 382, as well as cessation of the issuer's prior business and establishment of new business).

[22] IRC of 1986, P.L. 99-514. The Tax Reform Act of 1976 (P.L. 94-455) also enacted significant revisions to old section 382, but the 1976 bill had solely prospective application, and the enacted changes were repeatedly delayed until section 382 was revised again, in a different manner, in TRA 1986. Section 383, which applies the limitations of section 382 to various other tax attributes, was enacted in 1971. *See* Revenue Act of 1971, P.L. 92-178.

[23] H. Rep. No. 99-426, at 256 (1986); S. Rep. No. 99-313, at 231-232 (1986). The 1976 legislation also identified as problematic the differing treatment of taxable and tax-free acquisitions and the exclusion of certain transactions like section 368(a)(1)(B) reorganizations. *See, e.g.*, S. Rep. No. 94-938, at 202 (1976) ("When fixed rules are adopted for an area such as this, it is difficult to envision all possible abuses. It is equally difficult to assure that the rules will achieve equity in all situations. The present rules have defects of both of these kinds.").

[24] H.R. Rep. No. 99-841, Pt. II, at II-194 (1986) (Conf. Rep.) ("The conferees intend, however, that the *Libson Shops* doctrine will have no application to transactions subject to the provisions of the conference agreement.").

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Congress addressed the second and third concerns by synchronizing the treatments of taxable and tax-free acquisitions of stock, both of which became subject to the same 50 percent change-in-ownership rule, and by covering transactions that previously escaped the scope of old section 382, including section 368(a)(1)(B) reorganizations and section 351 exchanges. Section 382 now applies when there is an ownership change for a corporation that is otherwise entitled to use an NOL in the year of that ownership change or generates an NOL in that year (a loss corporation). An ownership change occurs when there is an owner shift involving a 5 percent shareholder, or an equity structure shift and, after this shift, the percentage of loss corporation stock owned by 5 percent shareholders has increased by more than 50 percentage points, as compared with the lowest percentage ownership for each 5 percent shareholder during the prior three years (or a shorter period in some cases) (the testing period).[25] Numerous complex rules apply to the determination of whether an ownership change has occurred, including rules that treat groups of persons as separate 5 percent shareholders and constructive and indirect ownership rules.[26]

The first concern identified in the legislative history was that old section 382's complete disallowance of NOLs was an overly harsh remedy. The 1986 code addressed this by limiting the annual use of NOLs by affected loss corporations during the five-year period beginning on and including the change date (the recognition period).[27] Section 382, when it applies to a loss corporation, generally sets this limitation to the product of the affected loss corporation's value (subject to various adjustments and special rules) and the federal long-term tax-exempt rate.[28] Thus, NOLs subject to limitation under section 382 are not completely disallowed (though they can become effectively worthless in some cases). This annual limitation is set to zero if the loss corporation's business is not maintained in accordance with the section 368 continuity of business enterprise test for at least two years after the date of the ownership change (the change date).[29] The portion of any deduction disallowed under the annual limitation is carried forward into future tax years under rules similar to the rules for loss carryovers, and it is subject to limitation in succeeding taxable years as though it were a pre-change loss.[30]

The legislative history indicates that the intent of the annual limitation is to approximate the effect of an economically fair partnership between the affected loss corporation and a profitable acquirer, in which the loss corporation and its partner would agree to allow the loss corporation to receive an amount of loss carryover sufficient to offset the income from the assets contributed by the loss corporation.[31] The annual limitation reflects only a risk-free rate of return on the loss corporation's assets.[32] The analogy to a loss corporation's contribution to a partnership nevertheless led the drafters of the 1986 code to increase the section 382 limitation to reflect RBIGs since any gains on assets contributed to a partnership would be allocated to the contributing partner, that is, the loss corporation.[33] In particular, Congress enacted section 382(h) to capture the economic return on assets, thus complementing the risk-free rate of return addressed by the annual limitation.

C. Built-In Gain and Loss Rules

Section 382(h) provides that if a loss corporation has a NUBIG, its annual limitation during any recognition period tax year is increased by the amount of RBIG, that is, gain recognized during that tax year to the extent

[25] Section 382(g)(1) and (i)(1). An owner shift involving a 5 percent shareholder is any change in ownership of a loss corporation affecting a person that is a 5 percent shareholder before or after that change. Section 382(g)(2). An equity structure shift generally means any acquisitive reorganization or recapitalization. Section 382(g)(3).

[26] *See* reg. section 1.382-3.

[27] A recognition period tax year, in turn, is any tax year of a loss corporation any portion of which is in the recognition period. Section 382(h)(7)(B). The change date is also, obviously, the last day of the pre-change period. As discussed later, this overlap between the pre-change period and the recognition period can lead to difficult interpretational issues in some cases.

[28] Section 382(b)(1) and (e)(1).

[29] *See* section 382(c)(1). According to the legislative history, this rule is based on the prohibition on changes in business in old section 382. H.R. Rep. No. 99-841, Pt. II, at II-189 (1986) (Conf. Rep.).

[30] Section 382(h)(6).

[31] H. Rep. No. 99-426, at 257 (1986); S. Rep. No. 99-313, at 232 (1986).

[32] H. Rep. No. 99-426, at 258 (1986); S. Rep. No. 99-313, at 233 (1986).

[33] *See* section 704(c).

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reflecting built-in gain in that asset on the date of the ownership change (also referred to as RBIG). By contrast, to the extent a loss corporation has a NUBIL, its annual limitation during any recognition period tax year is decreased by RBIL, that is, recognized losses reflecting built-in loss on the date of the ownership change (also referred to as RBIL). Also, the statute mandates a particular treatment of depreciation, amortization, and depletion deductions — these are included in RBIL except to the extent that a taxpayer can establish that they do not reflect NUBIL.[34]

Items of income taken into account during the recognition period but attributable to periods before the change date are treated as RBIG.[35] Deductions taken into account during the recognition period but attributable to periods before the change date are treated as RBIL.[36] Related adjustments are made to NUBIG/L to reflect items that would be treated as RBIG/L if those amounts were properly taken into account (or allowable as a deduction) during the recognition period.[37] Section 382(m) grants Treasury extensive authority to issue regulations to carry out the purposes of sections 382 and 383.

In 1994 Treasury issued final regulations under section 1374, which imposes a corporate-level tax on certain gains recognized by a subchapter S corporation following its earlier conversion from C corporation status.[38] These regulations adopted certain language and concepts from section 382(h), including "net unrealized built-in gain" and "recognized built-in gain."[39] Although these regulations did not have any immediate impact on section 382, they would later be incorporated in the section 1374 approach under Notice 2003-65.[40]

D. Notice 2003-65

Notice 2003-65, issued in September 2003, provided rules for measuring NUBIG/L and determining whether particular items of income, gain, deduction, and loss qualify as RBIG/L for purposes of section 382(h). The notice is the most important authority on section 382(h) since the enactment of the 1986 code.

The notice gives taxpayers two alternative approaches for classifying items: (1) an approach based on section 1374 and its regulations and (2) an approach based on a hypothetical transaction in which all the loss corporation's assets were deemed acquired in accordance with an election under section 338. The notice states that the IRS will not challenge a taxpayer's interpretation of section 382(h) regarding a particular ownership change occurring before the issuance of new final or temporary regulations thereunder if the taxpayer consistently applies either the section 1374 approach or the section 338 approach to that ownership change.[41] However, this forbearance does not apply if the taxpayer uses both approaches, or elements of both, or applies the approaches inconsistently, in each case, for a particular ownership change. Also, the notice clarifies that it is not the sole method for identifying RBIG and RBIL, because taxpayers may also apply their own methods, and it seeks comments from taxpayers on several key issues.

Nine pages long as published in the Cumulative Bulletin, Notice 2003-65 necessarily addresses the two approaches at a relatively high level and does not explain in detail how the rules it lays out would interact with other significant

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

[35] Section 382(h)(6)(A).

[36] Section 382(h)(6)(B).

[37] Section 382(h)(6)(C). This broad language reflects a 1989 statutory change that was, according to the legislative history, intended to include items without regard to "when or whether" those items are recognized during the recognition period. *See* H.R. Rep. No. 101-427, at 1406 (1989).

[38] T.D. 8579.

[39] *See* reg. sections 1.1374-3 and -4.

[40] Aside from Notice 2003-65, the IRS has issued various items of guidance addressing the application of section 382(h) under the 1986 code. *See, e.g.*, TAM 200217009 (post-change income earned from loss corporation's patient base existing as of change date was not RBIG); FSA 1992-415 (post-change income attributable to license of loss corporation's software that was fully expensed as of change date was RBIG); and Notice 87-79, 1987-2 C.B. 387 (government anticipated issuing regulations that would permit COD income "integrally related" to an ownership change to be allocated to pre-change periods even if that income was recognized after the change date).

[41] Thus, a taxpayer may apply different approaches to different ownership changes of the same loss corporation. Notice 2003-65, Section V.

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areas of federal tax law, such as the consolidated return rules. As described below, later guidance has addressed some of these areas. By its terms, Notice 2003-65 does not apply to section 384, but the notice requested comments on the treatment of built-in items under that provision.

1. Section 1374 approach.

The section 1374 approach generally relies on the rules of section 1374 and its regulations, and Notice 2003-65 directs taxpayers to follow those provisions in applying this approach, except to the extent the notice itself expresses a contrary position.[42] The section 1374 approach calculates NUBIG/L based on a hypothetical sale of all the loss corporation's assets, including goodwill, for fair market value consideration, increased by the amount of any liabilities of the loss corporation deemed assumed.[43] Generally, to the extent this amount exceeds the loss corporation's basis in its assets, there is a NUBIG, while a deficit is a NUBIL.[44] The section 1374 approach generally takes RBIG/L into account when an actual asset sale generates gain or loss.[45]

For other items of income and deduction produced in the recognition period, the section 1374 approach generally follows the accrual method of accounting and generally disregards items that would *not* have accrued as of the change date.[46] Under this approach, income produced by built-in gain assets after the change date does not count toward RBIG.[47] Further, contingent liabilities existing but not fixed as of the change date and deducted during the recognition period apparently are not included in the calculation of RBIL. However, some items are subject to special rules. Following the statute, depreciation, amortization, and depletion deductions produce RBIL except to the extent a taxpayer demonstrates that the deduction is not connected to NUBIL;[48] the notice provides that a taxpayer can do this by treating as RBIL only the excess of the actual deduction over the deduction that would have been available in the current year if the asset had been purchased on the change date for FMV.[49] COD income and bad debt deductions arising from debt owed at the beginning of the recognition period provide RBIG or RBIL, respectively, to the extent that they are properly taken into account in the first 12 months of the recognition period.[50]

2. Section 338 approach.

The section 338 approach generally calculates NUBIG and NUBIL in the same manner as the 1374 approach. The notice also specifies that contingent consideration and contingent liabilities are taken into account.[51] Gains and losses from actual asset sales also produce RBIG and RBIL, but based on a comparison of the actual gain or loss recognized over the amount that would have been recognized in a hypothetical sale with the same amount of consideration but with a fully stepped-up basis (as reduced by deemed cost recovery deductions).[52] Similarly, other actual items of income and deduction generally produce RBIG/L based on a comparison

[42] *Id.* at Section III.

[43] *Id.* at Section III.A. Because Notice 2003-65 generally applies the accrual method of accounting under the section 1374 approach, contingent consideration and contingent liabilities arguably should not be included in NUBIG/L except to the extent fixed as of the change date. However, the notice does not specifically explain how contingent consideration and contingent liabilities are treated for this purpose under the section 1374 approach, and the later description of the section 338 approach, which does include those items in the calculation of NUBIG/L, suggests that the section 1374 approach does as well. *See id.* at Section IV.A ("Under the 338 approach, NUBIG or NUBIL is calculated in the same manner as it is under the 1374 approach. Accordingly, unlike the case in which a section 338 election is actually made, contingent consideration (including a contingent liability) is taken into account in the initial calculation of NUBIG or NUBIL.").

[44] *See id.* Certain other amounts are included in this hypothetical consideration amount — namely, deductible liabilities (a decrease), section 481 adjustments resulting from the hypothetical asset sale (a decrease or an increase, depending on the type of adjustment), and RBIL that would not be allowed as a deduction (an increase). *See* reg. section 1.1374-3(a).

[45] Notice 2003-65, Section III.B.1. Some exceptions apply. Gain from an installment sale that would qualify as RBIG but for its recognition outside the recognition period still counts as RBIG under the section 1374 approach *Cf.* reg. section 1.1374-4(h). Gain from a sale that would qualify as RBIG but is deferred under the intercompany transaction rules until after the recognition period similarly qualifies. Notice 2003-65, Section III.B.1.

[46] Notice 2003-65, Section III.B.2.a.

[47] *Id.* at Section III.B.2.a.(i).

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

[49] Notice 2003-65, Section III.B.2.a.(ii), Example 7.

[50] *Id.* at Section III.B.2.b. This treatment of COD income conflicts with the statement in Notice 87-79 that such income would be allocated to pre-change periods based on whether the income was "integrally related" to the ownership change.

[51] *Id.* at Section IV.A.

[52] *Id.* at Section IV.B.1.

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with the amount of those items in the hypothetical sale scenario.[53] The section 338 approach subjects certain items to particular rules. For example, a deduction for a contingent liability produces RBIL in the amount of the estimate for that liability on the change date,[54] and COD income attributable to pre-change debt of a loss corporation recognized during the recognition period produces RBIG up to the amount of the excess of the adjusted issue price of the debt over its FMV on the change date.[55]

In a significant difference from the section 1374 approach, a depreciable or amortizable asset produces RBIG under the section 338 approach, even though the loss corporation does *not* dispose of the asset, based on the excess of the depreciation or amortization deduction that would be produced if the asset had basis equal to FMV, over the actual depreciation or amortization deduction taken.[56] Depreciation and amortization deductions for built-in loss assets produce RBIL in essentially the same manner as under the section 1374 approach — RBIL is the excess of the actual deduction over the hypothetical deduction that would be available if basis were reset to FMV on the change date.[57]

III. Proposed Regulations

Issued in September 2019, the proposed regulations would set out new rules for determining NUBIG/L and RBIG/L.[58] With some exceptions, the proposed regulations, when finalized, would apply to ownership changes occurring 30 days after the date they are published in the *Federal Register* (the delayed applicability date) or later, and Notice 2003-65 would remain applicable to earlier ownership changes.[59] Practitioners submitted significant comments addressing these regulations.[60] In response, as noted, the government intends to propose new rules under section 382(h). Therefore, this Section III contains only an abbreviated summary of the 2019 proposed regulations. The analysis offered in sections IV and V below also discusses many of the key issues raised by the proposed regulations.

The proposed regulations generally would modify the computation of NUBIG/L to incorporate, and require taxpayers to follow, a modified version of the section 1374 approach from Notice 2003-65. According to the preamble, this modified approach is intended to (1) follow the neutrality principle;[61] (2) ensure greater consistency between amounts that are included in the NUBIG/L computation and items that could become RBIG/L during the recognition period;[62] (3) simplify the application of section 382; (4) provide more certainty to taxpayers in determining built-in gains and losses for section 382(h) purposes; and (5) ensure that difficult questions regarding the application of the 2017 Tax Cuts and Jobs Act do not further complicate the application of section 382(h).[63]

A. NUBIG/L Computation

The rules for computation of NUBIG/L in the proposed regulations, which are more explicit than those in Notice 2003-65, require that a taxpayer take into account the aggregate amount realized in a hypothetical two-step disposition of

[53] *Id.* at Section IV.B.

[54] *Id.* at Section IV.C.

[55] *Id.* at Section IV.D. By comparison, the section 1374 approach generally permits COD income attributable to pre-change debt to produce RBIG only if the COD income is recognized in the first 12 months of the recognition period. *See supra* note 50.

[56] *See id*. When an asset is eligible for immediate expensing, the section 338 approach could result in a significantly accelerated deemed depreciation or amortization deduction for that asset, much of which would be RBIG under the section 338 approach. Shortly after enactment of the 2017 Tax Cuts and Jobs Act, the government excluded section 168(k) in determining deemed depreciation deductions under the section 338 approach, concluding that the drafters of section 168(k) did not intend this result. The government also excluded section 168(k) for purposes of calculating RBIL for depreciation, amortization, and depletion of built-in loss assets. Notice 2018-30, 2018-21 IRB 610.

[57] Notice 2003-65 at Section IV.B.3.

[58] Preamble to REG-125710-18, 84 F.R. 47455, 47458 (Sept. 10, 2019).

[59] *See* preamble to REG-125710-18, 85 F.R. at 2062.

[60] *See, e.g.*, American Bar Association Section of Taxation, "Comments on Proposed Regulations Under Section 382(h)" (Nov. 12, 2019) (ABA report); NYSBA Tax Section, "Report on Proposed Regulations Under Section 382(h) Related to Built-In Gain and Loss" No. 1426 (Nov. 11, 2019) (NYSBA 2019 report); RSM US LLP, "Comments on Proposed Regulations Issued Under Section 382 With Respect to Built-In Gains and Losses of Loss Corporations" (Nov. 18, 2019); American Institute of Certified Public Accountants, "Notice of Proposed Rulemaking Regarding Section 382(h) Related to Built-In Gain and Loss [REG-125710-18]" (Dec. 19, 2019) (AICPA comments); National Bankruptcy Conference, "Comments on Proposed Regulations Under Section 382(h)" (Oct. 3, 2019) (NBC comments).

[61] *See, e.g.*, preamble to REG-125710-18, 84 F.R. at 47459.

[62] *Id.* at 47458.

[63] *Id.* at 47457.

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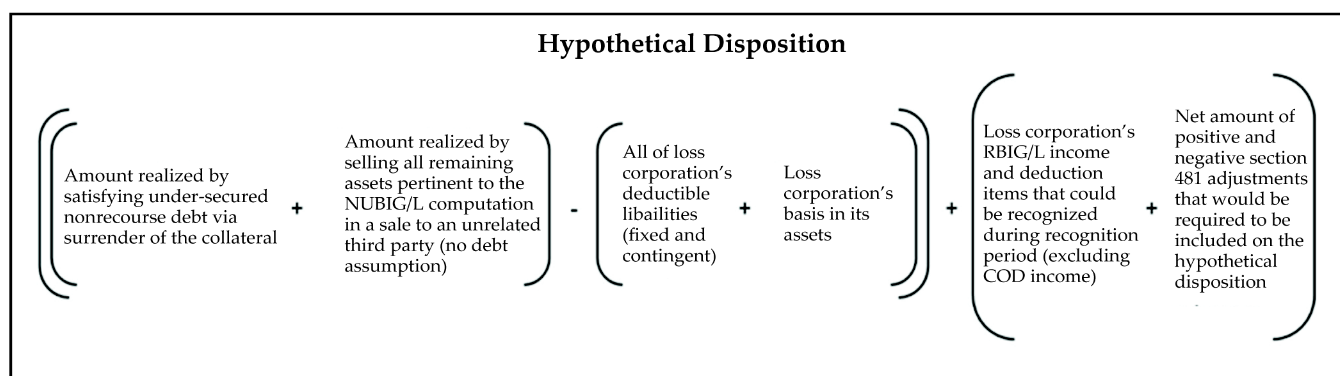

all the loss corporation's assets immediately before the ownership change.[64] The first step requires the corporation to treat all inadequately secured nonrecourse liabilities as having been satisfied by surrendering the assets used as collateral.[65] The second step is a hypothetical sale of all remaining assets (with some exceptions) to a third party in a transaction in which the buyer assumes *none* of the seller's liabilities.[66] The total amount realized by the loss corporation under these first two steps is then decreased by the sum of (1) the loss corporation's deductible liabilities (fixed and contingent) and (2) the loss corporation's basis in its assets.[67] The total is then increased or decreased by (1) the net amount of the total RBIG/L income and deduction items that could be recognized during the recognition period (excluding COD income); and (2) the net amount of positive and negative section 481 adjustments that would be required to be included on the hypothetical disposal of all the loss corporation's assets.[68] The formula for the calculation of NUBIG/L can be expressed in the diagram.

This formula is intended to follow, to some degree, the accrual-based section 1374 approach, which Treasury asserts is more consistent with the text and purpose of section 382 than the section 338 approach and has a greater body of authority to guide taxpayers and the government.[69]

B. Specified Changes

As noted, the proposed regulations would deviate from Notice 2003-65 in the treatment of contingent liabilities in several respects. As in Notice 2003-65, the proposed regulations would include the value of a loss corporation's contingent liabilities as of the change date in the calculation of NUBIG/L,[70] and deductible contingent liabilities, like deductible fixed liabilities, would reduce the overall number. However, in a significant change from Notice 2003-65, contingent liabilities, when paid, would generate RBIL up to the estimated value of those contingent liabilities on the change date.[71] According to the preamble, failing to include those liabilities in RBIL while also including their estimated amount in the NUBIG/L computation as in Notice 2003-65 would result in an improper calculation under section 382(h)(6)(C), which requires that items be included in the NUBIG/L computation if they would be treated as RBIG/L if properly taken into account during the recognition period.[72] When a loss corporation takes the estimated value of a contingent liability into account as of the change date, the loss corporation would also need to use the value for

[64] *Id.*; prop. reg. section 1.382-7(c)(3)(i).

[65] Preamble to the REG-125710-18, 84 F.R. at 47458; prop. reg. section 1.382-7(c)(3)(i)(A)(1).

[66] Preamble to REG-125710-18, 84 F.R. at 47458; prop. reg. section 1.382-7(c)(3)(i)(A)(2). This report refers to these two steps, collectively, as the liability exclusion rule.

[67] Preamble to REG-125710-18, 84 F.R. at 47458; prop. reg. section 1.382-7(c)(3)(i)(B)-(D).

[68] Preamble to REG-125710-18, 84 F.R. at 47458; prop. reg. section 1.382-7(c)(3)(i)(E)-(G).

[69] Preamble to REG-125710-18, 84 F.R. at 47456-47457.

[70] As described above in *supra* note 43, this is a clarification of Notice 2003-65, which was unclear on this point, but practitioners generally have concluded that such liabilities were included and thus the proposed regulations do not represent a change in this regard.

[71] Preamble to REG-125710-18, 84 F.R. at 47465; prop. reg. section 1.382-7(d)(3)(v).

[72] *See* preamble to REG-125710-18, 84 F.R. at 47465.

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that liability on its most recent applicable financial statement, if such a value exists.[73]

COD income generally is not included in the calculation of NUBIG/L under the proposed regulations.[74] However, subject to limitations discussed below, includable COD income of the loss corporation that is recognized on recourse debt during the 12 months following the change date is eligible for inclusion in the NUBIG/L computation.[75] Further, certain excluded COD income items can be treated as RBIG (thereby affecting the NUBIG/L computation) in some situations.

The proposed rules would exclude from RBIL treatment section 163(j) business interest carryforwards disallowed under section 382 if those amounts are allowed as a deduction under section 163(j) during the recognition period.[76] Subjecting the same section 382 disallowed business interest carryforward to the section 382 regime in two different ways could result in a double reduction of the annual section 382 limitation.[77] Further, the proposed regulations contain extensive rules for the treatment of excess section 163(j) interest expense of a partnership.[78]

C. Identifying RBIG/L Items

In identifying RBIG/L, the proposed regulations would closely track the accrual-based section 1374 approach with specific exceptions and thus would disallow use of the section 338 approach and its forgone amortization construct.[79] Declining to incorporate a forgone amortization construct, the proposed regulations expressly provide that "cost recovery deductions on an appreciated asset claimed during the recognition period are not treated as generating recognized built-in gain."[80]

As described earlier, the proposed rules would include as RBIL the amount of any deductible contingent liabilities paid or accrued during the recognition period, to the extent of the estimated value of those liabilities on the change date.[81] Also, according to the preamble, because RBIG carries out the neutrality principle[82] in the post-change period, COD income must be taken into account during the post-change period to qualify for RBIG status.[83] Specifically, the proposed regulations would give taxpayers the option to treat COD income from recourse and nonrecourse debt[84] recognized during the first 12 months of the recognition period as RBIG (and consequently allow for corresponding adjustments to the taxpayer's NUBIG/L computation).[85]

The proposed regulations also establish two RBIG ceilings for COD income attributable to recourse debt. First, taxpayers in bankruptcy at the time of the ownership change must limit their RBIG for excluded COD income to the amount of indebtedness discharged in the bankruptcy.[86] Second, all other taxpayers that recognize COD income must limit their RBIG to the excess of their liabilities over asset value immediately before the change date with some adjustments to avoid double counting of excluded COD offset by reductions in asset basis under sections 108(b) and 1017.[87]

The proposed regulations would prevent most excluded COD income from producing

[73] Prop. reg. section 1.382-7(c)(3)(iii)(A).

[74] Preamble to REG-125710-18, 84 F.R. at 47459; prop. reg. section 1.382-7(c)(3)(ii)(A).

[75] Preamble to REG-125710-18, 84 F.R. at 47459; prop. reg. section 1.382-7(c)(3)(ii)(B).

[76] Preamble to REG-125710-18, 84 F.R. at 47461; prop. reg. section 1.382-7(d)(5).

[77] Preamble to REG-125710-18, 84 F.R. at 47461.

[78] *See id.* at 47461-47462; and prop. reg. section 1.382-7(d)(3)(vi).

[79] *See* preamble to REG-125710-18, 84 F.R. at 47457-47458.

[80] Prop. reg. section 1.382-7(d)(2).

[81] *See supra* note 71.

[82] As stated above, this is the principle that built-in gains and losses of a loss corporation, once recognized after an ownership change, generally are treated in the same manner as if they had been recognized before the ownership change.

[83] *See* preamble to REG-125710-18, 84 F.R. at 47459-47460; and prop. reg. section 1.382-7(d)(2)(iii)-(iv) and (c)(3)(ii)(B).

[84] COD income from nonrecourse debt is treated as built-in gain only to the extent that the debt was unsecured immediately before the ownership change. Preamble to REG-125710-18, 84 F.R. at 47461; prop. reg. section 1.382-7(b)(5), (b)(3), and (d)(2)(iv).

[85] Preamble to REG-125710-18, 84 F.R. at 47459-47460; prop. reg. section 1.382-7(d)(2)(iii)-(iv) and (c)(3)(ii)(B). RBIG recognized on nonrecourse debt during the recognition period does not result in an adjustment to NUBIG/L, because the amount of the impairment to the nonrecourse debt is already built into the initial NUBIG/L computation for the deemed disposition of assets. Preamble to REG-125710-18, 84 F.R. at 47461; prop. reg. section 1.382-7(d)(2)(iv)(D).

[86] Preamble to REG-125710-18, 84 F.R. at 47461; prop. reg. section 1.382-7(b)(4) and (8).

[87] Preamble to REG-125710-18, 84 F.R. at 47461; prop. reg. section 1.382-7(b)(4) and (8).

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RBIG (and therefore exclude that income from the NUBIG/L calculation) on neutrality principle grounds.[88] However, to the extent that excluded COD income is recognized in the first 12 months of the post-change period and is offset by post-change tax attributes or basis reduction in assets acquired after the ownership change, the same neutrality principle concerns do not arise, and thus the excluded COD income in those cases can produce RBIG.[89]

IV. Inclusion of Liabilities in NUBIG/L

The proposed regulations would substantially redefine the NUBIG/L computation, principally by omitting from the calculation liabilities other than excess nonrecourse liabilities (as previously defined, the liability exclusion rule). As explained in Section IV.C below, the government's concern, which stems largely from potential inappropriate results from the realization of COD income that is built in at the time of the ownership change, is appropriate. However, for the most part, it should be possible to address the crux of the government's concerns without incorporating the liability exclusion rule, specifically by charging off a portion of RBIG to the extent attributable to excluded COD income that is offset by the loss corporation's pre-ownership-change tax assets.

Further, in many restructurings of distressed companies that give rise to an ownership change, the COD event occurs on the change date when the creditors equitize their debt. Under current section 382, the change date is *both* the last day of the pre-change period and the first day of the recognition period. Moreover, built-in items recognized on the change date that have a different character than the NUBIG/L that are allocated to the pre-change period distort the amount of NUBIG/L. The proposed regulations would deal with this issue in an indirect, meandering way that has the potential for inconsistent treatment. Although different approaches are possible, the simplest approach would be to define the recognition period as beginning at the end of the change date and, in general, to allocate change-date items to the pre-change period. In finalizing regulations, the government should give serious consideration to allocating excluded COD income realized on the change date to the post-change period because, among other reasons, the consequences of excluded COD income are determined at the end of the year. While this would mean that excluded COD income realized on the change date is included in the NUBIG/L computation, that seems like a modest benefit for distressed companies, and section 382 and companion provisions already demonstrate policy support for rehabilitating companies, thus suggesting that there is ample room under section 382(m) for regulations to take this approach.

A. Background Principles

As discussed, built-in gains recognized during the recognition period allow a loss corporation with a NUBIG to increase its annual limitation, whereas built-in losses recognized during the recognition period by a loss corporation with a NUBIL are subject to the loss corporation's section 382 limitation. These rules give effect to the neutrality principle by mandating that items receive the same treatment in the recognition period as they would have received if recognized before the ownership change. More specifically, section 382(h)(1)(A) provides that if a loss corporation has a NUBIG, the annual limit in the recognition period is increased by the RBIG for the tax year with cumulative increases limited to the amount of the NUBIG. Section 382(h)(1)(B) provides that if a loss corporation has a NUBIL, the use of any RBIL recognized during the recognition period is subject to the annual limitation. Subject to a de minimis rule, section 382(h)(3)(A)(i) provides that NUBIG/L is the amount by which the FMV of the loss corporation's assets immediately before an ownership change is more or less, respectively, than the aggregate adjusted basis of the corporation's assets at that time, subject to the adjustment in section 382(h)(6)(C) for certain built-in items of income or deduction.

Both the section 1374 approach and the section 338 approach of Notice 2003-65 give effect to the above statutory provisions in the same manner: (1) The loss corporation calculates the amount

[88] Preamble to REG-125710-18, 84 F.R. at 47459-47460.

[89] Preamble to REG-125710-18, 84 F.R. at 47460; prop. reg. section 1.382-7(c)(3)(ii) and (d)(2)(iii)-(iv).

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that it would have realized if immediately before the ownership change it sold all its assets at FMV to a third party that assumed all its liabilities; (2) this amount realized is decreased by the loss corporation's aggregate asset basis; (3) there is a further reduction for any deductible liabilities included in the hypothetical amount realized; and (4) several other miscellaneous adjustments are made. If the resulting amount is greater than zero, the loss corporation has a NUBIG; if the amount is less than zero, the loss corporation has a NUBIL.

Example 1. Immediately before an ownership change, LossCo has one asset with an FMV of $100 and a basis of $10, and a deductible liability of $30. Applying Notice 2003-65, LossCo has a NUBIG of $60 ($100, the amount LossCo would realize if it sold all its assets to a third party that assumed all its liabilities, decreased by $40, the sum of the deductible liability ($30) and LossCo's basis in its asset ($10)).[90]

Through adoption of the liability exclusion rule, the proposed regulations would introduce a significant change by positing a hypothetical two-step disposition of all the loss corporation's assets immediately before the ownership change. The first step requires the corporation to treat all inadequately secured *nonrecourse liabilities* as having been satisfied by surrendering the assets used as collateral; and the second step is a hypothetical sale of all remaining assets to a third party that assumes *none* of the seller's liabilities.[91] The total amount realized by the loss corporation under these first two steps is then decreased by the sum of the loss corporation's deductible liabilities (fixed and contingent), and specified other adjustments are made.[92]

Example 2. Immediately before an ownership change, LossCo has one asset with an FMV of $100 and a basis of $90; a liability of $30, for which LossCo will be allowed a deduction upon payment (fixed liability); and an estimated contingent liability of $20, for which, upon removal of the contingency and payment, LossCo will be allowed a deduction (contingent liability). Applying the proposed regulations, LossCo has a NUBIL of $40 ($100, the amount LossCo would realize if it sold all its assets to an unrelated third party, decreased by $140, the sum of the fixed liability ($30), the estimated value of the contingent liability ($20), and LossCo's basis in its asset ($90)).[93]

The government's proposed liability exclusion rule stems largely from concerns about potentially inappropriate results produced by built-in COD income. Those concerns are detailed later in this section. However, before discussing the government's rationale as well as a proposal for addressing the issue, this report considers some of the problems and other distortions caused by the liability exclusion rule.

B. Liability Exclusion Rule Issues

The liability exclusion rule gives rise to at least two significant distortions in the NUBIG/L computation. First, the proposed regulations measure a contingent liability based on the loss corporation's most recent applicable financial statement (if reflected thereon), and, equally important, the regulations reject the "assumption of liabilities" principle espoused in Notice 2003-65. Second, the proposed regulations put a distinct thumb on the scale in favor of nonrecourse liabilities and thus give taxpayers an incentive, when feasible, to argue in favor of characterizing their liabilities as nonrecourse.

1. Potential overstatement of contingent liabilities.

The applicable financial statement construct, as applied to contingent liabilities, may distort the NUBIG/L computation, such as when the value ascribed to the contingent liability is too high compared with the current estimate, or when the deductible liabilities exceed the value of loss corporation assets available to satisfy the liabilities. For example, under the rules of generally accepted accounting principles, a contingent liability accrues if it is probable that the liability has been incurred, and the amount of

[90] Notice 2003-65, Section III.1, Example 1; *see also id.* at Section IV.A ("Under the 338 approach, NUBIG or NUBIL is calculated in the same manner as it is under the 1374 approach.").

[91] Preamble to REG-125710-18, 84 F.R. at 47458.

[92] *Id.* at 47458-47459.

[93] *See* prop. reg. section 1.382-7(f), Example 1.

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loss can be reasonably estimated, and discounting is permissible only in certain circumstances.[94] Thus, valuing the contingent liability using this method may produce an inaccurate result because the amount of the recorded liability under the technical rules exceeds the present value of the liability presumably reflected in the stock's value at the time of the ownership change.

Example 3. Immediately before an ownership change, LossCo has an asset with an FMV and a basis of $100, and a deductible contingent liability recorded at $25 on LossCo's applicable financial statement that has a present value of $10. Under the proposed regulations, LossCo would have an amount realized of $100 (the FMV of its asset) and a NUBIL of $25 ($100, LossCo's amount realized, decreased by $125, the sum of the basis in LossCo's asset of $100 and $25, the amount recorded on LossCo's applicable financial statement). By contrast, the economic NUBIL is only $10.[95]

2. Distinction between recourse and nonrecourse liabilities.

In *Tufts*,[96] the Supreme Court held that a taxpayer's amount realized on the sale of property encumbered by a nonrecourse obligation that exceeded the FMV of the property included the entire amount of the obligation.[97] In recognition of *Tufts* and in furtherance of the neutrality principle, the first step of the liability exclusion rule treats the loss corporation as satisfying all inadequately secured nonrecourse liabilities by surrender of the assets used as collateral. In other words, because a loss corporation, before an ownership change, would recognize taxable gain equal to the difference between tax basis and the amount of the nonrecourse debt obligation, section 382(h) must permit the loss corporation, after an ownership change, to offset any such gain with pre-change losses.

The distinction in treatment between recourse and nonrecourse debt can result in significant differences.

Example 4. Immediately before an ownership change, LossCo has an asset with an FMV of $50 and basis of $100, subject to nonrecourse debt of $100. Under the proposed regulations, LossCo will not have any NUBIG/L because the nonrecourse debt is taken into account. By contrast, if the debt was recourse, under the proposed regulations, LossCo would have a $50 NUBIL.

The proposed regulations also can break down when applied to nonrecourse debt outside the foreclosure scenario. The regulations appear to assume that lenders in the distressed context will always foreclose on nonrecourse debt, giving rise to *Tufts* gain, which the liability exclusion rule in the proposed regulations generally can sufficiently handle. While that may be true in general, it is not mandatory. It is well established that nonrecourse debt can give rise to COD income. In Rev. Rul. 91-31, 1991-1 C.B. 19, the IRS ruled that the reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt (who was not the seller of the property securing the debt) results in the realization of COD income.

That ruling was consistent with the Tax Court's earlier decision in *Gershkowitz*,[98] which concluded that the settlement of a nonrecourse debt of $250,000 for a $40,000 cash payment (rather than surrender of the $2,500 collateral) resulted in $210,000 of COD income. The Tax Court, following the *Tufts* holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.[99]

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[94] *See* Financial Accounting Standards Board, Accounting Standards Codification paras. 45020252 and 45020301 (2019); *see also* NYSBA 2019 report, *supra* note 60, at 14 (discussing GAAP rule).

[95] The proposed regulations present other anomalies as well. For example, they understate NUBIG or overstate NUBIL, as applicable, where a loss corporation receives an advance payment in exchange for an obligation to provide goods, services, or other items. In the NUBIG/L computation, the amount of the loss corporation's advance payment and tax basis therein generally offset, and the cost to perform the obligation is an RBIL item. However, the related prepaid income is not an RBIG income. *See* NYSBA 2019 report, *supra* note 60, at 17 (recommending that NUBIG/L computation exclude deferred obligation to perform to the extent the related income is deferred).

[96] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[97] *Id.* at 309; *see also* reg. section 1.1001-2(c), Example 7 (illustrating this rule).

[98] *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987).

[99] *See id.* at 1014.

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The proposed regulations define "first-year nonrecourse COD income" to pick up COD income recognized during the first 12 months of the recognition period on "inadequately secured nonrecourse liabilities." The determination of whether nonrecourse debt is "inadequately secured" does not consider recourse debt. Hence, the proposed regulations in effect assume that the nonrecourse debt always receives priority over the recourse debt. Accordingly, the result is that COD income attributable to the reduction of nonrecourse debt may not give rise to RBIG when the amount of nonrecourse debt itself does not exceed the value of the collateral.

More generally, the disparate treatment given to recourse and nonrecourse debt would appear certain to make the long-running debate between whether debt is recourse or nonrecourse relevant for section 382 purposes as well. Some may point to rulings such as LTR 201644018, for instance, to support the argument that the concept of disregarded entities has introduced some amount of electivity for sophisticated taxpayers in denominating their debt as recourse or nonrecourse for tax purposes. In that private letter ruling, in accordance with a bankruptcy plan, a disregarded entity of a parent debtor corporation transferred its assets to a new corporation and distributed the stock of the new corporation to the disregarded entity's creditors in satisfaction of their debt (which was recourse to the disregarded entity) at a discount in a tax-free distribution under sections 355 and 368(a)(1)(G). The ruling (1) treated the discharged debt as nonrecourse debt, thereby avoiding the realization of COD income, and (2) treated the transfer of assets as occurring under a tax-free reorganization, thereby avoiding gain recognition. Hence, this produced a "best of both worlds" scenario.

It appears that the conversion of a borrower entity from a corporation to a disregarded entity for U.S. tax purposes (for example, through an entity classification election or conversion) could be treated as both (1) a conversion of recourse debt of the original borrower to nonrecourse debt of the parent entity and (2) a modification that is not a significant modification for purposes of reg. section 1.1001-3. Specifically, if a tax status approach to analyzing disregarded entities were adopted, the transformation of the borrower from a corporation to a disregarded entity would involve a substitution of obligors on the debt for tax purposes (the parent entity in place of the legal borrower). However, viewing the debt as recourse debt at inception, the substitution generally should fall within the exceptions allowing substitutions of obligors when the new obligor either is the acquiring corporation in a section 381(a) transaction (which a complete liquidation of the legal borrower into its corporate parent should represent) or acquires substantially all the assets of the prior obligor.

Further, if this were viewed as a conversion of debt from recourse to nonrecourse (that is, because the debt would remain a legal claim against actual borrower even if the parent entity becomes the new obligor for tax purposes), it would be a significant modification, unless the "continuing collateral" exception applies. This requires that the debt continue to be secured only by the original collateral and no change in payment expectations occurs. Although no change in payment expectations typically occurs, the "same collateral" requirement, if applied literally, would be harder to meet because the debt technically has no collateral if the debt is unsecured as a commercial matter. However, when recourse debt of the legal entity borrower becomes nonrecourse debt of its parent entity payable only out of the legal borrower's assets, it may be reasonable to conclude that those assets represent collateral (or its equivalent) for purposes of the same-collateral requirement.[100]

Under Notice 2003-65, the above issues are inapplicable or far less critical because there is no net effect in the NUBIG/L calculus. In other words, the notice does not discriminate between recourse and nonrecourse debt, and for a contingent liability, the computation is increased by the amount treated as an assumed liability and decreased by the same amount as a deductible

[100]James M. Peaslee, "Disregarded Entities and Debt Modifications," *Tax Notes*, Mar. 7, 2016, p. 1145; *see* NYSBA Tax Section, "Debt Issued by Disregarded Entities and Treasury Regulations Section 1.1001-3," No. 1383 (June 5, 2017) (discussing characterization of indebtedness as recourse or nonrecourse).

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liability. The liability exclusion rule in the proposed regulations, however, makes these issues critical.[101]

C. Asserted Rationale for the Rule

In the preamble to the proposed regulations, the government explains that Notice 2003-65 was an effort to provide guidance integrating into the NUBIG/L computation the amount of the loss corporation's insolvency (that is, the amount by which its liabilities exceed the value of its assets), and therefore the maximum possible amount of built-in COD income, as of the change date. Notice 2003-65 does not distinguish between the eventual excluded or included nature of COD income actually recognized by the loss corporation during the recognition period. In the government's view, this failure to distinguish results in the overstatement of RBIG (or understatement of RBIL) in contravention of section 382(h)(6)(C) and effectively provides for a duplicated benefit under the RBIG rules in some cases.[102]

Further, the preamble expresses the government's position that the treatment of COD income under Notice 2003-65 violates the neutrality principle insofar as RBIG treatment should be available only to the extent that the neutrality principle requires an increase in the loss corporation's section 382 limitation. The government asserts that the application of the attribute reduction rules of section 108(b) to excluded COD income complicates the NUBIG and RBIG calculations because most excluded COD income is offset under section 108(b) by reducing tax attributes of the loss corporation that represent pre-change losses under section 382. However, to the extent that pre-change losses have already been used to offset this pre-change income, the neutrality principle prohibits an increase in the section 382 limitation. Therefore, the government has determined, in general, that the realization of excluded COD income should not generate RBIG. Although the proposed regulations generally would not consider COD income in the NUBIG/L computation, subject to significant limits, they would grant narrow exceptions for includable and excluded COD income, as summarized earlier.[103]

Finally, the government invited public comment on the proposed regulations' approach regarding excluded and includable COD income in calculating NUBIG/L, including comments on whether it would be appropriate within the limits of the statute to consider special rules for insolvent or bankrupt loss corporations. The government also asked for comments on the possibility of redefining the recognition period to begin on the date after the ownership change and on any issues that might be eliminated or created by that redefinition.[104] The discussion below focuses on these issues.

D. Built-In COD Income Issues

The preceding discussion sets forth the government's rationale for the liability exclusion rule in the proposed regulations. Fortunately, as described below, there is a path available that would include a loss corporation's liabilities in the NUBIG/L computation and at the same time largely address the government's legitimate concerns about built-in COD income. The administration of these rules will also require adjustments to the treatment of items recognized on the change date itself. That, too, is addressed below.

1. Non-change-date items.

At the outset, as a technical matter, the inclusion of a loss corporation's liabilities (that is, built-in COD income) in the NUBIG/L computation is consistent with section 382(h)(6)(A) and (C). Those subparagraphs provide that (1) an item of income properly taken into account during the recognition period constitutes RBIG if the item is attributable to periods before the change date (section 382(h)(6)(A)); and (2) NUBIG/L is adjusted for items of income and deduction that would be treated as RBIG/L, respectively, under section 382(h)(6) if those amounts were taken into

[101] The amount of a contingent liability, of course, would still be relevant for determining RBIL in the case of a NUBIL taxpayer.

[102] Preamble to REG-125710-18, 84 F.R. at 47459.

[103] *Id.* at 47459-47460.

[104] *Id.* at 47460.

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account (or allowed as deductions) during the recognition period (section 382(h)(6)(C)). Regarding the latter provision, the legislative history indicates that "items of income . . . that would be treated as built-in gain . . . if recognized within the recognition period are included in the computation of net unrealized built-in gain . . . without regard to when or whether such items are actually recognized within the recognition period."[105]

In *Gitlitz*,[106] two taxpayers used excluded COD income to increase their bases in insolvent subchapter S corporation stock and to deduct suspended losses. The IRS argued that this was impermissible because (1) excluded COD income of an insolvent S corporation was not an item of income for section 1366(a)(1) purposes and thus did not pass through to the S corporation's shareholders; and (2) items of income were passed through to shareholders of an S corporation only after the reduction of the S corporation's tax attributes under section 108(b). The Supreme Court held that excluded COD income of an insolvent subchapter S corporation still constituted an item of *income* and that items of income were passed through to the shareholders of the S corporation before the reduction of the S corporation's tax attributes under section 108(b).[107]

Although Congress enacted section 108(d)(7)(A) in 2002 to reverse the result in *Gitlitz* and provide that the passthrough of items under section 1366(a) does not take into account excluded COD income, Congress tailored that response to the statutory provision at issue in *Gitlitz*. Therefore, nothing should impair reliance in other contexts on the Supreme Court's adoption of a plain meaning interpretation of the term "income." That approach would support the recognition of built-in COD income as income for section 382(h)(6) purposes.[108]

Abandonment of the liability exclusion rule and the resulting inclusion of all the loss corporation's liabilities in the NUBIG/L computation would avoid the need for the distortions to that computation that the proposed regulations would introduce. It would also be consistent with the approach set forth in section 382(h)(8), which provides that in determining NUBIL, if at least 80 percent of the value of the loss corporation's stock is acquired in a single transaction (or series of related transactions during any 12-month period), the FMV of the corporation's assets cannot exceed the "grossed up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items." Moreover, the inclusion of liabilities in the NUBIG/L computation would be consistent with the general rule in the section 1001 regulations and related case law that treats a purchaser's assumption of a seller's liabilities as part of the seller's amount realized.[109]

The limited wait-and-see approach of the proposed regulations risks excluding liabilities from the NUBIG/L computation in situations that do not implicate the concerns raised by the government in the preamble. To police the legitimate government concerns articulated in the preamble, one viable alternative generally would entail a charge-off (or reduction) of NUBIG without permitting a corresponding RBIG inclusion in cases in which excluded COD income is offset by pre-change tax assets, in which case the neutrality principle would hold that no future RBIG benefit is appropriate (the charge-off approach).[110] This construct, in general, would be similar to that set forth in the proposed regulations themselves for purposes of applying the narrow exception from the liability exclusion rule for certain first-year recourse COD income.[111]

Basically, the charge-off approach would operate as follows. First, *includable* COD income recognized at any point in the recognition period would be treated as RBIG. Second, excluded COD income that results in the reduction of pre-change tax attributes (other than tax basis in assets held at

[105] H.R. Rep. No. 101-427, at 1406 (1989).

[106] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

[107] *Id.* at 215.

[108] ABA report, *supra* note 60, at 56.

[109] *See* reg. section 1.1001-2(a)(1); *Crane v. Commissioner*, 331 U.S. 1 (1947); and *United States v. Hendler*, 303 U.S. 564 (1938).

[110] The issue of affording a benefit to an insolvent corporation or one in bankruptcy in the form of a noneconomic increase to NUBIG or reduction to NUBIL is addressed in Section IV.D.3, below.

[111] *See* preamble to REG-125710-18, 84 F.R. at 47460-47461, prop. reg. section 1.382-7(c)(3)(ii)(B).

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the time of the ownership change) or so-called black-hole COD income[112] would be subject to the charge-off of NUBIG without the realization of a corresponding RBIG amount. Third, for excluded COD income that reduces the tax basis of section 382 assets, there would be no charge-off of NUBIG or creation of RBIG, other than for any amount realized on the disposition of built-in gain assets. Fourth, in situations in which excluded COD income reduces post-change attributes, the concerns animating the government's position in the proposed regulations would be absent, and, accordingly, the normal operation of section 382(h) would apply (that is, realization of RBIG and corresponding charge-off of NUBIG).[113] The effect of charging off NUBIG without the realization of a corresponding RBIG is to prevent the loss corporation from increasing its annual limitation for RBIG from other sources, and it avoids the double-benefit concerns espoused in the preamble because NUBIG is reduced by any COD income that is not otherwise treated as RBIG.

Importantly, this adjustment would be solely to reduce the loss corporation's NUBIG and *not* to create a NUBIL. This approach would be consistent with the legislative history to section 382(h)(6)(C) cited above, which appears to support the concept of a single NUBIG/L computation made at the time of the ownership change. Moreover, the specter of potential retroactive redeterminations of NUBIG/L — including the potential for a loss corporation to change from a NUBIG to a NUBIL (or vice versa) — and the ripple effects that such an adjustment could have on other aspects of the loss corporation's (and, if applicable, its consolidated group's) tax return, possibly for several years, counsels strongly in favor of a one-time determination of NUBIG/L as a policy matter as well.

2. Proper treatment of change-date items.

NUBIG/L is measured immediately before an ownership change, subject to adjustment under section 382(h)(6)(C) for items of income or deduction taken into account during the recognition period but attributable to periods before the change date, which are treated as RBIG/L.[114] Section 382(h)(7) defines the "recognition period" as the five-year period beginning on the change date. A loss corporation must allocate its taxable income or loss for the year in which the ownership change occurs to the periods before and after the ownership change, and the pre-change period is the period in the year ending on or before the change date.[115] If the loss corporation has taxable income for the change year, the amount allocated to the pre-change period may be offset by pre-change losses without limitation; if there is a taxable loss, the portion allocated to the pre-change period is a pre-change loss the use of which is limited under section 382. Reg. section 1.382-6 sets forth detailed rules for the allocation of the loss corporation's taxable income or loss for the change year under either a ratable method or closing-of-the-books approach. Thus, the recognition period, which as defined begins on the change date, includes a portion of the pre-change period, which as defined ends on the change date itself.

Section 382(h)(5)(A) (the limited change date rule) mitigates this overlap, in part, by prohibiting the allocation to the pre-change period of change-date items taken into account in the computation of NUBIG/L. More specifically, in allocating taxable income or loss for the change year, the limited change date rule requires that the computation of taxable income exclude items of (1) RBIG that increased the limitation for the year or (2) RBIL that are treated as pre-change losses. The rule's purpose obviously is to enforce the neutrality principle underlying section 382(h) by excluding from the pre-change period, as applicable, (1) an item of change-date RBIG that increases the section 382 limitation of a loss corporation that has NUBIG or (2) an item of change-date RBIL that is treated as a pre-change loss of a loss corporation that has NUBIL. Technically, the limited change date rule does not address the proper treatment of a change-date

[112] "Black-hole COD" refers to the amount of excluded COD income that remains after application of all required attribute reduction under section 108. S. Rep. No. 96-1035, at 12 (1980).

[113] ABA report, *supra* note 60, at 62.

[114] Section 382(h)(3)(a)(1).

[115] Section 382(b)(3)(A) and (d)(1).

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item that would otherwise be taken into account as RBIG for a NUBIG taxpayer or as RBIL for a NUBIL taxpayer, except for the fact that such item is recognized on the last day of the pre-change period and thus potentially may be subject to allocation under section 382(b)(3)(A) and (d)(1) and reg. section 1.382-6.

Built-in items recognized on the change date that have a different character than the NUBIG/L and are allocated under the general rules to the pre-change period distort the amount of NUBIG/L. This outcome can cut for (or against) the taxpayer, yielding a duplicated benefit (or detriment). A loss corporation generally would realize a duplicated benefit if it has a NUBIL and on the change date recognizes an income item for purposes of section 382(h)(6)(A). Assuming the loss corporation elects to use the closing-of-the-books method, the allocation of the income item to the pre-change period allows the income to be offset by pre-change losses that otherwise would be subject to the section 382 limitation and decreases the amount of the loss corporation's NUBIL under section 382(h)(6)(C).

Example 5. LossCo, which has a $1,000 NOL carryforward, has a built-in loss asset with an FMV of $700 and a built-in gain asset with an FMV of $200 that LossCo sells on the change date immediately before an ownership change. Assume that item is LossCo's sole item for the change year. LossCo has a NUBIL of $500 (that is, a built-in loss asset with an FMV of $700 less a built-in gain asset with an FMV of $200). Because LossCo has a NUBIL, the RBIG from the sale of the built-in gain asset does not increase LossCo's section 382 limitation for the year. Accordingly, the gain is included in the determination of LossCo's taxable income for the change year that is subject to allocation under the general rules in reg. section 1.382-6. Assuming LossCo elects the closing-of-the-books method, the entire gain recognized on the change-date asset sale would be allocated to the pre-change period, in which case it would be offset by LossCo's NOL carryforward without limitation. Thus, LossCo would realize a duplicated benefit in that the built-in gain recognized in the change-date asset sale would both reduce the amount of NUBIL and be offset by the NOL carryforward without limitation.

The hallmarks of a duplicated detriment scenario, on the other hand, would be a loss corporation with a NUBIG that recognizes a deduction item for purposes of section 382(h)(6)(B). If the loss corporation has elected the closing-of-the-books method, the deduction would both (1) be allocated to the pre-change period, and, assuming it gave rise to an NOL, the use of that NOL in a post-change period would, of course, be subject to section 382; and (2) decrease the amount of the loss corporation's NUBIG under section 382(h)(6)(C).[116]

a. Change date approach in the proposed regulations.

The proposed regulations recognize the problems presented by the change date's dual status as the *last* day of the pre-change period and the *first* day of the recognition period. The proposed solution, however, is quite complex. As an initial matter, the proposed regulations admirably espouse a policy against a duplicated benefit or duplicated detriment scenario. To that end, the proposed regulations generally would exclude from the NUBIG/L computation an amount properly allocable to the pre-change period and included in the determination of the loss corporation's taxable income or loss for the change year.[117] How would the proposed regulations determine the allocation of change-date items between the pre-change period and the post-change period?

The limited change-date rule would be the arbiter that determines the allocation of change-date items. That is, if the rule requires the exclusion of an item from the general change year allocation rules under section 382(b)(3)(A) and (d)(1) and reg. section 1.382-6, the item is allocated to the post-change period. Otherwise the item is allocated to the pre-change period. Accordingly, if a loss corporation has a NUBIL, gain recognized on the change date would be allocated to the pre-change period (and excluded from the NUBIG/L computation) because that item is not treated as RBIG that increases the loss corporation's section

[116]Use of the ratable allocation method in reg. section 1.382-6 would affect these scenarios to the extent the item in question is allocated to the pre-change period.

[117]Preamble to REG-125710, 84 F.R. at 47459; prop. reg. section 1.382-7(c)(2)(i).

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382 limitation. Similarly, if a loss corporation has a NUBIG, a deduction recognized on the change date would be allocated to the pre-change period (and excluded from the NUBIG/L computation) because that item is not treated as RBIG that increases the loss corporation's section 382 limitation.

The opposite allocation method would apply when the change-date item in question has the *same* character as the loss corporation's NUBIG/L. Accordingly, if a loss corporation has a NUBIG, a change-date income item would be allocated to the post-change period (and included in the NUBIG/L computation) because that item would be treated as RBIG that increases the loss corporation's section 382 limitation. Similarly, if a loss corporation has a NUBIL, a change-date deduction item would be allocated to the post-change period (and included in the NUBIL/L computation) because that item would be treated as RBIL, the deduction of which is subject to the loss corporation's section 382 limitation.

The approach of the proposed regulations is exceedingly complex. It would prove quite difficult to administer and thus would contravene the government's stated preference for simplicity as expressed in other areas of the proposed regulations.

b. Define the recognition period to begin at the end of the change date.

A simpler and more uniform alternative would be to define the recognition period to begin at the end of the change date immediately after the ownership change. Subject to the discussion in Section IV.D.3 below, change-date items would be treated as recognized before the ownership change and start of the recognition period and hence would not be RBIG or RBIL and would not be taken into account in computing NUBIG/L. Accordingly, all such change-date items would be allocated to the pre-change period and available to be offset without limitation by the loss corporation's pre-change losses (in the case of income items) or would contribute to losses that would constitute pre-change losses (in the case of deduction items).

Defining the recognition period to begin at the end of the change date immediately after the ownership change should represent a reasonable interpretation of the recognition period in section 382(h)(7) as "the five-year period beginning on the change date" given the difficulties presented by the change date's dual status as both the first day of the recognition period and the last day of the pre-change period.[118] Moreover, such an end-of-the-day definition at least preserves the technical hook to the change date itself as compared, for example, with defining the recognition period to begin on the day after the change date.[119] This approach also finds support in private letter rulings issued to loss corporations with a potential NUBIL that were seeking confirmation that change-date deductions for contributions to a qualified settlement fund under section 468B would not be treated as RBIL.[120]

Finally, it is a fair question to ask why change-date items recognized as part of the same plan as an ownership change would be excluded from NUBIG/L given section 382(h)(6). Certainly, on other questions in subchapter C, one would normally hesitate before concluding that transactions carried out on the same day as part of a common plan should be treated separately under general step transaction doctrine principles.[121] However, as discussed below, there is support for delinking transactions in some cases.

For example, section 355(a)(1)(A) provides that a corporation whose stock is distributed in a section 355 distribution must be controlled by the distributing corporation within the meaning of section 368(c) immediately before the distribution. In Rev. Rul. 98-27, 1998-1 C.B. 1159, the IRS determined that this control requirement is met even if the controlled corporation is later acquired in a transaction in which its shareholders become minority shareholders in an acquirer, notwithstanding the step transaction doctrine. The ruling presents its conclusion as a decision by the government to turn off otherwise-applicable

[118] For regulations that adopt an "end of" or "close of" the day standard, see reg. sections 301.7701-3(g)(3)(i); 1.59A-2(c)(4)(ii); 1.871-15(q)(4); and 1.706-4(c)(1)(i).

[119] The NYSBA Tax Section proposed redefining the recognition period to begin on the day after the ownership change. *See* NYSBA 2019 report, *supra* note 60, at 21-23.

[120] *See* LTR 200751007 and LTR 200442011.

[121] *See, e.g.*, Rev. Proc. 77-37, 1977-2 C.B. 568 (cash used by a target corporation to pay non-regular dividends "immediately before" a reorganization is not treated as held by the target for purposes of the substantially all test in section 368).

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step transaction principles following the enactment of section 355(e).

Further, in Rev. Proc. 2016-40, 2016-32 IRB 228, the IRS announced two safe harbors for transactions in which section 368(c) control of a corporation is acquired before the corporation's distribution in a putative section 355 distribution. Specifically, the IRS determined that if a safe harbor applies, it will not assert that a transaction lacks substance and that, therefore, the distributing corporation lacked section 368(c) control of the controlled corporation immediately before the latter's distribution.

The government should be able to apply a similar approach here. As discussed in detail above, the change date's dual status as the last day of the pre-change period and the first day of the recognition period introduces substantial complexities in applying section 382(h). Accordingly, the government could conclude that, in general, delinking change date items from the ownership change, allocating these items to the pre-change period and thereby excluding these items from the NUBIG/L computation is a reasonable approach for addressing the problems discussed above.

3. Unique status of excluded COD income.

In the distressed context, a loss corporation typically realizes excluded COD and undergoes its ownership change on the change date itself. Even if the government were to decide, in general, to allocate change-date items to the pre-change period, excluded COD, by its nature, is unique and warrants special consideration as discussed below.

A taxpayer that excludes COD from gross income because of its insolvency or bankruptcy must reduce its tax attributes after the determination of its tax for the year of cancellation or, in the case of tax basis, as of the beginning of its next year. Section 108(b) establishes the order in which the taxpayer reduces its tax attributes, and includes an election to reduce the basis of depreciable property before the reduction of other tax attributes. Further, in the consolidated group context, reg. section 1.1502-28 provides a three-part rule for the reduction of tax attributes: (1) Separate member attributes are reduced; then (2) there is a push-down of any reduction in the stock basis of a subsidiary member to the tax attributes of the subsidiary member (the so-called look-through rule); and finally (3) consolidated attributes of all members are reduced.[122]

Regardless of the general rules implemented to compute NUBIG/L, it would be appropriate to treat change-date excluded COD income differently. As the rules summarized above demonstrate, the effects under section 108(b) occur only later, at the end of the tax year, so that the excluded COD income and resulting attribute reduction effectively have an impact only in the recognition period (not the pre-change period). Nor does excluded COD income typically present a case of double counting, because the realization of excluded COD on the change date does not result in any pre-change income or loss.[123]

As a technical matter, for reasons explained earlier, the Supreme Court's decision in *Gitlitz* would support the recognition of built-in COD income as "income" for purposes of section 382(h)(6). As a policy matter, support for that approach would lie, in part, in the excluded COD income rules, which, as the preamble to the proposed regulations acknowledged, demonstrate a congressional solicitude for a debtor's fresh start after bankruptcy,[124] and, in particular, in other subsections of section 382 itself that reflect congressional recognition of the unique nature of ownership changes that occur under a chapter 11 restructuring.[125]

For example, if section 382(l)(5) applies to an ownership change, the loss corporation's pre-change NOLs (and, if the loss corporation has a NUBIL, RBILs) are not subject to any section 382 limitation. Among other requirements, including certain toll charges, to qualify for section 382(l)(5), the pre-change shareholders and qualified creditors of the loss corporation must own, after the ownership change and as a result of being pre-change shareholders or qualified creditors, at least 50 percent (by vote and value) of the reorganized loss corporation's stock.[126]

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[122] *See* Linda Z. Swartz and Stuart J. Goldring, *Consolidated Attribute Reduction Regulations* (2020).

[123] ABA report, *supra* note 60, at 68-69.

[124] *See* preamble to REG-125710-18, 84 F.R. at 47459.

[125] *See* NBC comments, *supra* note 60, at 1.

[126] Section 382(l)(5)(A)(ii).

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Alternatively, under section 382(l)(6), a loss corporation's pre-change NOLs are subject to an annual limitation, but the limitation is calculated based on the equity value of the loss corporation immediately *after* the ownership change. This rule therefore allows the loss corporation to calculate its annual limitation based on its new capital structure after the chapter 11 plan goes into effect.

Of course, it would not be obligatory on the part of the government to allow excluded COD income special treatment in the NUBIG/L computation. Section 382(l)(5) and (6) are specific statutory enactments, while no specific statutory rule exists in section 382(h) for the treatment of excluded COD income in calculating NUBIG/L. However, paragraphs (5) and (6) of section 382(l) do demonstrate a special congressional regard for ownership changes experienced in bankruptcy, which is the quintessential distressed restructuring technique in which an ownership change occurs. Therefore, from the standpoint of potential Treasury regulations, it would be reasonable under *Chevron*[127] to interpret section 382(h)(6)(A) and (C) as including change-date excluded COD income as an item of income that is included in computing the loss corporation's NUBIG/L.

Finally, if the government determines that excluded COD income generally should be included in the loss corporation's NUBIG/L computation, the question arises whether a different answer should apply if the loss corporation deconsolidates from a consolidated group on the change date. For purposes of sections 108 and 1017, the consolidated return regulations allocate excluded COD income realized by a departing member on the date of deconsolidation to the transferor group's tax year, rather than to the loss corporation's separate tax year.[128] The government asserted in the preamble to the proposed regulations that including excluded COD income of a deconsolidating member in the NUBIG/L computation would be "particularly distortive" because of this allocation rule.[129]

The issue of whether the end-of-the-day rule as compared with the next-day rule in reg. section 1.1502-76 should apply is a separate question from whether excluded COD income should be included in the NUBIG/L computation.[130] Excluded COD income can cause the reduction of pre-change attributes regardless of whether the ownership change results in the loss corporation's deconsolidation. If a calendar-year stand-alone corporation experiences an ownership change on December 31 and realizes excluded COD income, that income should still be included in the NUBIG/L computation even though the excluded COD income is realized in the tax year that ends on the change date, and the related RBIG/L is not recognized until subsequent taxable years (if at all). The fact that a loss corporation may deconsolidate from a consolidated group on the change date does not affect the analysis. Accordingly, although a deconsolidation transaction presents a closer question, excluded COD income realized on the change date should be included in the NUBIG/L computation regardless of whether the loss corporation is the parent corporation or a deconsolidating member, and this answer should still attain even though the excluded COD income is not allocated to the loss corporation's separate tax year under the next-day rule in reg. section 1.1502-76(b).

E. Consolidated Group NUBIG/L

1. Proposed reg. section 1502-91.

In the consolidated return context, reg. section 1.1502-91 determines the application of section 382, including whether a consolidated group is treated as having a NUBIG/L for purposes of

[127] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984). The Supreme Court has announced that it will reconsider *Chevron* in the upcoming term. *See Loper Bright Enterprises v. Raimondo*, No. 22-451 (U.S. May 1, 2023).

[128] Reg. section 1.1502-28(b)(11).

[129] Preamble to REG-125710-18, 84 F.R. at 47459.

[130] Under reg. section 1.1502-76(b)(1)(ii)(A), a corporation is treated as joining or ceasing to be a member of a consolidated group at the end of the day on which its status as a member changes. Under reg. section 1.1502-76(b)(1)(ii)(B), if, on the day of a member's change in status, a transaction occurs that is properly allocable to the portion of the member's day after the event resulting in the status change, the transaction must be treated as occurring at the beginning of the following day.

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section 382(h).[131] The regulations generally provide that NUBIG/L determinations are made on the basis of the aggregate amount of separately computed NUBIG and NUBIL of group members.[132] Special rules determine which members are taken into account, and they apply differently depending on whether a taxpayer is testing for NUBIG or NUBIL.[133] In addition to several other specific rules applying section 382(h) to the consolidated return (or loss subgroup) context, the regulations generally provide that built-in gain or loss of one group member in another group member's stock is not taken into account when calculating NUBIG/L.[134]

This exclusion of built-in gains and losses in member stock arises from the assumption that in the classic case in which a multitier group of affiliated corporations holds assets at its lowest level, each tier of corporate stock will tend to have similar basis (because of tiered contributions down to the lowest level and the operation of reg. section 1.1502-32), and the built-in gain or loss in the underlying assets will affect the value of each tier of corporate stock, effectively producing duplicative built-in gains or losses at each tier. In this context, by excluding member stock from consideration, the current regulations seek to count only actual economic built-in gains or losses. However, member stock also can reflect other built-in gains or losses that are not duplicative of gains or losses at the asset level, and current regulations exclude these unduplicated built-in gains and losses as well.

Treasury regulations proposed in 2011 (prop. reg. section 1502-91) would take certain built-in gains and losses in member stock into account for section 382(h)(3) purposes.[135] Under those proposed regulations, member stock generally would still be disregarded, but NUBIG/L would be redetermined to take into account certain built-in gain or loss in member stock upon the occurrence of specified events related to that stock.[136] Groups would take built-in gain or loss in member stock into account, and would adjust group NUBIG/L accordingly, if (1) during the recognition period, any member of the overall consolidated group "directly or indirectly takes into account any gain or loss with respect to" that stock and (2) the built-in gain or loss in that stock is not duplicated.[137] Any event taking gain or loss into account for member stock would trigger a redetermination of NUBIG/L, and the amount of the redetermination would not be tied to the amount of gain or loss recognized in the event (in other words, $100 of gain or loss recognized on member stock could result in a change in NUBIG/L of any amount, not merely a change of $100). In that case, NUBIG/L would be redetermined according to specific procedures as of immediately before the gain or loss recognition event but apparently would not affect the tax treatment of previously completed transactions.[138] These proposed regulations have not yet been finalized.[139]

2. Potential alternatives for debt allocation.

Notably, the proposed regulations interpreting section 382(h) calculate NUBIG/L in a manner that does not necessarily produce the same result for a stand-alone corporation holding

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[131] Reg. section 1.1502-91(g). The regulations also apply section 382 to a smaller group within a consolidated group that originates from a prior consolidated group and carries over a loss that is a non-separate return limitation year loss for that former group (a loss subgroup). Reg. section 1.1502-91(d). The regulations apply to the determination of NUBIG/L for loss subgroups as well as for consolidated groups.

[132] Reg. section 1.1502-91(g)(1).

[133] Reg. section 1.1502-91(g)(2). More specifically, on the date a determination is made, the regulations include all current group members for NUBIG purposes but exclude certain group members for NUBIL purposes. *Id.*

[134] Reg. section 1.1502-91(g)(1). Many intercompany obligations are also excluded from consideration under this rule. *See id.* Built-in gain or loss recognized on the disposition of member stock is taken into account in determining RBIG or RBIL, notwithstanding its exclusion from the calculation of NUBIG/L. Reg. section 1.1502-91(h)(2).

[135] REG-133002-10; *see* NYSBA Tax Section, "Report on Prop. Reg. Section 1.1502-91(g)(7): Determining Section 382 Net Unrealized Built-In Gain and Loss of a Consolidated Group," No. 1269 (July 13, 2012) (discussing prop. reg. section 1502-91).

[136] *See* prop. reg. section 1.1502-91(g)(1)(ii)(A).

[137] Prop. reg. section 1.1502-91(g)(7)(i).

[138] *Id.* Thus, for instance, when a group member has a NUBIL and recognizes an RBIL upon the sale of the relevant asset, but then the NUBIL is redetermined to be a NUBIG in a subsequent year when built-in gain in member stock basis is taken into account under the proposed regulations of prop. reg. section 1.1502-91, the RBIL in the prior year remains subject to limitation despite the later redetermination. Prop. reg. section 1.1502-91(g)(8), Example 5(ii).

[139] Concerns about this redetermination concept may account for the long delay in finalizing prop. reg. section 1502-91. ABA report, *supra* note 60, at 59 n.156.

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a particular set of assets with particular bases as it does for a consolidated group holding those same assets, with the same bases, through different group members. In particular, if all the external debt of a group is located in a group member that does not have assets taken into account in the NUBIG/L calculation (such as a holding company with no assets other than stock of other group members), that entity would arguably have zero NUBIG/L, and its external debt would arguably be ignored — a major difference from the treatment of a stand-alone corporation holding business assets whose external debt generally would be counted as assumed liabilities in a hypothetical sale approach such as that used in Notice 2003-65.

There are several potential approaches to address this issue, which would take on heightened importance if the government adopts the recommendation to abandon the liability exclusion rule. For example, the consolidated group's external debt could be allocated among group members in proportion to the FMV of those group members' assets, before determining the separate amount of NUBIG/L for each consolidated group member. This approach would avoid the allocation of external debt to holding companies (which, having no cognizable assets under existing rules, would receive no allocation of external debt) and generally ensure that all external debt is taken into account in calculating NUBIG/L under section 382(h)(3).[140]

Example 6. Parent (P) holds no assets except the stock of two subsidiaries: Sub1, whose stock has an FMV of $30 and a basis of $20; and Sub2, whose stock has an FMV of $10 and a basis of $20. Sub1 holds a single asset (Asset1), with an FMV of $30 and a basis of $20, while Sub2 holds a single asset (Asset2), with an FMV of $10 and a basis of $20. All three corporations file a consolidated return, and P owes $80 in debt to third parties. The first approach would reallocate the $80 external debt by allocating $60 to Sub1 and $20 to Sub2, in accordance with their share of group assets other than member stock. P would have neither NUBIG nor NUBIL on account of holding only member stock; Sub1 would have $40 in NUBIG; and Sub2 would have neither NUBIG nor NUBIL, producing a total NUBIG of $40. This is the same amount that would be determined for a single corporation holding both Asset1 and Asset2 with an aggregate $40 basis and having the same $80 in external debt.

LTR 201051019 also provides a potential solution, under which the section 338 regulations' deemed allocation of consideration between asset classes would apply in determining NUBIG/L on a separate company basis for members of a consolidated group, and the rules excluding unrealized gain or loss on member stock would essentially be waived solely for this purpose.[141] Thus, if a group member has external debt exceeding the value of its assets (which would include member stock despite the general exclusion of that stock from consideration under reg. section 1.1502-91(g)(1)), the group member would allocate that excess to goodwill, solely for purposes of computing separate company NUBIG/L (and this would not create or increase the amount of goodwill available to be taken into account in accordance with any forgone amortization construct that the government may adopt under section 382(h)). To apply this approach to the example laid out above, no external debt would be reallocated, P would have a NUBIG of $40, Sub1 would have a NUBIG of $10, and Sub2 would have a NUBIL of $10 — again aggregating the same $40 of NUBIG that would have been determined for a single corporation with the same assets, tax attributes, and external debt.[142]

In light of the foregoing, the government should address the treatment of liabilities in computing NUBIG/L in the consolidated group context, either as part of the same package as the expected new proposed regulations or separately.

V. Forgone Amortization

As discussed above, under Notice 2003-65, a depreciable or amortizable asset may produce RBIG under the forgone amortization construct in the section 338 approach even though the loss

[140] AICPA comments, *supra* note 60, at 21.

[141] LTR 201051019; *see* reg. sections 1.338-4 and -6 (rules for calculating purchase price and allocating the purchase price among the target corporation's assets following a section 338 election).

[142] AICPA comments, *supra* note 60, at 21-22.

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corporation does *not* dispose of the asset. More specifically, the section 338 approach posits a hypothetical disposition of all the loss corporation's assets in an acquisition of the loss corporation for which a section 338 election is made. That acquisition, which the loss corporation could have effected on the change date, would have stepped up the basis of all the acquired assets and, for built-in gain assets, would have started a new depreciation or amortization schedule with larger yearly deductions. The excess of the deduction that would have been produced after this hypothetical acquisition (excluding immediate expensing as required under Notice 2018-30, 2018-21 IRB 610) over the actual deduction that the loss corporation takes is forgone amortization that reflects the built-in gain in the asset on the change date, and the section 338 approach treats this amount as RBIG.[143]

In the proposed regulations, the government rejected the 338 approach together with its forgone amortization construct, asserting in the preamble that the section 338 approach lacks sufficient textual support in section 382(h), is more complex than the accrual-based section 1374 approach, and can produce overstatements of RBIG/L.[144] The government's proposed rejection of forgone amortization elicited substantial commentary, which led to the issuance of the proposed regulations and culminated in the government's decision to issue new proposed rules as opposed to finalizing these. Although that is a welcome development, there is no assurance that the forthcoming rules will necessarily embrace forgone amortization.

This Section V defends most, but not all, aspects of the forgone amortization construct in Notice 2003-65's section 338 approach. This report posits that (1) although not uniformly adopted, the concept that wasting assets (that is, depreciable and amortizable assets used in a loss corporation's business) recognize built-in gain through their consumption as well as their outright disposition has a solid foundation in the tax law; (2) section 382(m) gives the government ample authority to adopt regulations under section 382(h) that use a forgone amortization construct in measuring RBIG; and (3) although the government's concern that the accelerated depreciation rules in section 168 may not be the appropriate proxy for determining RBIG is legitimate, it can address any perceived abuse without abandoning forgone amortization altogether. More specifically, the government could incorporate an approach like section 312(k), which mandates straight-line depreciation to measure earnings and profits, and mandate straight-line depreciation in measuring RBIG under section 382(h). Finally, this report concludes with a discussion of the considerations that would apply for section 384 purposes if the government adopts forgone amortization under the forthcoming section 382 regulations.

A. Wasting Assets

A recurring issue in the tax law involves the potential for wasting assets to recognize built-in gain through their consumption in business operations, as well as through their outright disposition (consumption theory). In the case of section 382(h), the theory is that post-change income attributable to pre-change depreciation and other expenses that generated the built-in gain represent RBIG. The post-change income is economically equivalent to income realized upon an asset's disposition because both types of income reflect a realization of value inherent on the change date. The neutrality principle further supports RBIG treatment because, absent an ownership change, there would be no limit on the corporation's ability to use its NOLs to offset the income in question.

Consumption theory finds strong support in the original understanding of depreciation.[145] Nearly a century ago, Justice Louis Brandeis explained, "The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it."[146] Thus, consumption theory recognizes the economic disposition of an

[143] Notice 2003-65, Section IV.D.

[144] Preamble to REG-125710-18, 84 F.R. at 47457.

[145] For a discussion of the history of U.S. tax depreciation laws and policies, see Richard M. Nugent, Sean E. Jackowitz, and L. Matthew Waterhouse, "Bonus Questions on the New Bonus Depreciation Rules," *Tax Notes*, July 23, 2018, p. 457.

[146] *United States v. Ludey*, 274 U.S. 295, 301 (1927).

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asset over time through its use in the taxpayer's business.[147] Similarly, the Supreme Court has recognized that "the primary purpose of depreciation accounting [is] to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes."[148] More recently, in *Newark Morning Ledger*,[149] the Court, in analyzing whether an intangible asset qualified for depreciation under section 167, reiterated the principle explained a generation earlier in *Massey Motors*,[150] stating that "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."[151]

The discussion below considers the applicability (or inapplicability) of consumption theory in three distinct areas of the code: (1) the denial of noneconomic stock losses in the consolidated return setting; (2) the recognition of built-in gain following the contribution of appreciated property to a tax partnership; and (3) the recognition of built-in gain by an S corporation after its conversion from C corporation status. To be sure, the government has not always applied consumption theory. However, as discussed below, those instances prove to be exceptions to the rule and are explainable primarily by administrative concerns unrelated to the central tenet of consumption theory that wasting assets in fact recognize built-in gain through their consumption as well as outright disposition.

1. Noneconomic stock losses in consolidated groups.

In 1986 Congress enacted section 337(d), which directs the Treasury secretary to prescribe such regulations as may be necessary or appropriate to carry out the repeal of the *General Utilities* doctrine (GU repeal).[152] The legislative history reflects a congressional concern that the *General Utilities* doctrine allowed "assets to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax" and thus tended "to undermine the corporate income tax."[153]

Section 337(d)(1) directs the secretary to promulgate regulations to prevent the circumvention of GU repeal through the use of the consolidated return regulations. The investment adjustment rules of reg. section 1.1502-32 aim to promote the clear reflection of the consolidated group's income, primarily by preventing a subsidiary's items of income, gain, deduction, and loss from giving rise to duplicative gain or loss on the subsidiary's stock.[154] The rules generally accomplish this goal by requiring positive or negative adjustments to the basis of the subsidiary's stock to reflect the increase or decrease resulting from gain or loss recognized by the subsidiary.[155]

However, the investment adjustment rules permitted a consolidated group to sell assets without paying a corporate tax and for the buyer of the assets to obtain a stepped-up tax basis in those assets. This transaction came to be known as the "son of mirror" transaction, illustrated by the following simple example.

Example 7. Target (T) has a single capital asset with an FMV of $50 and a basis of $0. Parent (P) buys all the T stock for $50, and P and T file a consolidated return. T sells its asset for $50, recognizing a gain of $50 and increasing P's stock basis in T by $50 to $100. P sells the T stock for $100, recognizing a capital loss of $50.

The "son of mirror" transaction contravenes GU repeal because the loss on the sale of T's stock

[147] T.D. 8294, 55 F.R. 9426, 9428 (Mar. 14, 1990) ("By using up or wearing out an asset in the process of earning income, the subsidiary is, in effect, disposing of the asset in exchange for the income.") (1990 temporary regulations).

[148] *Massey Motors Inc. v. United States*, 364 U.S. 92, 104 (1960).

[149] *Newark Morning Ledger v. United States*, 507 U.S. 546 (1993).

[150] *Massey Motors*, 364 U.S. 92.

[151] *Newark Morning Ledger*, 507 U.S. at 565 (quoting *INDOPCO Inc. v. Commissioner*, 503 U.S. 79, 84 (1992)).

[152] *See* TRA 1986, P.L. 99-514.

[153] H.R. Rep. No. 99-426, at 282 (1985).

[154] Preamble to T.D. 8294, 55 F.R. at 9426.

[155] *Id.*; *see also* reg. section 1.1502-32 (consolidated return investment adjustment rules).

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offsets the gain recognized upon the asset sale, resulting in the P consolidated group having no net income.[156] The elimination of corporate-level tax on the gain from the disposition of T's asset results from the prior reflection of that built-in gain in P's stock basis on the acquisition date. Accordingly, the increase in T's stock basis upon the recognition of built-in gain from the subsequent asset sale results in a double counting of the built-in gain in stock basis and allows P a noneconomic tax loss to offset T's economic gain on the asset sale.[157]

The government's initial response to GU repeal was Notice 87-14, 1987-1 C.B. 445, which set forth the intent to promulgate regulations affecting adjustments to members' bases in stock of any subsidiary acquired when the subsidiary held an appreciated asset. Notice 87-14 indicated that adjustments to subsidiary stock basis generally would not reflect gains on such assets.

Although Notice 87-14 envisioned a tracing-based regime, the government ultimately concluded that relying on the tracing of appreciation on particular assets, while theoretically accurate, would impose substantial administrative burdens on taxpayers and the government alike.[158] In March 1990 the government published the 1990 temporary regulations generally disallowing loss recognized upon the disposition of a consolidated subsidiary's stock.[159] After commentators strongly objected to a complete loss disallowance rule, in November 1990 the government withdrew the temporary regulations and issued proposed regulations that were finalized in September 1991.[160] In lieu of complete loss disallowance, the 1991 final regulations used certain presumptions to determine the extent to which investment adjustments could give rise to allowable stock loss.[161]

Significantly, the 1990 temporary regulations, the 1990 proposed regulations, and the 1991 final regulations all adopted consumption theory in explaining how GU repeal circumvention can result either from the disposition or the consumption of built-in gain assets. The preamble to the 1990 temporary regulations included two relevant examples:

> Example 2: Corporation S has one asset with a basis of $80 and a value of $100. Corporation P buys all the stock of S for $100 and P and S elect to file consolidated returns. S then sells the asset for $100 and recognizes gain of $100. Under the investment adjustment rules, P's basis in the stock of S is increased to $200 because the sale of the asset generated $100 of earnings and profits . . . to S. This basis increase permits P to recognize a loss of $100 if P sells the S stock, thus offsetting the gain on the sale of the asset.

The next example illustrated how the problem can equally arise upon the consumption of built-in gain assets:

> Example 3: The facts are the same as in Example 2, except that S uses the asset in business operations rather than selling it. The asset earns $20 and declines in value by $20 in each year over a 5-year period. As in Example 2, P's basis in the stock of S is increased by the earnings to $200, but the value of S remains $100 and P may recognize a loss of $100 if P sells the S stock.[162]

In both examples 2 and 3, the preamble explained, disallowance of P's $100 loss eliminates the possibility that investment adjustments caused by S's recognition of built-in gain, whether from dispositions or operations, will result in elimination of the gain and thus gives effect to GU

[156] NYSBA Tax Section, "Report on Temporary Regulation Section 1.337(d)-2 and Proposed Regulation Section 1.1502-35," No. 1029, at 8 (Feb. 2003) (NYSBA 2003 report).

[157] *Id.*

[158] Preamble T.D. 8294, 55 F.R. at 9428-9429.

[159] *Id.* at 9426.

[160] CO-93-90, 55 F.R. 49075 (Nov. 26, 1990) (1990 proposed regulations); T.D. 8364, 56 F.R. 47379 (Sept. 19, 1991) (1991 final regulations).

[161] Preamble to T.D. 8364, 56 F.R. at 47380-47383 (discussing comments received on the 1990 proposed regulations (CO-93-90) and explaining the loss disallowance rule in the 1991 final regulations).

[162] Preamble to T.D. 8294, 55 F.R. at 9427.

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repeal by ensuring that S's RBIG will be subject to a corporate-level tax.[163]

Similarly, the 1990 proposed regulations recognized that consumption of wasting assets can circumvent GU repeal. The government stated in the preamble: "Consumption of wasting assets is not outside the scope of *General Utilities* repeal because dispositions and consumption may produce identical investment adjustments. . . . Failing to take wasting assets into account would treat taxpayers in similar economic circumstances differently."[164]

Finally, the 1991 final regulations expressly reaffirmed consumption theory. The preamble acknowledges: "If an asset is amortizable or depreciable, its built-in gain may be recognized through consumption as well as disposition."[165] Both the 1990 proposed regulations and the 1991 final regulations cited Example 3 from the preamble to the 1990 temporary regulations set forth above to support the adoption of consumption theory.[166]

The study undertaken after the issuance of Notice 87-14 convinced the government that loss duplication was also a problem in the consolidated group setting, and the loss disallowance rule in the 1991 final regulations included a loss duplication component. However, in the 2001 *Rite Aid* decision,[167] the Federal Circuit addressed the denial of Rite Aid Corp.'s deduction for an economic loss on subsidiary stock solely because the stock loss could be duplicated by the subsidiary after it left the consolidated group. The court determined that the secretary's authority to change the application of a code provision to a consolidated group was limited to situations in which change was necessary to address a problem created by the filing of a consolidated return.[168] Because duplicated stock loss also occurs in the separate return setting, the court concluded that the duplicated loss component of the loss disallowance rule did not address a problem arising from the filing of a consolidated return, and the secretary therefore lacked the authority to change the rule in the code allowing a deduction for the stock loss.[169]

In response to *Rite Aid*, the IRS announced that it would not continue to litigate the validity of the duplicated loss component of the loss disallowance rule in the 1991 final regulations.[170] The government suspended the application of the entire loss disallowance rule in the 1991 final regulations given the interrelationship of the loss duplication component with the other components of the rule, and it promulgated former reg. section 1.337(d)-2T to provide an interim rule addressing noneconomic stock loss while the government studied the matter further.[171]

The former section 337(d) regulations generally disallowed stock loss and reduced stock basis (to value) upon the disposition or deconsolidation of subsidiary stock by a member of a consolidated group.[172] However, the taxpayer could avoid loss disallowance and basis reduction to the extent that it could establish that the loss or basis was not attributable to the recognition of built-in gain on the disposition of an asset.[173] A "disposition," in turn, was "any event in which gain or loss was recognized, in whole or in part."[174] Unlike the loss disallowance rule in the 1991 final regulations, the former section 337(d) regulations did not account for the consumption of unrecognized appreciation reflected in stock

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[163] *Id.*

[164] Preamble to CO-93-90, 55 F.R. at 49078.

[165] Preamble to T.D. 8364, 56 F.R. at 47381.

[166] Preamble to CO-93-90, 55 F.R. at 49078; preamble to T.D. 8364, 56 F.R. 47381.

[167] *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).

[168] *Id.* at 1359-1360.

[169] *Id.* at 1360. In the American Jobs Creation Act of 2004, P.L. 108-357, Congress amended section 1502 to provide that the Treasury secretary may prescribe rules different from the provisions of chapter 1 that would apply if the relevant corporations filed separate returns. In the legislative history, Congress stated that the secretary is authorized to change the application of a code provision when the secretary determines it is necessary to clearly reflect the income tax liability of the group and each corporation in the group both during and after the period of affiliation. H.R. Rep. No. 108-755, at 653 (2004) (Conf. Rep.).

[170] *See* Notice 2002-11, 2002-1 C.B. 526.

[171] *See* preamble to T.D. 9187, 70 F.R. 10319, 10320 (Mar. 3, 2005) (former section 337(d) regulations).

[172] Reg. section 1.337(d)-2(a)(1) and (b)(1).

[173] Reg. section 1.337(d)-2(c)(2).

[174] Reg. section 1.337(d)-2(a)(2)(ii).

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basis.[175] Accordingly, the former section 337(d) regulations did not adopt consumption theory.

At the same time, it is equally clear that the government viewed the former section 337(d) regulations merely as a stopgap measure designed to provide some protection against noneconomic stock losses pending the government's comprehensive review of the underlying issues in the wake of *Rite Aid*. Indeed, following *Rite Aid*, the government publicly declared on several occasions that it was undertaking a study of this area and referred to the interim nature of the former section 337(d) regulations.[176] Thus, the former section 337(d) regulations did not represent the government's settled views on this area of the law.

Consistent with the foregoing, more than five years after *Rite Aid*, the government issued proposed regulations under reg. section 1.1502-36 setting forth the unified loss rule (ULR).[177] The proposed regulations addressed the problems of noneconomic stock loss and loss duplication in the consolidated return context through an integrated system of stock and asset basis adjustments. Significantly, the proposed regulations fully embraced consumption theory in policing noneconomic stock losses.[178] In fact, in explaining the deficiencies of a safe harbor method that was available in applying the former section 337(d) regulations, the preamble stated:

> Because it is an interpretation of the current loss limitation rule in section 1.337(d)-2, [the safe harbor method] reflects limitations that inhibit the extent to which the rule addresses the circumvention of *GU* repeal. . . . For example, the model did not account for the consumption of unrecognized appreciation reflected in stock basis (the "wasting asset" problem). Thus, if unrealized gain reflected in stock basis was recognized as income . . . instead of a disposition of the property . . ., the resulting noneconomic stock loss was not disallowed under the current rule.[179]

Published in September 2008, the final regulations implementing the ULR firmly endorsed consumption theory as well.[180] The preamble to the final regulations explained that commentators and practitioners "have generally concurred with the major policy decisions reflected in the proposed regulations, including the retention of the loss limitation model, . . . the application of the rule to built-in income, and the systemic prevention of loss duplication."[181]

Following GU repeal, the government adopted several different approaches to policing noneconomic stock losses in consolidated groups. With the sole exception of the former section 337(d) regulations, which plainly were interim rules adopted in response to *Rite Aid* and pending the issuance of the definitive guidance now embodied in the ULR regulations, the rules disallowing noneconomic stock losses have embraced consumption theory by equating the built-in income of wasting assets with built-in gain recognized upon the disposition of an asset.

2. Contribution of appreciated property to a partnership.

Under section 704(c), a partnership must allocate income, gain, loss, and deduction for property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its FMV at the time of contribution. The purpose of this subchapter K provision is to prevent the shifting of tax consequences among partners for pre-contribution gain or loss.[182]

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[175] NYSBA 2003 report, *supra* note 156, at 22 ("The term 'disposition' does not appear to apply to assets (tangible assets like equipment or intangible assets like goodwill) that are consumed in the business.").

[176] *See, e.g.*, Notice 2004-58, 2004-2 C.B. 520 ("The IRS and Treasury Department are studying various approaches to implement the repeal of General Utilities in the consolidated return context . . . and intend to promulgate regulations that will prescribe a single set of rules. . . . While some might argue that [the] . . . concern [underlying GU repeal] was limited to stock losses created by the recognition of asset gain that existed when the stock or asset was acquired by the group, others might argue that this concern extended to losses created by any gain or income recognized.").

[177] REG-157711-02, 72 F.R. 2964 (Jan. 23, 2007) (proposed ULR regulations).

[178] *Id.* at 3000-3001, former prop. reg. section 1.1502-36(c)(3) and (8), Example 1(ii).

[179] Preamble to REG-157711-02, 72 F.R. at 2972.

[180] *See* prop. reg. section 1.1502-36(c)(3) and (8), Example 1(ii).

[181] T.D. 9424, 73 F.R. 53934 (Sept. 2008). The former section 337(d) regulations do not apply to transactions subject to the ULR regulations but otherwise remain applicable. *Id.*

[182] Reg. section 1.704-3(a)(1).

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Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis.[183] Book value is equal to FMV at the time of contribution, as later adjusted for cost recovery and other events that affect the basis of the property.[184] The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution.[185] Subsequent decreases in the difference between the property's book value and adjusted tax basis reduce the built-in gain.[186]

Reg. section 1.704-3 describes three allocation methods that are "generally reasonable": the traditional method, the traditional method with curative allocations, and the remedial allocation method. The traditional method generally requires that a partnership with income, gain, loss, or deduction attributable to section 704(c) property make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss.[187] For example, if the partnership sells the section 704(c) property and recognizes gain or loss, the partnership must allocate the built-in gain or loss on the property, as applicable, to the contributing partner.[188]

In addition, for section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to those items must take into account built-in gain or loss on the property.[189] Tax allocations to the noncontributing partners of cost recovery deductions for section 704(c) property generally must, to the extent possible, equal book allocations to those partners.[190] However, the total income, gain, loss, or deduction allocated to the partners for a tax year for a property cannot exceed the total partnership income, gain, loss, or deduction for that property for the tax year (the ceiling rule).[191]

The following example adapted from Example 1 of reg. section 1.704-3(b)(2) illustrates how compliance with section 704(c) principles extends beyond sale transactions to encompass the allocation of cost recovery deductions related to the consumption of built-in gain property in the partnership's business.

Example 8. A and B form Partnership AB and agree to share all partnership items equally. A contributes depreciable property with a 10-year life, an FMV of $10,000, a basis of $4,000, and a built-in gain of $6,000. B contributes $10,000 cash. The property is depreciated using the straight-line method over a 10-year recovery period. Because the property depreciates at an annual rate of 10 percent, B would have been entitled to a depreciation deduction of $500 per year for both book and tax purposes if the adjusted tax basis of the property were equal to its FMV at the time of contribution. Although each partner is allocated $500 of book depreciation per year, the partnership is allowed a tax depreciation deduction of only $400 per year (10 percent of $4,000). Under the ceiling rule, the partnership can allocate only $400 of tax depreciation, and it must be allocated entirely to B. In AB's first year, the proceeds generated by the equipment exactly equal AB's operating expenses. At the end of that year, the book value of the property is $9,000 ($10,000 less the $1,000 book depreciation deduction), and the adjusted tax basis is $3,600 ($4,000 less the $400 tax depreciation deduction). A's built-in gain for the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis).[192]

In Example 8, in year 1 the partnership allocated all $400 of tax depreciation for the built-in gain property to B (the noncontributing partner). The consequence of this is that A (the contributing partner) generally will be allocated more taxable income than book income. As three commentators explained: "Although A did not recognize gain on the contribution of the property, A in effect recognizes some of this built-in gain

[183] Reg. section 1.704-3(a)(3)(i).

[184] *Id.* (citing book value adjustment rules in reg. section 1.704-1(b)).

[185] Reg. section 1.704-3(a)(3)(ii).

[186] *Id.*

[187] Reg. section 1.704-3(a)(b)(1).

[188] *Id.*

[189] *Id.*

[190] *Id.*

[191] *Id.*

[192] *See* Arthur Willis, Philip Postlewaite, and Jennifer Alexander, *Partnership Taxation* para. 10.08 (2023).

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over time as depreciation is allocated to B."[193] Accordingly, this is an additional example of the tax law adopting consumption theory insofar as section 704(c) requires the contributing partner to recognize built-in gain upon a sale of the relevant property as well as through consumption of the property in the partnership's business.

3. Built-in gain rules applicable to S corporation conversions.

During the five-year period following conversion from C corporation status, an S corporation generally is subject to corporate-level tax under section 1374 on recognized income or gain that reflects unrealized appreciation in the corporation on the conversion date.[194] Section 1374 is another provision designed to police GU repeal.[195]

Section 1374(d)(5) treats any item of income or deduction properly taken into account by an S corporation during the recognition period as RBIG/L if the item is attributable to periods before the recognition period. The language of this provision is similar to section 382(h)(6). The regulations under section 1374 generally treat an S corporation's items of income or deduction as RBIG/L if the item would have been taken into account before the recognition period by a taxpayer using the accrual method.[196] The accrual method does not embrace consumption theory. In the preamble to the former proposed regulations under section 1374(d)(5), the government explained that the accrual method is used "because valuing items of income and deduction on the first day of the recognition period would be unduly burdensome both for S corporations, many of which are small businesses, and the Service."[197]

The government adopted the accrual method in the regulations implementing section 1374(d)(5) as a matter of administrative convenience given the types of businesses that traditionally are S corporations. Significantly, the adoption of the accrual method in the regulations did not reflect in any respect a conclusion by the government that the statutory language of section 1374(d)(5) was incompatible with consumption theory. Moreover, recognizing the similarity in language between section 1374 and other code sections, the preamble made explicit that the government intended no inference regarding the standard to adopt in other regulatory projects, including under section 382(h)(6).[198]

B. Section 382 and Consumption Theory

Although, as demonstrated above, the tax law generally embraces consumption theory, a separate question exists of whether anything in the text of section 382 precludes the government from embracing consumption theory in regulations interpreting the meaning of RBIG. As the Supreme Court has explained: "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter."[199]

1. Textual analysis.

Section 382(h)(2)(B) represents the strongest technical argument that section 382(h) rejects consumption theory. That provision expressly treats recognition period depreciation, amortization, and depletion as RBIL except to the extent the loss corporation establishes that the amount is not attributable to the excess of the relevant asset's adjusted basis over its FMV on the change date. Given the absence of an express rule treating income from the consumption of wasting assets as RBIG, one might posit that Congress intended this disparate treatment.[200] However, an examination of section 382(h)'s statutory evolution between 1986 and 1988 refutes that argument.

As enacted in 1986, section 382(h)(6) authorized the secretary to promulgate

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[193] *Id.*

[194] Section 1374(a). The net RBIG for any tax year generally equals the S corporation's taxable income for that year (determined as if it were a C corporation and only RBIG and RBIL were taken into account), limited to the lesser of the corporation's taxable income for that year (generally determined as if it were a C corporation) and its NUBIG limitation for the year (generally, NUBIG reduced by net RBIG in prior years in the recognition period). Section 1374(c)(2).

[195] H.R. Rep. No. 99-841, Vol. II, at 198-207 (1986) (Conf. Rep.).

[196] Reg. section 1.1374-4(b).

[197] CO-80-87, 57 F.R. 57971, 57972-57973 (Dec. 8, 1992).

[198] *Id.* at 57973.

[199] *Chevron*, 467 U.S. at 842.

[200] NYSBA 2019 report, *supra* note 60, at 29.

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regulations treating as RBIL amounts which accrue on or before the change date but which are allowable as a deduction during the recognition period. The accompanying conference report stated:

> The Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date . . . will be treated as built-in losses. Under the conference agreement, depreciation deductions cannot be treated as accrued deductions or built-in losses. The conference agreement, however, requires the Secretary . . . to conduct a study of whether built-in depreciation deductions should be subject to section 382, and report to the tax-writing committees of the Congress.[201]

Further, recognizing the obvious parallel in the RBIG context, the Joint Committee on Taxation explained: "Section 382 does not provide relief for built-in income other than gain on disposition of an asset."[202]

In 1987 Congress amended section 382(h)(2)(B) to address depreciation, amortization, and depletion in the RBIL context.[203] The accompanying conference report reflected the congressional determination that "preacquisition losses that may not be used to shelter built-in gains include built-in losses or items of deduction that have economically accrued prior to deduction."[204]

The following year, Congress adopted the third relevant amendment, revising section 382(h)(6) to treat as RBIG/L any item of income or deduction that is properly taken into account during the recognition period but is attributable to periods before the change date.[205] Although this amendment generally was effective as though it were included in the 1986 code, both the House report and the Senate report to the 1988 Technical and Miscellaneous Revenue Act state that amounts allowable as depreciation, amortization, or depletion would constitute RBIL only to the extent consistent with the December 15, 1987, effective date for section 382(h)(2)(B) provided in the Omnibus Budget Reconciliation Act 1987.[206]

The focus on section 382(h)(6)'s effective date is instructive in that it indicates that Congress considered section 382(h)(6)(B), which addresses built-in deduction items in the RBIL context, to encompass built-in depreciation, amortization, and depletion notwithstanding the enactment of 382(h)(2)(B) one year earlier. Significantly, section 382(h)(6) addresses both built-in income items in the RBIG context (section 382(h)(6)(A)) and built-in deduction items in the RBIL context (section 382(h)(6)(B)). Section 382(h)(6) provides the textual basis to include built-in deduction items in the NUBIL calculation (section 382(h)(6)(C)) and then to treat those items as RBIL. Section 382(h)(2)(B), in turn, provides the textual basis for a NUBIL taxpayer to calculate RBIL with respect to depreciation, amortization, and depletion of built-in loss assets. In short, section 382(h)(6)(B) and (2)(B) operate in tandem.

The above statutory developments refute the argument that section 382(h)(2)(B) demonstrates a congressional determination to include depreciation, amortization, and depletion as RBIL for NUBIL taxpayers, but to exclude built-in income from the consumption of wasting assets as RBIG for NUBIG taxpayers. Following TAMRA, the argument for that disparate treatment is not persuasive. Section 382(h)(6) does not discriminate. Rather, it has parallel provisions covering built-in income items in the case of RBIG and built-in deduction items in the case of RBIL.

The legislative history to TAMRA does not explain the significance of the terminology change from "accrue," which the 1986 code used,

[201] H.R. Rep. No. 99-841, at 191 (1986).

[202] JCT, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 320, n.36 (May 4, 1987).

[203] OBRA 1987, P.L. 100-203, section 10225(b).

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

[205] 1988 Technical and Miscellaneous Revenue Act, P.L. 100-647, section 1006(d)(22).

[206] TAMRA section 1019; H.R. Rep. No. 100-795, at 47 and n.19 (1988); S. Rep. No. 100-445, at 49 and n.22 (1988); *see also* NYSBA 2019 report, *supra* note 60, at 29; and Noel P. Brock, "The Forthcoming Built-In Item Regulations: Issues for the Government to Address," *Tax Notes*, Apr. 1, 2002, p. 97 (discussing effective date). In 1989 Congress amended section 382(h)(6)(C) to adjust NUBIG/L, as applicable, for amounts that would constitute RBIG/L if properly taken into account during the recognition period (without regard to whether or when those items are actually recognized within the recognition period). OBRA 1989, section 7811(c)(5)(A)(i); *see* H.R. Rep. No. 101-247, at 1406 (1989).

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to "attributable to." Nevertheless, Supreme Court decisions and other case law interpreting the phrase "attributable to" in other contexts are instructive in interpreting the phrase for section 382(h)(6) purposes.[207] As the Tax Court has said, "The plain meaning of 'attributable to' is simply due to, caused by, or generated by."[208] For present purposes, the long-standing, plain meaning of "attributable to" supports adoption of regulations interpreting "attributable to" in section 382(h)(6)(A) to treat as RBIG recognition period income from the consumption of change-date built-in gain of wasting assets. The "attributable to" standard requires a nexus between post-change income and pre-change period activity. If this nexus is present, the income in question represents built-in income under section 382(h)(6)(A) that is eligible for RBIG treatment.

Finally, section 382(m) gives Treasury authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." The legislative history describes this grant of authority as broad.[209] Indeed, two prominent corporate tax commentators have characterized the grant of regulatory authority under section 382(m) as a "megadelegation."[210] Accordingly, no serious question exists as to whether the government has the authority as a technical matter to adopt consumption theory in promulgating RBIG rules under section 382(h).

[207] *See, e.g.*, *Braunstein v. Commissioner*, 374 U.S. 65, 70 (1963) (interpreting "attributable to" in former section 117(m) as "merely confin[ing] consideration to that gain caused or generated by the property in question").

[208] *Lawinger v. Commissioner*, 103 T.C. 428, 435 (1994). A significant body of authority interprets the term "attributable to" under section 6511(d) for purposes of determining whether a refund claim is timely. *See, e.g.*, ILM 202023006 (discussing case law).

[209] H.R. Rep. No. 100-795, at 54 (1988) (under section 382(m), Treasury has "broad regulatory authority to prescribe any regulations necessary or appropriate to carry out the purposes of the loss limitation provisions").

[210] Boris I. Bittker and James S. Eustice, *Taxation of Corporations and Shareholders* para. 14.42 (2023).

2. Policy analysis.

In addition to this technical analysis, several policy rationales support the adoption of consumption theory under section 382(h)(6)(A).[211] First, as discussed above, for a NUBIL taxpayer's change-date built-in loss assets, subparagraphs (6)(B) and (2)(B) of section 382(h) treat a portion of the recognition period depreciation, amortization, and depletion as RBIL. Thus, for RBIL purposes, section 382 mandates equivalent treatment during the recognition period between actual dispositions of built-in loss assets and their consumption in the taxpayer's business. Adopting consumption theory for RBIG purposes would establish symmetry between the RBIG and RBIL rules in that they would apply to both the disposition and the consumption of assets during the recognition period.[212]

Second, embracing consumption theory for RBIG purposes would be consistent with the neutrality principle, which animates section 382(h) and mandates that built-in gain or loss recognized after an ownership change be treated in the same manner as if recognized before the ownership change. Because section 382 would not have limited NOL usage to offset built-in gain recognized before an ownership change, the neutrality principle requires an increase to the annual limitation so that pre-change NOLs are fully usable to offset that gain if recognized during the recognition period. Moreover, no policy reason requires distinguishing between gain recognized upon the asset's disposition as compared to income recognized upon the asset's consumption.

Third, it is important to highlight the similarities between the outright disposition of assets and their consumption in the taxpayer's business. For NUBIG taxpayers, section 382(h)(2)(A) explicitly treats as RBIG change-date built-in gain recognized during the recognition period by virtue of the asset's sale or other taxable disposition. As discussed above, the Supreme

[211] *See Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44, 58 (2011) (if Congress has not directly addressed the precise question at issue, the second step under *Chevron* asks whether the rule at issue "is a 'reasonable interpretation' of the enacted text") (quoting *Chevron*, 467 U.S. at 844).

[212] *See* NYSBA 2019 report, *supra* note 60, at 36.

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Court has previously recognized that the consumption of an asset in the taxpayer's business represents a "gradual sale" of the asset.[213] Thus, the consumption of assets in the taxpayer's business is tantamount to a series of partial dispositions of the assets.

Fourth, if the government restricts RBIG to built-in gain recognized upon the sale or other taxable disposition of an asset, some taxpayers inevitably will resort to self-help measures that may permit gain recognition (and NOL use) without surrendering control over the asset — for example, sale leaseback structures.[214] Adopting consumption theory would allow taxpayers to avoid the need to pursue structures motivated predominantly by tax objectives and instead allow them to focus exclusively on commercial objectives. This benefit of consumption theory would be particularly important for bankruptcy restructurings.

Finally, the rejection of consumption theory in interpreting section 382(h)(6)(A) essentially would disregard a portion of the TAMRA amendments that Congress enacted in 1988. This would effectively return taxpayers to the tax accrual standard under the 1986 code. Interpreting section 382(h)(6)(A) to mandate a tax accrual standard for measuring RBIG is not the best reading of the statute, especially when taking into account the policy reasons discussed herein for adopting consumption theory.

Based on the foregoing, consumption theory generally has broad support in the tax law. Nothing in section 382(h) precludes the government from embracing consumption theory in measuring RBIG under section 382(h)(6)(A). Further, several policy rationales support its adoption in this context.

C. Rightsizing RBIG

The preceding discussion demonstrates that the government has the authority to adopt consumption theory in promulgating RBIG rules under section 382(h). That gives rise to a separate question as to the appropriate way to measure RBIG. The preamble to the proposed regulations contends that, in applying the section 338 approach under Notice 2003-65, accelerated depreciation can overstate the loss corporation's RBIG. While acknowledging that the government's concern is legitimate, the discussion below maintains that the government can address this concern without abandoning consumption theory (forgone amortization under Notice 2003-65) altogether.

Three points are critical in analyzing how best to measure RBIG under section 382(h). First, a tracing construct would be untenable and would likely understate RBIG in many cases. A proxy is necessary to measure RBIG, and tax depreciation and amortization rules in general are logical candidates to serve as proxies. Second, any construct should respect the compromises Congress made in enacting section 197 and treat goodwill as a wasting asset for RBIG purposes. Finally, as noted, accelerated depreciation may tend to overstate RBIG. In Notice 2018-30, the government acted swiftly after the adoption of section 168(k) in the TCJA to exclude immediate expensing in applying the section 338 approach of Notice 2003-65. Assuming the government decides to apply consumption theory in regulations under section 382(h), it has ample tools at its disposal to refine the measurement of RBIG. Section 312(k), which generally adjusts the amount of depreciation in measuring E&P, is one source the government could use for this purpose. As discussed below, the provision's history is enlightening because Congress adopted the statutory predecessor to section 312(k) more than a half-century ago, after concluding that the existing depreciation rules produced inappropriate results. Accordingly, the government might tap the principles of section 312(k) here as well to remedy any perceived abuse.

1. Need a proxy to measure RBIG of wasting assets.

To be sure, section 382 mandates a tracing approach insofar as NUBIG/L is determined based on the loss corporation's assets and built-in

[213] *Ludey*, 274 U.S. at 301.

[214] ABA report, *supra* note 60, at 52.

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items immediately before the ownership change.[215] During the recognition period, the loss corporation recognizes RBIG/L attributable to those particular assets and built-in items. However, imposing a tracing regime to measure the income attributable to the consumption of the loss corporation's wasting assets is a different issue. Requiring tracing for this purpose would compel the loss corporation to identify particular income items that are directly attributable to the built-in gain assets. Outside limited contexts (such as licenses), a tracing regime likely would understate the loss corporation's RBIG — by a significant amount in some cases.

In fact, the government extensively analyzed potential tracing regimes in considering the various packages of consolidated group noneconomic stock loss rules. For example, the preamble to the proposed ULR regulations explained:

> The most problematic aspect of tracing, however, has typically been establishing the connection, or lack thereof, between items taken into account by the group and particular amounts of tainted appreciation. . . . If tainted appreciation is recognized as income earned through the wasting or consumption of the appreciation, instead of as gain on the disposition of the asset, there are additional difficulties. In those cases, tracing is possible only if the tainted appreciation generates an identifiable stream of income. However, this is frequently not the case. For example, intangible assets, like patents or goodwill, are the source of significant tainted appreciation and they typically do not generate identifiable income streams.[216]

The same problems would exist if a tracing regime applied in measuring RBIG attributable to wasting assets for section 382(h) purposes. Alternatives to tracing are therefore necessary in measuring RBIG for wasting assets.

Tax depreciation and amortization rules are the logical proxies to apply here. As discussed above, the original purpose of tax depreciation generally was to allocate the cost of a wasting asset to the periods to which the asset contributes,[217] and the Supreme Court has recognized that the matching of revenue and related expenses, in turn, generally produces a more accurate calculation of the taxpayer's net income.[218] Moreover, the various depreciation rules in the code give the government a menu of options for adopting appropriate depreciation rules for measuring RBIG. Finally, no obvious alternative to depreciation exists that is more accurate in estimating income on an annual basis and is equally administrable.[219]

2. Goodwill is a wasting asset for this purpose.

Although the preamble to the proposed regulations focused on accelerated depreciation of tangible assets in discussing the government's concern that the section 338 approach in Notice 2003-65 overstates RBIG, the issue is equally relevant in the intangible asset context. In fact, although tangible asset depreciation is important to the modeling used by loss corporations applying the section 338 approach to measure RBIG following an ownership change, section 197 amortization (particularly for goodwill) often is an even more important part of this analysis. However, some may dispute goodwill's treatment as a wasting asset for income tax purposes and may note that goodwill is no longer amortized for financial accounting purposes but rather is subject to regular testing for impairment.[220] Assuming the government adopts consumption theory under section 382(h)(6), it is imperative that it incorporate section 197 principles and include

[215] Preamble to REG-157711-02, 72 F.R. at 2970 (stating that section 382(h) is "generally concerned only with the unrecognized appreciation and depreciation in a pool of assets held by a corporation on a single date — the date . . . a corporation has an ownership change").

[216] *Id.*; *see* preamble to T.D. 8294, 55 F.R. at 9428 ("Accordingly, if the subsidiary, rather than selling a built-in gain asset, uses it in its business, the wearing out or obsolescence of the asset must be matched with the earnings generated by its use. In practice, to restrict basis adjustments to those derived from the subsidiary's earnings that are not related to the effective disposition of built-in gain assets, it would be necessary to appraise the subsidiary's assets, mark their bases to market . . ., and depreciate those bases over the assets' remaining economic life.").

[217] *Massey Motors*, 364 U.S. at 104.

[218] *Newark Morning Ledger*, 507 U.S. at 565.

[219] Regarding accuracy, there is precedent in the tax law for accepting less exact estimates of income from assets. *See* section 951A(b)(2)(A) (attributing a 10 percent return to certain qualified business assets).

[220] NYSBA 2019 report, *supra* note 60, at 34-35.

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income attributable to the consumption of intangible assets.

Section 167, by its terms, is not limited to tangible assets. For certain intangible assets such as patents and copyrights, taxpayers may be able to substantiate a limited useful life and claim depreciation under section 167.[221] The regulations, however, caution that this is no easy task, stating: "No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life."[222]

For nearly a century, the IRS has treated goodwill as nondepreciable under section 167 and its predecessors.[223] Indeed, in *Newark Morning Ledger*, the Supreme Court said that "this proposition is so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is 'goodwill.'"[224]

In 1993 Congress enacted section 197 to resolve disputes regarding the qualification of intangible assets for tax expensing. The legislative history is extremely informative. Congress noted the belief 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."[225] Significantly, Congress expressly acknowledged that "the useful lives of certain acquired intangible assets to which the bill applies may be shorter than [15] years, while the useful lives of other acquired intangible assets to which the bill applies may be longer than [15] years."[226] Not surprisingly, courts are unequivocal that section 197 intangibles must be amortized under section 197 despite the existence of a shorter useful life.[227]

The Supreme Court has said: "We must respect the compromise embodied in the words chosen by Congress."[228] Section 197 is a quintessential compromise in that Congress established a uniform amortization period for all covered intangibles. It is critical that consumption theory apply equally to goodwill and other section 197 intangibles. Otherwise, taxpayers, the IRS, and the courts inevitably will find themselves in the same position they were in before section 197's enactment — that is, in costly, time-consuming disputes over whether particular intangible assets are severable from goodwill. As Yogi Berra would say, this would be like "déjà vu all over again."[229]

The prudent course is to respect the policy choices Congress made in enacting section 197 30 years ago. Section 197 deems goodwill to be a wasting asset for income tax purposes. Accordingly, regulations under section 382(h)(6) should adopt consumption theory for tangible assets as well as for goodwill and other section 197 intangibles.

3. Concerns regarding accelerated depreciation.

Before the Economic Recovery Tax Act of 1981 (ERTA),[230] section 167 governed the depreciation of tangible property and permitted depreciation only if the taxpayer established the useful life of the property.[231] The useful life, in turn, was the

[221] Reg. section 1.167(a)-3(a).

[222] *Id.*

[223] *Id.*; *see* T.D. 4055, VI-2 C.B. 63 (1927). Justice David H. Souter pointed out in his dissenting opinion in *Newark Morning Ledger* that some courts viewed goodwill as having an indefinite useful life, while others concluded that goodwill wastes but lacks a useful life determinable with reasonable accuracy. *Newark Morning Ledger*, 507 U.S. at 577 n.5 (Souter, J., dissenting); *cf., e.g., Red Wing Malting Co. v. Willcuts*, 15 F.2d 626, 633 (8th Cir. 1926) (goodwill is not depreciable because it "does not suffer wear and tear, does not become obsolescent, [and] is not used up in the operation of the business") *with, e.g., Dodge Brothers Inc. v. United States*, 118 F.2d 95, 100 (4th Cir. 1941) (goodwill is not depreciable because of "manifest difficulties" inherent in estimating its life span).

[224] *Newark Morning Ledger*, 507 U.S. at 554-555 (internal quotations omitted).

[225] H.R. Rep. No. 103-111, at 760 (1993).

[226] *Id.* at 777. Although the legislative history contemplated a 14-year amortization period, Congress later modified the bill to reflect a 15-year amortization period. In any case, revenue neutrality considerations, rather than empirical economic analysis, apparently determined the length of the amortization period. *See* JCT, "Technical Explanation of the Tax Simplification Act of 1993," JCS-1-93, at 147 (Jan. 8, 1993).

[227] *See Recovery Group Inc. v. Commissioner*, 652 F.3d 122, 125 (1st Cir. 2011); *Frontier Chevrolet Co. v. Commissioner*, 329 F.3d 1131, 1135 (9th Cir. 2003).

[228] *Mohasco Corp. v. Silver*, 447 U.S. 807, 826 (1980).

[229] Berra, *The Yogi Book* 9 (1998).

[230] ERTA section 201, P.L. 97-34.

[231] Reg. section 1.167(a)-1(a) and (b).

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period over which the asset could reasonably be expected to be useful to the taxpayer in its trade or business or in the production of income.[232] The asset depreciation range (ADR) system was the primary method employed to determine the useful life of assets. The ADR grouped assets into broad classes of industry assets, with each class assigned a guideline life, and it extended from 20 percent below to 20 percent above the guideline class life.[233]

Congress made the policy determination that the rules for calculating depreciation were too complicated and failed to generate the investment incentive critical for economic expansion.[234] It therefore concluded that a different capital cost recovery system was necessary. In enacting ERTA, Congress minimized the relevance of useful life by basing depreciation on an arbitrary statutory period of years unrelated to (and shorter than) an asset's estimated useful life.[235] This responded, in part, to economic policy concerns that prior law discouraged investment in income-producing assets by allocating depreciation over an excessive period of time.[236]

The decision to modify the depreciation rules was appropriately one for Congress to make. However, it must be acknowledged that the adoption of accelerated depreciation in ERTA delinked the depreciation rules from their more modest origins. In describing the original foundations of depreciation tax law, the Supreme Court observed that "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss."[237] Similarly, the Second Circuit explained that, "in its traditional incarnation, . . . the pace of depreciation deductions was determined by the period of time that the asset would produce income in the taxpayer's business."[238]

[232] *Fribourg Navigation Co. v. Commissioner*, 383 U.S 272, 277 (1966).

[233] Reg. section 1.167(a)-11; Rev. Proc. 83-35, 1983-1 C.B. 745, *superseded by* Rev. Proc. 87-56, 1987-2 C.B. 674.

[234] S. Rep. No. 97-144, at 47 (1981).

[235] *Simon v. Commissioner*, 103 T.C. 247 (1994), *aff'd*, 68 F.3d 41 (2d Cir. 1995).

[236] S. Rep. No. 97-144, at 47 (1981).

[237] *Massey Motors*, 364 U.S. at 101.

[238] *Simon*, 68 F.3d at 44.

As noted earlier, shortly after Congress enacted the TCJA, the IRS determined that it was inappropriate for a loss corporation to use immediate expensing to calculate RBIG under the section 338 approach. In Notice 2018-30, the IRS excluded section 168(k) in calculating deemed depreciation deductions under the section 338 approach. The IRS's measured response in Notice 2018-30 points the way toward a solution here as well. Rather than jettison the forgone amortization construct in the section 338 approach, to the extent the government has concerns, it should recalibrate how loss corporations calculate the deemed depreciation deductions attributable to tangible property in measuring RBIG. As discussed below, moreover, section 312(k) principles would be an ideal source for any such recalibration.

When a corporation distributes cash or other property to a shareholder, section 301(c) treats the distribution as a dividend to the extent of the corporation's E&P, with any portion of the distribution that is not treated as a dividend applied against the adjusted basis of the stock and any remainder treated as gain from the sale or exchange of property. Before Congress enacted the predecessor of section 312(k), taxpayers computed E&P using the same depreciation method they applied in calculating taxable income. Consequently, a corporation using an accelerated cost recovery method reduced its E&P by a greater amount than the corporation would have using straight-line depreciation. Congress found that the reduction to E&P attributable to accelerated cost recovery inappropriately allowed shareholders of real estate companies, public utilities, and other corporations in capital-intensive industries to treat distributions as a return of capital or capital gain (instead of as dividends).[239]

More specifically, Congress concluded that using accelerated cost recovery in calculating E&P represented "an improper tax benefit to shareholders which is generally unrelated to the purposes for which accelerated depreciation deductions are made available to corporations."[240]

[239] H.R. Rep. No. 91-413, at 134 (1969).

[240] *Id.*

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Enacted in 1969 with a delayed effective date to July 1, 1972, to avoid significant disruptions to the stock price of affected companies, section 312(k) requires a corporation using accelerated cost recovery to adjust taxable income upward for E&P purposes to account for the difference between the corporation's accelerated cost recovery method and the straight-line method.[241]

Section 312(k) serves as a viable option for addressing any concerns the government may have about using accelerated depreciation to measure RBIG attributable to a loss corporation's tangible assets.[242] Just like Congress concluded that section 312(k) was necessary to limit tax-free distributions in capital-intensive industries by recalibrating the depreciation taken into account in calculating E&P, the government may conclude that the adoption of section 312(k) principles would curtail any perceived overstatements in the calculation of RBIG under section 382(h) because of the use of accelerated depreciation. That approach would represent a far more targeted response than abolishing forgone amortization outright.

D. Section 384 Lurking

1. Introduction.

Following an acquisition of one corporation by another, in which either corporation has built-in gains at the time of the acquisition, section 384 generally limits the ability of each corporation with built-in gains to use pre-acquisition losses of the other corporation to offset its own built-in gains.[243] Specifically, section 384 applies, when its other requirements are satisfied, to (1) acquisitions of the direct or indirect control of a target corporation, within the meaning of section 1504(a)(2), by another corporation; and (2) acquisitions of the assets of a target corporation by another corporation in a section 368(a)(1)(A), (C), or (D) reorganization.[244]

Section 384 imports the same five-year recognition period, based on tax years, used in section 382.[245] Although section 382 normally applies to a profitable corporation's acquisition of a loss corporation, section 384 most often applies to the acquisition by a loss corporation of a corporation with built-in gains.[246] Nonetheless, because section 384 applies to either corporation involved in a covered acquisition, it can also apply in addition to section 382 when a corporation with built-in gains acquires a loss corporation and then recognizes built-in gain after the acquisition. Thus, section 384 could prevent the loss corporation's NOLs from offsetting the built-in gain even if this would otherwise be permissible under section 382 and the consolidated return rules.

In short, sections 382 and 384 are complementary and normally apply in opposite scenarios.[247] Therefore, tax-favorable transactions from a section 382 standpoint may be unfavorable for section 384 purposes (and vice versa).

Although section 384 imports many definitions and principles from section 382, it has received much less attention from Congress and Treasury. The statute has not been substantively updated since 1988, and, though several portions of section 384 refer to the issuance of regulations, no regulations have ever been issued. Section 384 is also the subject of only limited guidance, a significant contrast from section 382. This discrepancy in attention, in turn, has produced various actual or potential discrepancies between

[241] Section 312(k)(1).

[242] In measuring depreciation or amortization during the recognition period, this construct would assume that the loss corporation first places its assets in service on the change date. *See* ABA report, *supra* note 60, at 54 n.83 (a uniform approach would address concerns about assets previously subject to depreciation/amortization that have minimal tax life, if any, remaining at the time of the ownership change).

[243] Section 384(a) and (c)(8), and section 382(h)(7).

[244] Section 384(a)(1). Acquisitions between commonly controlled entities are excluded. Section 384(b). References to a particular corporation in section 384 include its predecessors and successors, and thus the restrictions of section 384 continue to apply even when the assets and losses of a target corporation are acquired by another in a reorganization. Section 384(c)(7).

[245] Section 384(c)(8) and (h)(7).

[246] The legislative history of section 384 focuses exclusively on acquisitions of gain corporations by loss corporations. *See* H.R. Rep. No. 100-495, at 973-974 (1987) (Conf. Rep.); H.R. Rep. No. 100-391, at 1093-1094 (1987).

[247] *See, e.g.*, Gordon D. Henderson and Goldring, *Tax Planning for Troubled Corporations*, section 708 (2022) ("Code section 384 is in many ways the reverse of Code section 382"); Deanna Walton Harris and Mark R. Hoffenberg, "Code Sections Interact: Is Section 382's Treasure Section 384's Trash?" *Corp. Tax'n* 17, 21 (Mar./Apr. 2009) ("Section 384 is essentially Section 382 reversed.").

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the treatment of particular issues under section 384 and section 382.[248]

Section 384 applies only to the extent that either corporation involved in the acquisition is a gain corporation, which is defined as a corporation with a NUBIG (importing the same definition used in section 382) on the acquisition date.[249] Further, section 384 limits only "preacquisition losses," a term that includes NOL carryforwards to the year of the acquisition, NOLs for the acquisition year to the extent allocable to the period in that year before the acquisition date,[250] and RBIL of any corporation with NUBIL (again, importing both terms from section 382), as well as equivalent amounts for excess credits and net capital losses.[251]

Finally, section 384 prevents pre-acquisition losses from offsetting income only to the extent that the income is attributable to "recognized built-in gains," a term that is separately defined for section 384 purposes (section 384 RBIG) and is capped at the amount of NUBIG in the relevant corporation's assets on the acquisition date.[252] Section 384 RBIG includes all gain recognized during the recognition period by the gain corporation (or the acquirer if the gain corporation is acquired in a reorganization) except to the extent that the taxpayer can demonstrate that the gain came from a new asset or non-built-in gain.[253] This is the reverse of section 382, which treats each recognized loss as RBIL except to the extent the taxpayer proves otherwise, and the burden is on the taxpayer to demonstrate that a recognized gain is, in fact, RBIG.[254]

The following examples illustrate section 384's application.

Example 9. Parent (P) holds no assets except the stock of two subsidiaries: Sub1, whose stock has an FMV and a basis of $100; and Sub2, whose stock has an FMV and a basis of $100. Sub1 holds a single asset (Asset1) with an FMV and a basis of $100, while Sub2 holds a single asset (Asset2) with an FMV and a basis of $100. All three corporations file a consolidated return. The P group has a $20 NOL carryforward. On January 1, P acquires all the stock of a target corporation (Sub3) that holds a single ordinary income asset (Asset3) with an FMV of $40 and a basis of $20 (that is, Sub3 is a gain corporation and section 384 applies). In the same year, Sub1 recognizes a $20 ordinary loss, Sub2 recognizes $20 of ordinary operating income, and Sub3 disposes of Asset3 and recognizes $20 of ordinary gain. Sub1's post-acquisition loss should be allocated ratably between Sub2's and Sub3's ordinary income, leaving $10 of Sub2 income that could be offset by the P group NOL carryforward, and $10 of Sub3 ordinary gain that would represent section 384 RBIG and thus could not be offset by the NOL carryforward.

Example 10. The facts are the same as Example 9, except that Sub1 recognizes $20 of ordinary operating income, Sub2 does not recognize any income or loss, and Sub3 recognizes a $20 operating loss before disposing of Asset3 and recognizing a $20 ordinary gain. Sub3's income should be computed on a separate basis before combining it with the results of other group members. Sub3's ordinary gain and loss fully offset, and all $20 of Sub1's ordinary operating income can be offset by the group's NOL carryforward. Under reg. section 1.1502-11(a), consolidated group taxable income is calculated first by combining the separate taxable income of each group member, and then by making adjustments for various items, including consolidated capital gain net income. Therefore, if Sub3's gain from the sale of Asset3 had been

[248] For instance, section 382(d)(3) includes section 163(j) carryforwards as pre-change losses in appropriate circumstances. To avoid double counting, the proposed regulations would exclude these carryforwards from the definition of RBIL (because RBIL is also treated as a pre-change loss under section 382). Preamble to REG-125710-18, 84 F.R. at 47461. By contrast, section 384 does not specify the treatment of section 163(j) carryforwards, and it imports the definition of RBIL from section 382. Section 384(c)(8). Accordingly, under the proposed regulations, section 163(j) carryforwards arguably would be wholly excluded from treatment as section 384 pre-acquisition losses.

[249] Section 384(c)(8).

[250] Except as provided in regulations, these NOLs are deemed to arise ratably over each day in the year in which the acquisition occurs. Section 384(c)(3)(A). No regulations have been issued under section 384.

[251] Section 384(c)(3) and (d). If there are both pre-acquisition losses subject to limitation under section 384 and other losses for a particular tax year, an ordering rule applies section 384 pre-acquisition losses first to taxable income for that year. Section 384(e)(2).

[252] Section 384(c)(1)(C).

[253] Section 384(c)(1). Section 384 does not preclude a corporation's preacquisition loss from offsetting RBIGs of that same corporation. Section 384(a)(1).

[254] Section 384(h)(2).

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capital gain, the separate taxable income of each group member would have been combined first, causing the $20 loss and income of Sub2 and Sub1 to offset. The P group would have been left with a $20 NOL carryforward, which could not have offset any of Sub3's section 384 RBIG.

Example 11. Corp1 holds a single asset (Asset1) with an FMV of $100 and a basis of $50. In a section 368(a)(1)(A) reorganization, Corp1 merges into Corp2, which holds a single asset (Asset2) that also has an FMV of $100 and a basis of $50, and Corp2 becomes the successor to Corp1. This acquisition is subject to section 384 because it is a covered acquisition, and both Corp1 and Corp2 are gain corporations. If Corp1 has an NOL carryforward in the year of acquisition that carries over to Corp2, this would be a pre-acquisition loss. If Corp2 disposes of each of Asset1 and Asset2 during the recognition period at a gain, Corp1's pre-acquisition losses could be used to offset gain from the sale of Asset1 but not offset section 384 RBIG upon the sale of Asset2.

Example 12. Corp1 holds a single asset (Asset1) with an FMV of $100 and a basis of $50. Corp1 acquires all the stock of Corp2, which has an NOL carryforward of $20 and holds a single asset (Asset2) that has an FMV and a basis of $100. Corp1 is a gain corporation for section 384 purposes, and Corp2 is a loss corporation for section 382 purposes. Both section 384 and section 382 apply. Assume the section 382 limitation for Corp2's NOL carryforward is sufficiently high that it would not preclude utilization of Corp2's NOLs. Section 384 would nevertheless prevent the use of Corp2's NOL carryforward, which would be a pre-acquisition loss, to offset section 384 RBIG following a sale by Corp1 of Asset1 during the recognition period.

2. Section 384 in consolidation.

Section 384(c)(6) treats all corporations that are members of a single affiliated group immediately before the acquisition date as a single corporation. However, the statute does not elaborate on how to apply section 384 to consolidated groups and does not yet have accompanying regulations to expand on this point as does section 382. One particular item of guidance is often cited in determining how to apply section 384 in consolidated group scenarios.

TAM 200447037 considers several issues concerning the application of section 384 to the acquisition by one consolidated group with NOLs (the acquirer group) of all the stock of a target corporation that was the parent of its own profitable consolidated group (the target group). The technical advice memorandum assumes that the target group qualified as a gain corporation on a consolidated basis for section 384 purposes. At closing, the target group held assets with built-in gain and had a capital loss carryforward sufficient to offset that built-in gain. The target group recognized section 384 RBIG later in the tax year in which the acquisition occurred. For undisclosed reasons, the target group's capital loss carryforward was later determined to be unavailable, raising the question of how much of the historic acquirer group's NOLs were available to offset the section 384 RBIG.

The taxpayer argued that in determining the pre- and post-acquisition allocation of losses, the historic acquirer group's income and losses for the acquisition year should be computed separately from the historic target group's income and losses for the year, in which case the target group's income for the year would not reduce the acquirer group's losses for that year that could be allocated between the pre-acquisition and post-acquisition portions of the year. Further, under the separate group approach, the taxpayer argued that an ordering rule should apply in the acquisition year to allow (1) pre-acquisition losses to offset non-section 384 RBIG to the maximum extent possible, and (2) then post-acquisition losses to offset section 384 RBIG (which, of course, cannot be offset by pre-acquisition losses) to the maximum extent possible. This rule would have allowed a relatively large reduction in section 384 RBIG in the year of acquisition.

However, after a lengthy analysis of the legislative history, structure, and principles of section 384, TAM 200447037 ultimately concluded that the relevant section 384 calculations should be made using the combined results of the historic

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target group and the historic acquirer group, which the memo calls the "combined group approach."[255] The IRS explained that the income or loss for the acquisition year that is properly available for allocation is the consolidated income for the year, which includes the historic target group's income (other than its section 384 RBIG) for the portion of the year that the target group is in the acquirer group.

The memo's combined group approach avoided the need for any ordering rule. The combined group's income for the year of acquisition would simply be calculated (excluding section 384 RBIG), and the resulting loss allocated between pre- and post-acquisition periods. Accordingly, although the historic acquirer group had an actual post-acquisition loss (as measured on a stand-alone basis), none of it was available for allocation to reduce the historic target group's section 384 RBIG. Because combining the tax results of a target group and an acquirer group, on balance, will tend to produce fewer losses, the memo's combined group approach generally should minimize the amount of acquisition year loss that is treated as post-acquisition loss available to offset section 384 RBIG.

3. Section 384 and forgone amortization.

Items of income properly taken into account in the recognition period but attributable to periods before the acquisition date are included in determining section 384 RBIG.[256] Although there is no authority directly on point, given the parallelism of sections 382 and 384, it seems difficult to argue as a policy matter that a forgone amortization concept should not apply to section 384 if regulations incorporate the concept into section 382. That is, if forgone amortization is an income item attributable to periods before the change date described in section 382(h)(6)(A), it is difficult to see why forgone amortization is not also an income item attributable to periods before the acquisition date described in section 384(c)(1)(B). Indeed, mandating or permitting forgone amortization solely for section 382 purposes arguably would provide taxpayers a windfall since the introduction of a forgone amortization approach to increase the amount of section 384 RBIG would adversely affect taxpayers. Therefore, the government might conclude that taxpayers must take the bitter with the sweet.[257]

Despite the similarity between sections 382 and 384, there are some obvious issues to confront before applying a forgone amortization concept under section 384. A forgone amortization approach under section 382 merely increases the amount of the loss corporation's NOL carryforward that is utilizable during the recognition period to offset income generated from other sources. Accordingly, it is irrelevant whether the loss corporation has actual income itself. Section 384, on the other hand, prohibits the use of a corporation's losses to offset another corporation's actual, recognized income. These differences, in turn, can lead to unusual results.[258]

If section 384 applies in addition to section 382, and taxpayers must apply forgone amortization, the former can end up overriding the latter. Consider the following example.

Example 13. Corp1 owns a section 197 intangible asset with an FMV of $225 and a $0 basis and other assets with a value in each case equal to basis. Corp1 acquires all the stock of Corp2, which has a single asset with a value equal to its basis and an NOL carryforward. Corp1 is a gain corporation for section 384 purposes, and Corp2 is a loss corporation for section 382 purposes. Both section 384 and section 382 apply. Assume Corp2's section 382 annual limitation is $10, and Corp1 has $10 of income in the year

[255] For the calculation of pre-acquisition loss, the combined group approach resulted in the target group's income offsetting part of the acquirer group's loss, and only the remaining reduced amount of loss was eligible for allocation between pre- and post-acquisition periods. Moreover, in conducting this allocation, the taxpayer tried to use a closing-of-the-books method, which the government has permitted in private letter rulings because of the availability of a regulatory election to use that method in the section 382 regulations, but the memo denied the request as untimely.

[256] Section 384(c)(1)(B).

[257] As noted earlier in this report, Notice 2003-65 requested comments on the extent to which section 384 regulations identifying built-in items should differ from those under section 382. Notice 2003-65, Section VII. In the interim, the extent, if any, to which taxpayers must conform the approaches used for section 384 and section 382 purposes is unclear. Moreover, even assuming conformity is required, exactly what that means is subject to debate. For instance, some might argue that conformity applies solely with respect to the corporation that experienced a section 382 ownership change (typically, the target corporation), while others might contend that it applies to the acquirer as well.

[258] *See* Harris and Hoffenberg, *supra* note 247, at 23.

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following the acquisition. If forgone amortization were applicable for section 384 purposes, it would tend to indicate that all $10 of Corp1's income is section 384 RBIG that cannot be offset by Corp2's NOL carryforward.

Although there is a statutory determination to allow the use of $10 of Corp2's NOL carryforwards under section 382, section 384 overrides this determination by tainting all the income that Corp2's NOL carryforward would otherwise offset. In addition, as Example 13 demonstrates, a situation in which an acquirer's income is wholly tainted will be especially likely to arise when the acquirer has a substantial amount of self-created goodwill (and therefore section 384 RBIG) under a forgone amortization approach. In that scenario, the section 384 RBIG that would result from the use of forgone amortization with respect to the acquirer may significantly limit the benefit otherwise available under section 382 from the use of forgone amortization with respect to the loss corporation. Although other statutory provisions such as section 269 can intersect with section 382, it is still striking how sections 382 and 384 could conceivably work at such cross-purposes.

The difficulties outlined above — the different purposes of section 382 and section 384 and the lack of prior guidance under section 384 — suggest caution before implementing a forgone amortization approach in measuring section 384 RBIG. Assuming the government adopts a forgone amortization approach under section 382(h), it would be best for the government to open a separate regulatory project and solicit comments before venturing into these waters under section 384.

VI. Conclusion

As discussed in detail, the proposed regulations would substantially revise significant aspects of the NUBIG/L computation and the RBIG rules in section 382(h). These changes are unnecessary, and the government's public declaration of an intent to issue a new set of proposed regulations on section 382(h) is a welcome sign. As this report demonstrates, it should be quite possible to address issues of legitimate governmental concern without adopting the wholesale revisions that the proposed regulations would make to this area of the law, which has existed in substantially unchanged form without any congressional objections since the release of Notice 2003-65 20 years ago. Finally, assuming the government ultimately adopts a forgone amortization construct for applying the RBIG rules under section 382(h), it would make sense for the government to consider a separate regulatory project to explore the application of a forgone amortization construct in measuring section 384 RBIG as well. ■

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