KPMG report: Proposed regulations on treatment of built-in items for section 382 (initial impressions)

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Introduction

The U.S. Treasury Department and IRS this week released proposed regulations (REG-125710-18) (the "Proposed Regulations") that address items of income and deduction that are included in the calculation of built-in gains and losses under section[1] 382(h).

If finalized, the Proposed Regulations [PDF 364 KB] (19 pages) would significantly change the landscape of current law in ways that have almost universally adverse implications for affected taxpayers.

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Background

Section 382 seeks to prevent loss trafficking[2] by imposing a limitation on the use of pre-change losses to offset post-change income after a loss corporation undergoes an ownership change.[3] In general, a section 382 limitation is equal to the value of the stock of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate in effect on the change date, with certain potentially significant adjustments.[4]

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[1] "Section" refers to sections of the Internal Revenue Code of 1986, as amended, and the term Treasury Regulations refers to the Treasury Regulations promulgated thereunder.

[2] Loss trafficking often involves an acquisition of "loss corporation" stock, followed by the contribution of income-producing assets to the loss corporation, for the purpose of using the losses to offset the income. A "loss corporation" generally is a corporation that (1) is entitled to use a net operating loss carryforward, a capital loss carryover, a carryover of excess foreign taxes, a carryforward of a general business credits, a carryover of a minimum tax credit, or a section 163(j) disallowed interest carryforward; (2) incurs such a loss or generates such a credit in a year in which it undergoes an ownership change; or (3) has a net unrealized built-in loss. Section 382 is only applicable to loss corporations. Section 382(k)(1) and Reg. section 1.382-2(a)(1)(i).

[3] Section 382(a). In general, an "ownership change" occurs under section 382 when, on a particular "testing date," the percentage stock ownership (by value) of one or more "5-percent shareholders" has increased by more than 50 percentage points over the lowest percentage stock ownership (by value) held by such shareholders at any time during a prescribed "testing period" (generally three years). Section 382(g).

[4] Section 382(b)(1).

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One such adjustment is contained in section 382(h). Section 382(h) provides rules for the treatment of built-in gain or loss recognized during the five-year period beginning on the change date (the "recognition period") with respect to assets owned by the loss corporation immediately before ownership change. Generally, if an old loss corporation has net unrealized built-in gain ("NUBIG") immediately before the ownership change, the section 382 limitation for any recognition period tax year is increased by the recognized built-in gain ("RBIG") for such tax year, up to the amount of the NUBIG (reduced by NUBIG absorbed in prior years).[5] If, on the other hand, an old loss corporation has net unrealized built-in loss ("NUBIL") immediately before the ownership change, any recognized built-in loss ("RBIL") for any recognition period tax year is treated as a pre-change loss for purposes of the section 382 limitation, up to the amount of the NUBIL (reduced by NUBIL absorbed in prior years).[6] These rules reflect a neutrality principle, which aims to treat built-in gains and losses of a loss corporation recognized during the recognition period in the same manner as if they had been recognized before the ownership change.

In 2003, the IRS issued Notice 2003-65 to provide interim guidance regarding the identification of built-in items for purposes of section 382(h). Notice 2003-65 provides two alternative approaches on which taxpayers can rely in making such determinations.

- The first approach generally adopts the methodology used under section 1374(d) and the Treasury Regulations sections promulgated thereunder, which apply accrual accounting concepts (the "1374 Approach").
- The second approach generally compares a loss corporation's actual items of income, gain, deduction, and loss against those that would have resulted had the loss corporation made a section 338 election with respect to a hypothetical sale of all its stock on the change date (the "338 Approach").

Generally, the 338 Approach provides taxpayer-favorable rules for taxpayers that are in a NUBIG position. Also generally, the 1374 Approach provides taxpayer-favorable rules for taxpayers that are in a NUBIL position.

Proposed regulations (REG-125710-18)

The Proposed Regulations would require taxpayers to apply a modified version of the 1374 Approach, but would eliminate a number of taxpayer-favorable provisions set forth in Notice 2003-65, including the entire 338 Approach and many of the favorable components of the 1374 Approach. One way to think of the method prescribed by the Proposed Regulations is as a combination of the least taxpayer-favorable provisions of each of the two Notice 2003-65 approaches. As discussed in greater detail below, the Proposed Regulations treat as RBIL many built-in loss or deduction items that would not have been taken into account as RBILs under the 1374 Approach but which might have been taken into account under the 338 Approach, while adhering to a fairly strict accrual method with respect to built-in gain items.

The Proposed Regulations would apply to any ownership change occurring after date of publication of the Treasury Decision adopting the Proposed Regulations as final in the Federal Register. However, taxpayers may choose to apply the Proposed Regulations to ownership changes occurring in a year which respect to which section 6511(a) has not expired, so long as the rules are applied consistently to such ownership change and all subsequent ownership changes before the applicability of the final

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[5] Section 382(h)(1)(A).

[6] Section 382(h)(1)(B). If a loss corporation's NUBIG or NUBIL does not exceed a threshold amount (the lesser of $10 million or 15% of the fair market value of certain assets immediately before the ownership change), the loss corporation's NUBIG or NUBIL will be zero. Section 382(h)(3)(B).

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regulations. Outlined below are some of the ways in which the Proposed Regulations differ from current law.

KPMG observation

Given the likelihood of substantial pushback from taxpayers, it is to be anticipated that finalization will take some time following the 60-day notice period. Government representatives have informally emphasized that the package is "just a proposal" and they are amenable to comments.

Wasting assets

One notable feature of the 338 Approach is that it allows built-in gain assets for which depreciation, amortization, or depletion deductions can be taken ("wasting assets") to generate RBIG without a realization event.

Specifically, the 338 Approach treats as RBIG the excess of:

- The cost recovery deduction that would have been allowable with respect to a built-in gain asset had an election under section 338 been made for the hypothetical purchase of that asset (disregarding bonus depreciation under section 168(k), per Notice 2018-30) over
- The loss corporation's actual allowable cost recovery deduction for the asset.

The deduction allowable had a section 338 election been made is determined based on the fair market value of the asset on the change date and a cost recovery period that begins on the change date. The logic of this rule is that such built-in gain assets would generate income in subsequent years; in the absence of an acquisition, such income could have been offset freely by the old loss corporation's net operating losses ("NOLs").

This feature would no longer apply under the Proposed Regulations. The preamble to the Proposed Regulations indicates that the IRS and Treasury determined that the treatment of wasting assets under the 338 Approach is problematic for two reasons. First, the IRS and Treasury noted that the schedules for cost recovery deductions were never intended to match the production of income from each asset; rather, they were intended to accelerate cost recovery to stimulate investment. Thus, this proxy is likely to, on average, overstate income created by those assets, further increasing NOL usage beyond the neutral baseline. Second, the IRS and Treasury argued that the value of a built-in gain asset already is reflected in the equity value of the company, which is used to determine the base section 382 limitation. Consequently, treating foregone amortization as RBIG would constitute a "double benefit" that could incentivize uneconomic acquisitions.

KPMG observation

Treasury's substantive argument appears to overlook the fact that a "wasting" asset economically must be expected to generate more income than a "non-wasting" asset to justify the same value. For example, if a non-wasting asset worth $100 generates a $5 annual return, an asset that wastes to zero over a five-year period would have to be expected to generate approximately $25 a year to warrant that same $100 valuation. Such additional income is the economic equivalent of the

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recognition of built-in gain. Failure to capture that gain in the section 382 rules arguably violates the neutrality principle by deterring economic transactions. In terms of the procedural argument, tax professionals acknowledge that the 338 Approach's method for estimating the income generated by the wasting of a wasting asset may have been over-inclusive because it was based on cost-recovery schedules that did not tie directly to the actual economic wasting of the asset. However, that infirmity could have been addressed without eliminating the concept of wasting assets entirely. Treasury could have instead required taxpayers to prove out the actual income produced by the asset that, if the asset had not been in a built-in gain position, would have been offset by basis recovery.[7]

KPMG observation

The new bonus depreciation rules already incentivize many loss corporations anticipating an ownership change to engage in an asset transaction rather than a stock transaction, often incurring additional transaction costs. Tax professionals anticipate that eliminating the wasting assets benefit will increase that trend. They also note, however, that engaging in an asset transaction may be easier in certain industries than others. Loss corporations that have significant intangible assets (e.g., technology companies or service industry companies) may be particularly disadvantaged by the elimination of this rule.

Modification to treatment of deferred deductions

The 1374 Method under Notice 2003-65 is very restrictive. It includes built-in deduction items as RBIL only if they would already have been deducted by an accrual-method taxpayer before the change date, generally modified only to account for amounts for which the economic performance rule is deferring the deduction. In other words, with certain limited exceptions, if anything other than the economic performance requirement would cause the item not to be deductible, that item does not give rise to RBIL under Notice 2003-65.

Under the Proposed Regulations, however, deductions are treated as RBIL (and therefore affect the NUBIG/NUBIL calculation) even if they are deferred as a result of a taxable income or timing limitation.

KPMG observation

This change is a significant shift from the approach in Notice 2003-65, which will cause many more items to be treated as RBIL.

Modification to treatment of contingent liabilities

Under Notice 2003-65, the estimated value of contingent deductible liabilities (as of the change date) was subtracted as part of the NUBIG/NUBIL calculation. However, the ultimate payment of such liabilities did

[7] Note that the legislative history to section 384 expressly recognizes that income associated with assets that have been prematurely depreciated is the equivalent of built-in gain. H.R. REP. NO. 100-495 (1987).

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not give rise to RBIL. The preamble to the Proposed Regulations notes that this asymmetry violates the principle of neutrality between pre-change and post-change deductions. Therefore, the Proposed Regulations treat payments on a contingent liability as RBIL to the extent of the estimated value of the contingent liability as of the change date.

KPMG observation

The asymmetry under Notice 2003-65 could have been resolved as easily—more easily, because it would have eliminated the need to value contingent liabilities on the change date—by removing contingent liabilities from the NUBIG/NUBIL calculation. Including contingent liabilities as RBIL is fundamentally inconsistent with the accrual method.

KPMG observation

Treating contingent liabilities as RBIL (and as a subtraction from the NUBIG/NUBIL calculation) can lead to incongruous results when a taxpayer has contingent liabilities that are also associated with anticipated income items. If the associated income item does not meet strict accrual standards, it is not taken into account, which leads to distortive results. For example, an insurance company will often have contingent deductible liabilities associated with potential claims, but if such claims were to mature, it would also have related taxable income as a result of the release of reserves. The Proposed Regulations appear to take into account the contingent deductible liabilities but not the associated income, which could cause significant distortion.

While some distortions may have existed in Notice 2003-65 as well, under current law, taxpayers facing such aberrational results can choose to follow the statutory language instead of the safe harbor in the notice. That option will no longer be available if the Proposed Regulations are finalized.

Modification to treatment of bad debt deductions

The 1374 Approach under Notice 2003-65 treated as RBILs only those bad debt deductions taken in the first 12 months of the recognition period. This mirrored the approach to cancellation of debt income ("COD"), which could give rise to RBIG only if recognized in that period. Under the Proposed Regulations, bad debt deductions, to the extent attributed to built-in loss on the change date, are treated as RBILs if recognized at any time during the recognition period.

KPMG observation

Expanding the period for bad debt deductions will capture RBILs that would not have been caught under Notice 2003-65. The rule is incongruous with the proposed treatment of COD (discussed below) which can only give rise to a benefit if recognized in the first 12 months of the recognition period.

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KPMG observation

Because there is no longer an automatic presumption of RBIL, taxpayers may be able to establish that bad debt deductions, even in the first year, were not actually built in on the change date. For example, taxpayers such as banks that regularly reserve and deduct a portion of their debt portfolios each year may now be able to avoid RBIL treatment on a portion of their post-change bad debt deductions. Posit a taxpayer that has a 10% reserve against a particular portfolio of debt because each debt has a 90% likelihood of being paid in full and a 10% likelihood of becoming wholly worthless. When an instrument in the portfolio becomes worthless in the recognition period, can the taxpayer treat only 10% of the resulting bad debt deduction as built-in loss?

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Built-in COD

Under Notice 2003-65, NUBIG or NUBIL is determined by calculating the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change. Notice 2003-65 provides that NUBIG or NUBIL is calculated by determining the amount that would be realized "if immediately before the ownership change the loss corporation had sold all of its assets, including goodwill, at fair market value to a third party *that assumed all of its liabilities*…."[8] If the hypothetical third party assumes all of the liabilities of the loss corporation, the amount realized cannot be less than the adjusted issue price of the loss corporation's outstanding liabilities.[9] Therefore, the NUBIG/NUBIL calculation set forth in Notice 2003-65 will, in practice, reflect built-in COD of an insolvent loss corporation. The IRS acknowledged this result in at least one private letter ruling.[10]

If, for example, a loss corporation has assets valued at $100, with an aggregate adjusted basis of $100, and outstanding recourse debt of $200, the amount realized in a hypothetical sale would be $200 (the amount of the outstanding liabilities), and the loss corporation would have a $100 NUBIG. If, on the other hand, NUBIG/NUBIL was calculated by reference to the fair market value of the assets without a deemed assumption of liabilities, the loss corporation would have zero NUBIL/NUBIG. The additional $100 gain that results from the inclusion of the liabilities of an insolvent loss corporation represents built-in COD.

KPMG observation

The inclusion of built-in COD into the NUBIL/NUBIG calculation often is proper from a policy

[8] (Emphasis added). Under Notice 2003-65, the gross amount realized on such sale is then (i) decreased by the sum of (A) any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale and (B) the loss corporation's aggregate adjusted basis in all of its assets; (ii) increased or decreased by the corporation's section 481 adjustments that would be taken into account on a hypothetical sale; and (iii) increased by any RBIL that would not be allowed as a deduction under sections 382, 383 or 384 on the hypothetical sale. To the extent the amount realized under such calculation is positive, such amount is the loss corporation's NUBIG; to the extent it is negative, such amount is the loss corporation's NUBIL.

[9] See, e.g., *Comm'r v. Tufts*, 461 U.S. 300 (1983) (amount realized on the sale of underwater property for a nominal sum plus the buyer's agreement to take the property subject to a mortgage was equal to the amount of the mortgage liability assumed by the buyer).

[10] See, PLR 201051019 (Sept. 14, 2010) (including in the NUBIG/NUBIL calculation liabilities that were discharged on the change date).

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perspective because in many circumstances a loss corporation will recognize RBIG post-change that is attributable to COD that was built in pre-change (e.g., when COD is included in gross income or when COD excluded from gross income under section 108 results in a reduction in basis in assets that are later sold at an increased gain). Under the principles of section 382(h), such amounts should not be subject to the section 382 limitation. Therefore, it is appropriate to include such amounts as NUBIG. However, there are circumstances in which the policy argument is less persuasive, e.g., when a loss corporation applies section 108 to reduce pre-change NOLs, rather than basis in assets.

The Proposed Regulations would modify the treatment of built-in COD. First, the Proposed Regulations modify the calculation of NUBIG/NUBIL. The Proposed Regulations generally provide that a loss corporation's NUBIG, if positive, or NUBIL, if negative, is the amount equal to:

(A) the sum of the amount that would be realized if, immediately before the ownership change, the loss corporation—(1) had satisfied each inadequately secured nonrecourse liability by surrendering to the creditor all of the assets securing that debt; and (2) had sold at fair market value to an unrelated third party, with the hypothetical buyer assuming no liabilities, all of its "Section 382 assets"[11] other than those described in prior clause (1); decreased by

(B) the aggregate adjusted basis of the loss corporation's Section 382 assets immediately before the ownership change; decreased by

(C) the amount of any non-contingent deductible liability of the loss corporation (determined without regard to any taxable income or timing limitation); decreased by

(D) the estimated value of any contingent deductible liability (determined without regard to any taxable income or timing limitation); increased or decreased by

(E) the loss corporation's section 481 adjustments that would be taken into account on the deemed sale described in clause (A); increased by

(F) the amount that would be treated as RBIG under the Proposed Regulations if all potential built-in gain items (except for RBIG recognized on the disposition of an asset) were properly taken into account during the recognition period; decreased by

(G) the amount that would be treated as RBIL under the Proposed Regulations if all potential built-in loss items (except for RBIL recognized on disposition of an asset) were properly taken into account during the recognition period.

KPMG observation

This calculation distinguishes recourse and nonrecourse debt, presumably because of the different results under general income tax principles when property is transferred in satisfaction of nonrecourse debt versus recourse debt. When encumbered property is transferred in full

[11] "Section 382 assets" are defined as any asset of the loss corporation immediately before the ownership change, other than other than (i) cash or cash items, (ii) any marketable security which has a value which does not substantially differ from adjusted basis, and (iii) all accounts receivable, other than those that were acquired in the ordinary course of the loss corporation's business).

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satisfaction of nonrecourse debt, the entire amount of the debt is treated as amount realized for purposes of determining gain or loss, and the transfer does not result in COD.[12] When encumbered property is transferred in full satisfaction of recourse debt, the tax consequences are bifurcated. The fair market value of the encumbered property is treated as the amount realized for purposes of determining gain or loss (i.e., the debtor should recognize gain or loss in an amount equal to the difference between the fair market value of the encumbered property and its adjusted basis). In addition, the debtor should realize COD in an amount equal to the excess of the amount of the debt over the fair market value of the encumbered property (i.e., the amount of the debt that was cancelled in connection with the transfer). Hence, any amounts from a transfer of underwater encumbered property in satisfaction of recourse debt is generally part gain or loss and part COD.[13]

KPMG observation

This approach appears to take into account all built-in COD in inadequately secured nonrecourse debt in the NUBIG/NUBIL calculation, while underwater recourse debt is only taken into account when it will give rise to RBIG. Thus, taxpayers may get favorable results where the debtor is a disregarded entity, such that all its debt is treated as nonrecourse to the loss corporation for U.S. federal income tax purposes.

KPMG observation

The formula appears to double count certain items. For example, Clause (G) appears to reduce the NUBIG/NUBIL calculation for amounts that would be treated as RBILs for excess cost-recovery or bad debt deductions, which are already included in the formula under Clause (B). Similarly, it includes deductions for payments of deductible liabilities, which are already included in Clauses (C) and (D). Tax professionals anticipate that the anti-duplication rule would be interpreted to prevent actual double counting.

Furthermore, the Proposed Regulations provide an adjustment to the NUBIG/NUBIL calculation for certain COD that would also be treated as RBIG under the Proposed Regulations. The Proposed Regulations provide that COD recognized during the post-change period generally would not be treated as RBIG. However, the Proposed Regulations would provide taxpayers with the option to treat COD recognized on pre-change debt during the first 12 months of the recognition period as RBIG in certain cases.

[12] Reg. § 1.1001-2(a)(1), (b); *Comm'r v. Tufts*, 461 U.S. 300 (1983) *rev'g* 651 F.2d 1058 (5th Cir. 1981); PLR 9302001 (Aug. 31, 1992).

[13] Reg. § 1.1001-2(a)(2), (c) Example 8.

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KPMG observation

The Proposed Regulations limit RBIG treatment to COD recognized on pre-change debt. There is no provision to address debt that is treated as newly issued merely as a result of a significant modification under Reg. section 1.1001-3. Arguably COD with respect to modified debt which has the same adjusted issue price as pre-change debt should be eligible for RBIG if it otherwise qualifies.

Specifically this option is available with respect to recourse debt that gives rise to: (1) taxable COD, and (2) excluded COD, to the extent section 108(b) reduces attributes that are not pre-change losses, including reduction of the basis of the loss corporation's assets that were not held at the time of the ownership change.

The amount of RBIG that can arise from these provisions generally is capped at (1) the amount of recourse liabilities discharged by the federal bankruptcy court (when the loss corporation is under the jurisdiction of a court under title 11 of the United States Code on the change date), or (2) the extent to which the adjusted issue price of the recourse liabilities taken into account in determining insolvency exceeds the sum of (A) the fair market value of assets of the corporation that are not securing nonrecourse debt and (B) the excess value of assets securing nonrecourse debt over the amount of debt they secure immediately before the ownership change (when not in bankruptcy). The amount of COD that could be taken into account as RBIG under these provisions is added to the NUBIG/NUBIL calculation.

KPMG observation

The cap for insolvency appears to add in the value of assets securing nonrecourse debt only to the extent that the assets in the aggregate exceed all nonrecourse debt in the aggregate. This appears to be a misstatement, which tax professionals anticipate would be corrected in final regulations. The example implementing this calculation takes into account the sum of the excess of assets securing each nonrecourse debt over the amount of that debt, which is more consistent with the apparent goal of limiting the RBIG benefit to the extent of insolvency before the ownership change.

Excluded COD from recourse debt that applies to reduce the tax basis of a loss corporation's Section 382 assets (i.e., assets held immediately before the ownership change, as opposed to assets not held at the time of the ownership change), does not give rise to immediate RBIG. However, the basis reduction is treated as occurring immediately before the ownership change for purposes of computing NUBIG/NUBIL, such that the corresponding amount of excluded COD is included in the NUBIG/NUBIL computation.

KPMG observation

Although the preamble states that the adjustment to basis of assets is treated as occurring immediately before the ownership change for both NUBIG/NUBIL and RBIG/RBIL, it does not

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appear that the text of the Proposed Regulations properly captures that reduction for purposes of computing RBIG/RBIL. This appears to be an oversight that it is anticipated would be corrected in final regulations.

The option to treat certain COD recognized on pre-change debt during the first 12 months of the recognition period as RBIG is also available with respect to nonrecourse debt that gives rise to: (1) taxable COD; and (2) excluded COD to the extent section 108(b) reduces attributes that are not pre-change losses, including reduction in the basis of assets that the loss corporation did not own immediately before the ownership change. The amount of RBIG that can arise from these provisions is capped at the amount by which the adjusted issue price of the nonrecourse debt exceeds the fair market value of the property securing the debt immediately before the ownership change. No corresponding adjustment is made to the NUBIG/NUBIL computation, as the full amount of excess nonrecourse debt is already taken into account in that calculation, so an adjustment would be duplicative.

As with recourse debt, excluded COD from nonrecourse debt that applies to reduce the tax basis of assets that the loss corporation owned immediately before the ownership change (as opposed to assets not owned immediately before the ownership change), does not give rise to immediate RBIG. However, the basis reduction is treated as occurring immediately before the ownership change for purposes of computing RBIG/RBIL. Consequently, if the asset with the reduced basis is disposed of during the recognition period, any additional gain resulting from the reduction should be treated as RBIG at that time.

KPMG observation

The preamble indicates that different rules apply when COD results in a reduction in basis in assets held immediately before the ownership change (which gives rise to RBIG only on disposition of the underlying asset) versus those not held immediately before the ownership change (which gives rise to immediate RBIG with respect to the COD) because a taxpayer cannot adjust NUBIG/NUBIL or generate RBIG with respect to an asset that was not held immediately before the ownership change. However, this rule appears to create a strong incentive to cycle assets after the ownership change to get into the more favorable immediate RBIG situation.

KPMG observation

The Proposed Regulations refer only to excluded COD that reduces the loss corporation's Section 382 assets—a defined term that excludes cash or cash items; any marketable security which has a value which does not substantially differ from adjusted basis; and all accounts receivable, other than those that were acquired in the ordinary course of the loss corporation's business. The use of this term has the effect of denying an RBIG or NUBIG benefit for built-in gain created as a result of section 108(b) attribute reduction in excluded assets owned immediately before the ownership change. There does not appear to be a good policy rationale for that distinction.

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KPMG observation

Query whether a reduction in the basis of assets that takes place after the ownership change as a result of COD recognized before the ownership change (but in the year of the ownership change), should also give rise to RBIG and/or create an adjustment in the computation of NUBIG/NUBIL. Note that this issue arises under Notice 2003-65 as well, but the issuance of regulations may be a good opportunity to resolve it.

KPMG observation

Under current law, the recognition period begins on the change date; however, the pre-change period also includes the change date. This can lead to some aberrational results. The IRS and Treasury requested comments on the possibility of redefining the recognition period to begin on the date after the ownership change. The Proposed Regulations limit RBIG treatment to COD recognized during the first 12 months of the recognition period. Presumably if the definition of the recognition period is changed to exclude the change date, adjustments would be made to the COD rules to allow change-date COD to benefit from these rules.

The Proposed Regulations further indicate if a loss corporation enters or leaves a consolidated group on the date of an ownership change, the principles of Reg. section 1.1502-76(b) apply in determining the treatment of any taxable item for purposes of this section. Accordingly, items that are includible under the end of the day rule in the tax year that ends as a result of the change in status of a loss corporation are not treated as recognized or taken into account during the recognition period, nor are they included in the determination of NUBIG or NUBIL. Thus, COD that is includible in the tax year that ends as a result of the member's change in status does not generate RBIG and is not includible in NUBIG / NUBIL.

KPMG observation

The Proposed Regulations provide no other discussion of how they might interface with the consolidated return rules. For example, if COD results in the reduction to the basis of subsidiary stock which then results in reduction to subsidiary pre-change NOLs, would the group nonetheless get to increase its NUBIG/NUBIL calculation because there was a reduction in a Section 382 asset (the stock)? If not, would there be an adjustment later on if the stock is disposed of in the recognition period, causing the recognition of gain related to the pre-change COD?

Modification to treatment of cost recovery deductions

The 1374 Method set forth in Notice 2003-65 treats as RBIL all amounts allowable as depreciation, amortization or depletion deductions during the recognition period, except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its fair market value on the change date. Notice 2003-65 provides that loss corporation may use any reasonable method to establish that the amortization deduction amount is not attributable to an asset's built-in loss on the change date. One acceptable method set forth in Notice 2003-65 is to compare the

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amount of the cost-recovery deduction actually allowed to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its fair market value on the change date.

The preamble to the Proposed Regulations notes that, because depreciation deductions under section 168 tend to be larger closer to the beginning of an asset's life, this approach can lead to absurd results. Thus, the Proposed Regulations would abandon this approach. Instead, the hypothetical cost recovery deduction would be computed by applying the same depreciation schedule actually used by the corporation to the fair market value of the asset.

KPMG observation

Tax professionals with KPMG previously concluded that a reasonable method under Notice 2003-65 would be to treat as RBIL the amount of the deduction that corresponds to the percentage of the basis that represented built-in loss on the change date, which effectively is the methodology prescribed in the Proposed Regulations. For example, consider an asset which amortizes on a straight-line basis over 15 years with basis of $150, value of $75, and a remaining cost-recovery period of 10 years on the change date. Because 50% of the basis in the asset represents the built-in loss, KPMG tax professionals historically have believed the proper approach is to treat 50% of each year's amortization deduction (i.e., $7.5) as RBIL.

Interplay between section 163(j) and section 382

Section 163(j), as significantly modified by the 2017 U.S. tax law (Pub. L. No. 115-97, also referred to as the Tax Cuts and Jobs Act ("TCJA")), limits the deduction for any tax year for business interest to the sum of (1) the business interest income of such taxpayer for such tax year, (2) 30% of the adjusted taxable income of such taxpayer for such tax year, plus (3) the floor plan financing interest of such taxpayer for such tax year. If an amount of business interest is not allowed as a deduction for a tax year due to the section 163(j) limitation, the amount is carried forward and treated as business interest paid in the next tax year (i.e., a disallowed business interest expense carryforward).

Section 382(d)(3) indicates that that carryovers of disallowed business interest expense under section 163(j) are to be treated as pre-change loss under rules similar to those that apply to limit net operating losses—i.e., that disallowed business interest expense can be subject to limitation under section 382. The preamble to the Proposed Regulations notes that disallowed interest under section 163(j) could likewise fall within the definition of an RBIL under section 382(h)(6), thereby causing such items to be counted twice for the purpose of section 382. To prevent this result, the Proposed Regulations provide that use of section 163(j) carryovers during the recognition period does not give rise to RBIL.

The Proposed Regulations also address the application of section 382(h) to business interest expense of a partnership that is disallowed under section 163(j) but not suspended under section 704(d) ("section 382 excess business interest expense").

As provided in section 163(j)(4)(B)(iii) and Prop. Reg. section 1.163-6(h)(3)(i), if a partner disposes of all or substantially all of its partnership interest, the adjusted basis of the partner in the partnership interest would be increased immediately before the disposition to reflect the partner's section 382 excess business interest expense from the partnership, if any. These Proposed Regulations would provide that, for purposes of determining RBIL, as well as for computing NUBIG or NUBIL, a loss corporation's adjusted basis in a partnership interest is adjusted as if the loss corporation disposed of all or substantially all of its partnership interests immediately before the ownership change.

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This mechanism allows a deduction or loss equal to the section 382 excess business interest expense to be treated as RBIL, either when the loss corporation is able to deduct the section 382 excess business interest expense, or when it sells all or substantially of its partnership interest. In either case, no further adjustment to the loss corporation's NUBIG or NUBIL computation would be necessary, because the positive adjustment to the basis of the partnership interest ensures that an amount equal to the section 382 excess business interest expense already is included in the computation.

Treasury and the IRS have requested comments on whether certain excess business interest expense suspended under section 704(d) should also be treated as RBIL.

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