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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-125710-18]

RIN 1545-BP07

Regulations under Section 382(h) Related to Built-in Gain and Loss

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the items of income and deduction which are included in the calculation of built-in gains and losses under section 382 of the Internal Revenue Code (Code), and reflecting numerous changes made to the Code by the enactment of recent tax legislation. These proposed regulations would affect corporations that experience an ownership change for purposes of section 382. This document also proposes to withdraw the following IRS notices and incorporate their subject matter, as appropriate, into these proposed regulations under section 382: Notice 87-79, Notice 90-27, Notice 2003-65, and Notice 2018-30.

DATES: Written or electronic comments must be received by **[INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**. Written or electronic requests for a public hearing and outlines of topics to be discussed at the public hearing must be received by **[INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-125710-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: Internal Revenue Service, CC:PA:LPD:PR (REG-125710-18), Room 5203, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (indicate REG-125710-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning proposed regulations, Kevin M. Jacobs at (202) 317-5332 or Marie C. Milnes-Vasquez at (202) 317-7700; concerning submissions of comments or requests for a public hearing, Regina L. Johnson at (202) 317-6901 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Overview

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 382 of the Code.

A. Section 382 Generally

Section 382 imposes a value-based limitation (section 382 limitation) on the ability of a "loss corporation" to offset its taxable income in periods subsequent to an

“ownership change” with losses attributable to periods prior to that ownership change. A loss corporation is defined under section 382 as a corporation that has one or more of the following tax items: (i) certain carryovers (including net operating loss (NOL), capital loss, disallowed business interest under section 163(j), and certain credit carryovers), (ii) certain attributes (including an NOL, net capital loss, and certain credits) for the taxable year during which an ownership change occurs, or (iii) a net unrealized built-in loss (NUBIL) as of the ownership change. (Any recognized built-in loss (RBIL) associated with a NUBIL, as well as each of the items in (i) and (ii) is referred to herein as a pre-change loss.) For purposes of section 382, an ownership change occurs if the percentage of the loss corporation’s stock owned by any “5-percent shareholders” (that is, a shareholder that owns at least five percent of the loss corporation’s stock) increases by more than 50 percentage points during a specified testing period. The section 382 limitation imposed on a loss corporation’s use of pre-change losses for each year subsequent to an ownership change generally equals the fair market value of the loss corporation immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate as defined in section 382(f).

Section 382(m) requires the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 382 (as well as section 383, which limits the use of certain credits after an ownership change).

The existing regulations under section 382, which have developed over the past three decades, provide detailed guidance on numerous (but not all) aspects of the relatively detailed statutory rules set forth in section 382. However, in some cases, the

Treasury Department and the IRS have found it appropriate to provide guidance to the public through the issuance of notices or other sub-regulatory guidance.

B. Built-in Gains and Losses Generally

Section 382(h) provides rules relating to the determination of a loss corporation's built-in gains and losses as of the date of the ownership change (change date). In general, built-in gains recognized during the five-year period beginning on the change date (recognition period) allow a loss corporation to increase its section 382 limitation, whereas built-in losses recognized during the recognition period are subject to the loss corporation's section 382 limitation. These rules exist to implement the "neutrality principle" underlying the statute, which is discussed in more detail in part II.B.2. of the Explanation of Provisions. Under this principle, the built-in gains and losses of a loss corporation, if recognized during the recognition period, generally are to be treated in the same manner as if they had been recognized before the ownership change.

Specifically, section 382(h)(1)(A) provides that, if a loss corporation has a net unrealized built-in gain (NUBIG), the section 382 limitation for any taxable year ending during the recognition period is increased by the recognized built-in gain (RBIG) for the taxable year, with cumulative increases limited to the amount of the NUBIG. Section 382(h)(3)(A) defines NUBIG with respect to a loss corporation as the amount by which the fair market value of its assets immediately before an ownership change exceeds the aggregate adjusted basis of such assets at such time. Section 382(h)(2)(A) defines RBIG as any gain recognized during the recognition period on the disposition of any asset of the loss corporation, to the extent the loss corporation establishes that (i) the loss corporation held the asset on the change date, and (ii) such gain does not exceed

the asset's built-in gain on the change date. Section 382(h)(6)(A) also treats as RBIG “[a]ny item of income which is properly taken into account during the recognition period ... but which is attributable to periods before the change date.” Because RBIG can increase the section 382 limitation only up to the amount of NUBIG, section 382(h)(6)(C) provides that NUBIG is increased to reflect amounts that would be treated as RBIG under section 382(h)(6)(A) if such amounts were taken into account during the recognition period. This adjustment can cause (i) an increase in NUBIG, (ii) a decrease in NUBIL, or even (iii) a change from NUBIL to NUBIG status.

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 section 382 limitation. Section 382(h)(3)(A) defines NUBIL with respect to a loss corporation as the amount by which the aggregate adjusted basis of the loss corporation’s assets immediately before an ownership change exceeds the fair market value of such assets at such time. Section 382(h)(2)(B) defines RBIL as any loss recognized during the recognition period on the disposition of any asset of the loss corporation, except to the extent the loss corporation establishes that (i) the loss corporation did not hold the asset on the change date, or (ii) such loss exceeds the asset's built-in loss on the change date. Section 382(h)(6)(B) also treats as RBIL “[a]ny amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the change date.” In addition, section 382(h)(6)(C) provides that a loss corporation’s NUBIL is properly adjusted for amounts which would be treated as RBIL under section 382(h)(6)(B) if such amounts were properly allowable as a deduction during the recognition period.

Finally, section 382(h)(3)(B) provides that if a loss corporation's NUBIG or NUBIL is not greater than the lesser of (i) 15 percent of the fair market value of the loss corporation's assets immediately before the ownership change, or (ii) \$10,000,000, then the loss corporation's NUBIG or NUBIL is zero.

II. Notice 2003-65

The rules for identifying RBIG and RBIL under sections 382(h)(6)(A) and 382(h)(6)(B) are sufficient for determinations regarding dispositions of assets. Section 382(h)(6)(A) and (B) provide that income and deduction items that constitute RBIG and RBIL are those tax items that are "attributable to periods before the change date", but are not taken into account for tax purposes until a later time. However, taxpayers historically have expressed uncertainty regarding how to integrate into their RBIG/RBIL and corresponding NUBIG/NUBIL calculations the effects of (i) discharge of indebtedness income, (ii) contingent liabilities, (iii) bad debt deductions, and (iv) cost-recovery deductions. In many instances, the fact-specific characteristics of those items have presented significant complications for such taxpayers in determining whether those items were attributable to periods before the change date. The Treasury Department and the IRS agree with taxpayers that sections 382(h)(6)(A) and 382(h)(6)(B) do not provide sufficient guidance regarding identification of other items of RBIG and RBIL.

To provide interim guidance regarding the identification of those built-in gains and losses under section 382(h), the IRS published Notice 2003-65 (2003-2 C.B. 747) . This notice permits taxpayers to rely on safe harbor approaches for applying section 382(h) to an ownership change "prior to the effective date of temporary or final

regulations under section 382(h).” Notice 2003-65, section V. In addition, the IRS announced its intent in the notice to publish proposed regulations to “provid[e] a single set of rules for identifying built-in items for purposes of section 382(h).” *Id.*, section VII. In particular, the notice requested comments regarding “whether one of the two approaches described in th[e] notice should be adopted and to what extent, if any, the approaches should be combined or modified to produce a set of rules that is both reflective of statutory intent and administrable.” *Id.*

Notice 2003-65 provides, among other things, a single safe harbor for computing the NUBIG or NUBIL of a loss corporation, which (i) is based on principles underlying the calculation of net recognized built-in gain under section 1374 for purposes of the tax imposed on C corporations that elect to be S corporations, and (ii) analyzes a hypothetical sale or exchange of all assets of the loss corporation to a third party who assumed all of the loss corporation’s liabilities. In addition, Notice 2003-65 provides two safe harbors for the computation of a loss corporation’s RBIG or RBIL: the 1374 approach and the 338 approach. These safe harbors specifically inform the identification of built-in income and deduction items under section 382(h)(6)(A) and (B), and the adjustments to NUBIG or NUBIL that would result under section 382(h)(6)(C).

The 1374 approach identifies RBIG and RBIL at the time of the disposition of a loss corporation’s assets during the recognition period. Generally, this approach relies on accrual method of accounting principles to identify built-in income and deduction items at the time of the ownership change, with certain exceptions. In contrast, the 338 approach identifies items of RBIG and RBIL generally by comparing the loss corporation's actual items of income, gain, deduction, and loss recognized during the

recognition period with those that would have been recognized if an election under section 338 (section 338 election) had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date. Section V. of Notice 2003-65 provides that taxpayers may rely on either the 338 approach or the 1374 approach until the Treasury Department and the IRS issue temporary or final regulations under section 382(h).

Prior to the issuance of Notice 2003-65, the Treasury Department and the IRS issued Notice 87-79 (1987-2 C.B. 387) and Notice 90-29 (1990-1 C.B. 336), which provided much more limited guidance regarding the determination of built-in gains and losses. Notice 87-79, which Notice 2003-65 modified, discussed anticipated regulations regarding the interplay of section 382(h) and discharge of indebtedness income. Notice 90-29 set forth an approach that Notice 2003-65 adopted as part of its section 1374 safe harbor, and similarly discussed anticipated regulations (regarding the application of section 382(h) to gains reported using the installment method under section 453). As discussed in more detail in part I.B.2 of this Explanation of Provisions, the Treasury Department and the IRS published Notice 2018-30 (2018-21 I.R.B. 610) following “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” Public Law 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Specifically, Notice 2018-30 makes the section 338 safe harbor of Notice 2003-65 unavailable when computing items arising from bonus depreciation under section 168(k).

III. Response to Notice 2003-65

Over the past fifteen years, the Treasury Department and the IRS have received thoughtful formal and informal commentary highlighting numerous shortcomings of the interim guidance set forth in Notice 2003-65. Examples of these shortcomings include: (i) the overstatement of NUBIG (or understatement of NUBIL) that occurs when a loss corporation has excluded discharge or cancellation of indebtedness income (COD income), (ii) the asymmetry that occurs if certain amounts are included in the NUBIG/NUBIL computation when those amounts cannot be treated as RBIG or RBIL (such as contingent liabilities under the 1374 approach), which appears to contravene section 382(h)(6)(C), and (iii) taxpayer uncertainty and tax administration challenges that arise from a lack of definitive guidance under section 382(h). Commenters and commentators (collectively, commentators) generally have emphasized the simplicity, objectivity, and administrability of the accrual-based 1374 approach, as well as that approach's close adherence to a plain reading of the statutory text of section 382(h) and section 382(h)'s legislative history. With regard to the 338 approach, commentators generally have appreciated that approach's attempt to quantify and capture items that were economically built-in at the time of the ownership change, rather than simply accrued under tax accounting principles. Commentators have also noted that the 338 approach will reduce the impact of the recognition period's limited duration, by not requiring taxpayers to dispose of certain assets within such period to be treated as RBIG. In sum, commentators have acknowledged merits, as well as weaknesses, unique to each of the 1374 and 338 approaches but have not reached consensus

favoring a universal application of either approach during the 15 years since the IRS published Notice 2003-65.

IV. Enactment of the TCJA

On December 22, 2017, Congress enacted the TCJA, which introduced substantial changes to the Code. These changes have generated significant, additional uncertainty regarding the application of section 382 in general, and Notice 2003-65 in particular. As described in greater detail in part II. of the Explanation of Provisions, the changes to various provisions of the Code made by the TCJA have exacerbated longstanding, unresolved issues regarding the application of section 382(h) and created new areas of complexity and ambiguity for taxpayers and the IRS. In particular, the Treasury Department and the IRS have identified numerous issues that would arise from the interaction of the 338 approach with various provisions of the Code following the TCJA's enactment. See Explanation of Provisions, part I.B.2.

Consequently, the Treasury Department and the IRS are issuing these proposed regulations to provide clearer and more comprehensive guidance for taxpayers in applying section 382(h) than that currently provided by notice. The Treasury Department and the IRS have determined that the proposed regulations would (i) simplify the application of section 382, (ii) provide more certainty to taxpayers in determining built-in gains and losses for section 382(h) purposes, and (iii) ensure that difficult questions regarding the application of the TCJA do not further complicate the application of section 382(h). The Treasury Department and the IRS note that, as provided in Section V. of Notice 2003-65, taxpayers may rely on the approaches set forth in Notice 2003-65 for purposes of applying section 382(h) to an ownership change

that occurred prior to the issuance of Notice 2003-65 or on or after the issuance of the notice and prior to the effective date of temporary or final regulations under section 382(h). After consideration of all comments regarding the proposed regulations set forth in this notice of proposed rulemaking, the Treasury Department and the IRS expect to issue final regulations to adopt the proposed regulations, which may include modifications in response to those comments. It is further expected that the Treasury decision adopting these proposed regulations as final regulations will withdraw and obsolete Notice 2003-65 and other administrative guidance associated with section 382(h) set forth in the Effect on Other Documents section of this notice of proposed rulemaking.

Explanation of Provisions

I. Proposed Adoption of NUBIG/NUBIL Safe Harbor and 1374 Approach

A. Overview

With regard to the computation of NUBIG and NUBIL, these proposed regulations would adopt as mandatory the safe harbor computation provided in Notice 2003-65 based on the principles of section 1374, with modifications described in part II.B. of this Explanation of Provisions. Regarding the identification of RBIG and RBIL, based on study and taxpayer input, and as discussed further in part I.A. and part I.B. of this Explanation of Provisions, the Treasury Department and the IRS have concluded that the 1374 approach is more consistent with the text and the purpose of section 382 than the 338 approach and would simplify tax administration. Accordingly, these proposed regulations would adopt as mandatory the 1374 approach with certain modifications also described in part II.C. of this Explanation of Provisions.

As previously highlighted, the Treasury Department and the IRS, along with numerous commentators, view favorably the simplicity, objectivity, and administrability of the 1374 approach. The accrual-based 1374 approach to be used in determining RBIG and RBIL is simpler to apply than the 338 approach because, among other reasons, corporate taxpayers and their advisors are familiar with the accrual method of accounting. Indeed, a sizable volume of case law, Code provisions, and regulations govern the accrual method (for example, Schlude v. Commissioner, 372 U.S. 128 (1963), Brown v. Helvering, 291 U.S. 193 (1934), and United States v. Anderson, 269 U.S. 422 (1926); sections 446, 451, and 461; and the regulations under those Code provisions). In addition, the accrual-based 1374 approach avoids many facts-and-circumstance inquiries by avoiding tracing, valuation uncertainties, and presumptions regarding whether items of income are realized for Federal income tax purposes.

The Treasury Department and the IRS have determined that the certainty provided by the 1374 approach would streamline (i) the calculation of built-in gains and losses for taxpayers, as well as (ii) the administration of this area for the IRS. The 1374 approach turns on an accrual analysis of the loss corporation's actual transactions and circumstances, and consequently minimizes the importation of new issues arising from changes made by the TCJA, particularly those issues described in detail later in part I.B.2. of this Explanation of Provisions. The Treasury Department and the IRS welcome public comment on the proposed adoption of a modified 1374 approach for determining RBIG and RBIL.

B. Consideration and Proposed Elimination of the 338 Approach

After study, and based on taxpayer input, the Treasury Department and the IRS have decided not to incorporate the 338 approach into these proposed regulations. As described in part I.B.1. of this Explanation of Provisions, the Treasury Department and the IRS have concluded that the 338 approach lacks sufficient grounding in the statutory text of section 382(h). Further, the Treasury Department and the IRS have determined that the mechanics underlying the 338 approach (i) are inherently more complex than the accrual-based 1374 approach, (ii) can result in overstatements of RBIG and RBIL, and (iii) as a result of the TCJA, would require substantial modifications to eliminate increased uncertainty and ensure appropriate results. By eliminating the 338 approach, the Treasury Department and the IRS have determined that these proposed regulations would significantly reduce current and future complexity of section 382(h) computations for taxpayers and the IRS alike. The Treasury Department and the IRS welcome public comment on this proposed elimination of the 338 approach for determining RBIG and RBIL.

1. Historical Weaknesses of the 338 Approach

The 338 approach originated in subregulatory guidance set forth in Notice 2003-65, and possesses significantly less grounding in the statutory text of section 382(h) than the 1374 approach. The comparatively tenuous connection between the 338 approach and the plain meaning of the statutory text of section 382(h) is exemplified by the method by which the 338 approach identifies RBIG. Under the 338 approach, depreciation deductions on certain built-in gain assets give rise to RBIG, even though no actual recognition of gain or income has occurred. However, sections 382(h)(2)(A)

and 382(h)(6)(A) do not authorize RBIG treatment in the absence of actual gain or income recognized by the loss corporation.

Further, commentators have noted that difficult questions arise regarding deemed tiered section 338 elections when the 338 approach is applied to a loss corporation that is the parent of other corporations. For example, there are often significant differences between the basis of stock held by a loss corporation in subsidiaries and the basis of the assets held by the subsidiaries, and those differences create disparate outcomes. Tiered section 338 elections, including with respect to controlled foreign corporations, could have significant impacts on the outcomes produced under this approach.

2. Additional Complications of the 338 Approach Following the TCJA

The Treasury Department and the IRS introduced the 338 approach in 2003 after substantial review of the manner in which then-applicable Code provisions would apply to a section 338 election. In the pre-TCJA environment, provisions of the Code largely would have applied to the taxpayer in the same manner under a hypothetical sale resulting from a section 338 election as those provisions would have applied to the taxpayer without that hypothetical-sale treatment. However, certain important changes under the TCJA have caused the treatment of newly purchased assets to diverge from the treatment of historic assets, thus potentially compromising the mechanics of the 338 approach.

For example, the Treasury Department and the IRS have observed that TCJA amendments to section 168(k) invalidate the key assumption underlying application of the 338 approach to depreciable (“wasting”) assets, which is to reflect an estimate of

income or expense generated by an asset during a particular period. Consequently, to prevent unintended collateral consequences of the additional first-year depreciation available under amended section 168(k), the Treasury Department and the IRS published Notice 2018-30 (2018-21 I.R.B. 610). Without the additional guidance set forth in Notice 2018-30, the Treasury Department and the IRS concluded that the 338 approach's hypothetical cost recovery deduction resulting from a hypothetical application of additional first-year depreciation under section 168(k) would fail to provide a reasonable estimate of the income or expense produced by a built-in gain or loss asset during the recognition period.

Moreover, the Treasury Department and the IRS have identified additional issues that would arise from the interaction of the 338 approach with other provisions of the TCJA, each of which would require extensive study and potentially the issuance of additional guidance. For example, the limitation on a loss corporation's interest deduction under amended section 163(j) and the modifications to the NOL deduction rules under amended section 172 are each based on variants of taxable income. However, a hypothetical sale of a loss corporation's assets under section 338 upon an ownership change would result in different taxable income computations than before the TCJA. Unanswered questions related to sections 163(j) and 172 would further complicate application of the 338 approach. Further, income inclusions under section 951A may increase existing concerns (including as a result of potential changes in hypothetical QBAI basis from deemed tiered section 338 elections) arising under the 338 approach. Taken as a whole, the Treasury Department and the IRS have determined that the continued application of the 338 approach likely would not be

tenable after the changes to the Code enacted by the TCJA. The Treasury Department and the IRS request public comment on the proposed elimination of the 338 approach for determining RBIG and RBIL, including detailed comments with regard to whether it would be appropriate within the limits of the statute to consider special rules for insolvent or bankrupt loss corporations, and whether a redefinition of the date on which the recognition period begins would increase simplification.

II. Description of Proposed NUBIG/NUBIL Safe Harbor and Proposed 1374 Approach

A. Overview

The proposed approach described in this part II incorporates certain modifications to the NUBIG/NUBIL safe harbor and the 1374 approach to ensure greater consistency between (i) amounts that are included in the NUBIG/NUBIL computation and (ii) items that could become RBIG or RBIL during the recognition period. These modifications would better implement the requirements of section 382(h)(6)(C). As described in this part II, the RBIG and RBIL rules remain closely based upon the 1374 approach set forth in Notice 2003-65. However, these proposed regulations would make the modifications described in this part II to improve accuracy, particularly with regard to COD income and deductions for the payment of contingent liabilities.

B. Proposed Rules for Computation of NUBIG or NUBIL

1. In General

The proposed rules regarding the computation of NUBIG/NUBIL set forth in these proposed regulations would capture a range of items that closely tracks the NUBIG/NUBIL safe harbor computation under Notice 2003-65. However, the proposed

regulations would enhance the transparency and clarity of that computation by making its component steps more explicit. Specifically, the proposed NUBIG/NUBIL computation first takes into account the aggregate amount that would be realized in a hypothetical disposition of all of the loss corporation's assets in two steps treated as taking place immediately before the ownership change. In the first step, the loss corporation is treated as satisfying any inadequately secured nonrecourse liability by surrendering to each creditor the assets securing such debt. In the second step, the loss corporation is treated as selling all remaining assets pertinent to the NUBIG/NUBIL computation in a sale to an unrelated third party, with the hypothetical buyer assuming no amount of the seller's liabilities. That total hypothetical amount realized by the loss corporation pursuant to steps one and two is then decreased by the sum of the loss corporation's deductible liabilities (both fixed and contingent), and also decreased by the loss corporation's basis in its assets. Finally, the decreased hypothetical total is then increased or decreased, as applicable, by the following: (1) the net amount of the total RBIG and RBIL 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 previously-described hypothetical disposal of all of the loss corporation's assets.

The Treasury Department and the IRS welcome public comment on all aspects of these proposed rules regarding the computation of NUBIG and NUBIL.

2. Proposed Adjustments to Account for Built-In COD Income

Section 61(a)(12) of the Code provides that gross income includes COD income, except as provided by law. Section 108(a) provides, in part, that gross income of a C

corporation does not include COD income of the taxpayer if the discharge occurs in a title 11 case, or the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency (excluded COD income).

If a taxpayer has excluded COD income, section 108(b)(1) requires the taxpayer to reduce its tax attributes by the amount excluded. In general, pursuant to section 108(b)(2), tax attributes are reduced in the following order: NOLs and NOL carryovers, general business credits under section 38, minimum tax credits under section 53(b), net capital losses and capital loss carryovers, asset basis, passive activity loss and credit carryovers under section 469(b), and foreign tax credits and foreign tax credit carryovers. Any amount of debt discharge that remains after attribute reduction is not includible in income. See H.R. Rep. No. 96-833 at 11 (1980); S. Rep. No. 96-1035 at 13 (1980).

These provisions are designed to “preserve the debtor’s ‘fresh start’ after bankruptcy.” H.R. Rep. No. 96-833 at 9 (1980); see S. Rep. No. 96-1035 at 10 (1980). In addition, they are intended to “carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.” H.R. Rep. No. 96-833 at 9 (1980); see S. Rep. No. 96-1035 at 10 (1980). By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.

As discussed in part II of the Background section, significant uncertainty has existed with regard to administering the built-in gain and loss framework of section 382(h). However, in administering this area, the Treasury Department and the IRS have always sought to implement a guiding principle discussed in the section 382

legislative history, which is commonly referred to as the “neutrality principle.” Under this principle, the built-in gains and losses of a loss corporation, once recognized after an ownership change, generally are to be treated in the same manner as if they had been recognized before the ownership change. For example, it is the neutrality principle that causes RBIL to be limited in the same manner as a pre-change NOL carryforward or net capital loss carryforward. Similarly, in the built-in gain context, the neutrality principle dictates that section 382-limited losses be freely usable against RBIG because, had the gain been taken into account before the ownership change, use of the loss would not have been subject to (that is, limited by) section 382. Under section 382(h), RBIG results in a dollar-for-dollar increase in the loss corporation’s section 382 limit in order to replicate this pre-ownership change treatment. See S. Rept. 99-313 at 235; H.R. Rept. 99-426 at 261.

In Notice 2003-65, the Treasury Department and the IRS attempted to provide guidance integrating into the NUBIG/NUBIL computation the amount of insolvency of the loss corporation (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. However, 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. After administrative experience under Notice 2003-65 and as highlighted by commentators, the Treasury Department and the IRS have determined that this failure to distinguish between includable and excludable COD income results in the overstatement of RBIG (or understatement of RBIL) in contravention of section 382(h)(6)(C). This failure also effectively provides for a

duplicated benefit under the section 382(h) RBIG rules in certain cases. The Treasury Department and the IRS interpret section 382(h)(6)(C) as requiring inclusion in the NUBIG/NUBIL computation only the amounts that would be treated as RBIG or RBIL if those amounts were properly taken into account during the recognition period.

Further, the Treasury Department and the IRS have determined that the treatment of COD income under Notice 2003-65 violates the neutrality principle previously discussed. The Treasury Department and the IRS have determined that RBIG treatment (as well as the ancillary increase in NUBIG or decrease in NUBIL) should be available only to the extent that the neutrality principle requires an increase in the loss corporation's section 382 limitation.

The application of the attribute reduction rules of section 108(b) to excluded COD income complicates the RBIG and NUBIG calculation. The Treasury Department and the IRS understand that most excluded COD income is offset under section 108(b) by reducing tax attributes of the loss corporation that are treated as pre-change losses under section 382. To the extent that pre-change losses have already been used to offset this pre-change income, the neutrality principle prohibits an increase in the section 382 limitation. Indeed, such an increase could make excluded COD income more attractive than included COD income (or any other built-in gain item) for purposes of section 382. For this reason, the Treasury Department and the IRS have determined that the recognition of such excluded COD income should not generate RBIG. Because NUBIG functions as a ceiling on the amount of RBIG that may be claimed (and the corresponding amount of increase in the section 382 limitation), there does not appear

to be a policy need nor a statutory basis for adjusting the NUBIG/NUBIL computation if there is no need to increase the section 382 limitation.

Inclusion of excludable COD income in the calculation of NUBIG/NUBIL would be particularly distortive if a loss corporation deconsolidates from a group as a result of its ownership change, and recognizes excludable COD income on the change date. Under the consolidated return regulations, any excludable COD income recognized on the date of deconsolidation is treated as attributable to the taxable year of the transferor group (rather than post-change, in the loss corporation's separate taxable year). Therefore, such excludable COD income should not be treated as RBIG (pre-change income recognized in the post-change period).

Accordingly, these proposed regulations generally would not allow COD income to be included in the calculation of NUBIG/NUBIL, but would provide certain exceptions. Includable COD by its nature is not complicated by the interaction of section 108(b). Therefore, to satisfy the neutrality principle, all includable COD income of the loss corporation that is recognized on recourse debt during the 12-month period following the change date would be eligible for inclusion in the NUBIG/NUBIL computation, subject to limitations discussed in part II.C.2 of this Explanation of Provisions. However, these proposed regulations would permit excluded COD income items to be treated as RBIG (and thus affect NUBIG/NUBIL calculation) only to the extent described in part II.C of this Explanation of Provisions. The Treasury Department and the IRS welcome public comment on the proposed regulations' approach regarding excludible and includible COD income in calculating NUBIG and NUBIL, including comments with regard to whether it would be appropriate within the limits of the statute to consider

special rules for insolvent or bankrupt loss corporations. Comments are also invited with regard to the possibility of redefining the recognition period to begin on the date after the ownership change, and any issues that might be eliminated or created by such a redefinition.

C. Proposed Rules for Identification of RBIG and RBIL Income and Deduction Items

1. In General

These proposed regulations would apply a methodology for identifying RBIG or RBIL that closely tracks the 1374 approach described in Notice 2003-65. This approach is generally accrual based, with specific exceptions. Many of the special rules incorporated in these proposed regulations originate in regulations underlying section 1374. However, these proposed regulations would make minor changes to improve the computational accuracy of the 1374 approach. For example, in response to comments on Notice 2003-65, these proposed regulations would provide an improved methodology for computing the amount of depreciation deductions treated as RBIL during the recognition period.

In addition, these proposed regulations would significantly modify the 1374 approach set forth in Notice 2003-65 to 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. Commentators noted that Notice 2003-65 appeared to include this estimated amount in its NUBIG/NUBIL computation, but did not treat deductible liability payments or accruals as RBIL. That incongruity contravenes section 382(h)(6)(C), which requires that items be included in the

NUBIG/NUBIL computation if they would be treated as RBIG or RBIL if properly taken into account during the recognition period.

Further, these proposed regulations would add a rule clarifying that certain items do not constitute RBIG. For example, the proposed regulations provide that dividends paid on stock during the recognition period are not RBIG, even if the loss corporation has a NUBIG and there is gain built into the pertinent stock immediately before the ownership change. On the other hand, gain recognized on the disposition of stock generally would be treated as giving rise to RBIG. However, gain taxable as a dividend under section 1248 would generally give rise to a deduction under section 245A, with no net income being generated. Because no losses would be required to offset this item of income, the Treasury Department and the IRS have determined that this income item should not give rise to RBIG.

The Treasury Department and the IRS welcome public comment on the proposed regulations' identification of RBIG and RBIL. In particular, the Treasury Department and the IRS request comments regarding whether dividends paid on built-in gain stock should constitute RBIG, and whether final regulations should clarify the eligibility of other, similar income items for RBIG treatment.

2. Proposed Treatment of COD Income as RBIG

These proposed regulations would provide limitations on the extent to which excluded COD income is treated as RBIG, and thus would impact the calculation of NUBIG/NUBIL. As discussed in part II.B.2 of this Explanation of Provisions, RBIG effectuates the neutrality principle in the post-change period and therefore COD income must be able to be taken into account during the post-change period in order to qualify

for RBIG status. Thus, COD income that is taken into account during the pre-change period (for example, excluded COD income recognized by a consolidated group member on an ownership change that causes the member to deconsolidate) should not qualify as RBIG. The proposed regulations also provide that COD income recognized during the post-change period generally would not be treated as RBIG. However, these proposed regulations would provide taxpayers with the option to treat certain COD income recognized during the first 12 months of the recognition period as RBIG (and consequently to make corresponding adjustments to the taxpayer's NUBIG/NUBIL computation). For example, the proposed regulations provide that COD income on recourse debt that is included in a loss corporation's taxable income under section 61(a)(12) during the first 12 months of the post-change period would be treated as RBIG as described in part II.B.2. of this Explanation of Provisions. Therefore, the loss corporation's section 382 limitation would be increased by the amount of such COD income, and pre-change losses may be deducted in the amount of the COD income. The 12-month limitation on RBIG treatment is adopted from the 1374 approach under Notice 2003-65.

Under the proposed regulations, excluded COD income recognized during the post-change period generally would not be treated as RBIG, in order to prevent the duplication of section 382 benefits. For example, if excluded COD income recognized during the post-change period (but not included in a loss corporation's income) is offset by pre-change losses, the loss corporation would receive the same benefit as a loss corporation that recognized included COD income: the ability to offset the COD income with pre-change losses. Therefore, the Treasury Department and the IRS have

determined that extending the additional benefit of RBIG treatment (and the resulting increase in NUBIG or decrease in NUBIL) to post-change period excluded COD income generally would result in a duplication of section 382 benefits to the loss corporation.

However, these proposed regulations would provide two exceptions to this general rule to address cases in which excluded COD income recognized by a loss corporation during the first 12 months of its post-change period is offset by post-change tax attributes under section 108(b) or by basis reduction in assets held as of the change date under section 1017. To the extent that excluded COD income is offset by post-change tax attributes, the loss corporation would not yet have used pre-change loss equal to the amount of that excluded COD income. Therefore, the excluded COD income would be treated as RBIG, and the loss corporation's NUBIG/NUBIL would be adjusted accordingly. Similarly, to the extent that excluded COD income is offset by reduction in the tax basis of assets held immediately before the ownership change, the loss corporation would not have used pre-change loss equal to that excluded COD income. Under these proposed regulations (as under Notice 2003-65), that basis reduction would be treated as occurring immediately before the ownership change. As a result of that basis reduction, the corresponding amount of excluded COD income would be included in the NUBIG/NUBIL computation, and no further adjustment would be necessary. Accordingly, the excluded COD income would not be treated as RBIG, to avoid double-counting. Any additional gain on the disposition of assets during the recognition period resulting from the basis adjustment would be treated as RBIG, to the extent of the NUBIG limitation.

Different treatment is required, to the extent that excluded COD is offset by reduction in the tax basis of assets that were acquired after the ownership change. The basis adjustments to those assets would not result in an adjustment to NUBIG/NUBIL, nor could any RBIG be produced from those assets because assets not held at the time of the ownership change are not included in the NUBIG/NUBIL computation. Similarly, RBIG cannot be generated on the sale of assets that were not held at the time of the ownership change. Therefore, the excluded COD income would be treated as RBIG and the NUBIG/NUBIL would be adjusted accordingly.

The Treasury Department and the IRS welcome public comment on the proposed regulations' approach regarding the treatment of excludible and includible COD income as RBIG. Further, the Treasury Department and the IRS request comments regarding what rules should govern the treatment of COD that is excluded under section 108(a)(1)(C) and (D) (qualified farm indebtedness and qualified real estate business indebtedness).

3. Overall limitations on amount of RBIL for COD on Recourse Debt

These proposed regulations set forth two different RBIG ceilings with regard to COD on recourse debt. The first ceiling applies to taxpayers that are in bankruptcy at the time of the ownership change, and have COD income pursuant to that bankruptcy action during the first twelve months of the recognition period. The maximum RBIG for those taxpayers related to excluded COD income would be the amount of indebtedness discharged in that bankruptcy action. The second ceiling applies to all other taxpayers who recognize COD income during the first twelve months of the recognition period. The maximum RBIG for those taxpayers is the excess of liabilities over asset value

immediately before the change date, with certain adjustments. Adjustments must be made to avoid double counting amounts of excluded COD that are offset by reductions in asset basis under sections 108(b) and 1017. The Treasury Department and the IRS welcome public comment on these two RBIG ceilings with regard to COD income on recourse debt.

4. Special Rules for Nonrecourse Debt

RBIG status for COD income on nonrecourse debt recognized in the first 12 months of the recognition period is subject to rules similar to those previously described. However, such COD income is treated as built-in gain only to the extent that the nonrecourse debt was under-secured immediately before the ownership change. Because a nonrecourse creditor has a claim only on the assets securing the indebtedness, the amount of the impairment at the time of the ownership change is the appropriate measure of built-in COD in the nonrecourse debt. Further, RBIG recognized on nonrecourse debt during the recognition period does not result in an adjustment to NUBIG/NUBIL, because the amount of the impairment to the nonrecourse debt is already built into the initial NUBIG/NUBIL computation with regard to the deemed disposition of assets. The Treasury Department and the IRS welcome public comment on the treatment of COD income on non-recourse debt, including comments on the treatment of accrued but unpaid interest.

D. Interactions between sections 163(j) and 382

The addition of new section 163(j) under the TCJA has created numerous issues concerning the interaction of those interest deduction limitations with section 382. These proposed regulations attempt to eliminate the possibility of duplication of RBIL

items, as well as to clarify the treatment under section 382 of certain items that are allocated from a partnership.

1. Elimination of Possible Duplicative Recognized Built-in Loss

Proposed §1.382-7 addresses the possible duplicative application of section 382 to certain disallowed business interest expense carryforwards, including the portion of any disallowed business interest expense of the old loss corporation that is (i) paid or accrued in the taxable year of the testing date (as defined in §1.382-2(b)(4)), (ii) attributable to the pre-change period, and (iii) carried forward into later years (collectively, a section 382 disallowed business interest carryforward). Section 382 disallowed business interest carryforwards are subject to section 382 by virtue of section 382(d)(3), which treats any section 163(j)(2) carryover from a pre-change period as a pre-change loss. Additionally, such carryforwards are potentially subject to the section 382 limitation under section 382(h)(6) as RBIL. Section 382(h)(6)(B) provides that any amount allowable as a deduction during the recognition period (within the meaning of section 382(h)(7)), determined without regard to any carryover, that is attributable to periods before the change date is treated as a RBIL for the taxable year for which it is allowable as a deduction. Further, section 382(h)(6)(C) provides that the amount of NUBIG or NUBIL must be properly adjusted for amounts that would be treated as RBIG or RBIL under section 382(h)(6) if such amounts were properly taken into account or allowable as a deduction during the recognition period.

Section 382 disallowed business interest carryforwards should not be counted twice for purposes of the application of section 382. 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. Moreover, because disallowed business interest expense carryforwards would be absorbed before NOL carryovers under proposed §1.383-1(d), subjecting the same disallowed business interest expense carryforward to the section 382 regime twice could preclude taxpayers from utilizing their NOL carryovers or other attributes. In addition, treatment of disallowed business interest carryforwards as potential RBIL would result in an unwarranted increase in NUBIL (or decrease in NUBIG).

Accordingly, proposed §1.382-7(d)(5) would provide that section 382 disallowed business interest carryforwards would not be treated as RBIL under section 382(h)(6)(B) if such amounts were allowable as a deduction during the recognition period.

2. Treatment of Excess Business Interest Expense of a Partnership

Proposed §1.382-7 addresses the application of section 382(h) to excess business interest expense of a partnership to the extent that the item was not suspended under section 704(d) and is allocable to an old loss corporation (as partner) with regard to a period prior to an ownership change (section 382 excess business interest expense). Section 382(h)(3)(A)(i) provides that the amount of the old loss corporation's NUBIG or NUBIL includes the amount by which the aggregate fair market value of certain assets is more or less than the aggregate adjusted basis of such assets. As provided in section 163(j)(4)(B)(iii) and proposed §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. Therefore, proposed §1.382-7(c)(3)(iii)(E) would provide that, for purposes of determining RBIL under section 382(h)(2)(B)(ii), as well as for computing NUBIG or NUBIL under section 382(h)(3)(A), 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.

During the recognition period, a deduction or loss equal to the section 382 excess business interest expense could be recognized 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, such amount is properly characterized as RBIL. However, in either case, no 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 is included in the computation.

A partner also can be allocated section 382 excess business interest expense that is characterized as negative section 163(j) expense. See §1.163(j)-6(h)(1) as proposed in REG-106089-18 (83 FR 67490, 67556 (Dec. 28, 2018)). Negative section 163(j) expense does not reduce the partner's basis in the partnership and therefore would not be taken into account if the partner sold all or substantially all of its partnership interest. However, if the loss corporation were able to deduct the negative section 163(j) expense during the recognition period, then such expense presumably could be treated as RBIL pursuant to section 382(h)(6)(B). These proposed regulations do not address whether deductions resulting from negative section 163(j) allocations are RBIL.

The Treasury Department and the IRS request comments as to whether a corporate partner's section 382 excess business interest expense and negative section 163(j) expense should be treated as a built-in item under section 382(h)(6) or as a section 382 disallowed business interest carryforward, and therefore be treated as a pre-change loss.

Applicability Dates

Section 7805(b)(1)(A) and (B) of the Code generally provides that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the *Federal Register*, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the *Federal Register*.

Except as otherwise provided in the following sentence, these regulations are proposed to be effective for ownership changes occurring after the date the Treasury decision adopting these proposed regulations as final regulations is published in the *Federal Register*. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply these proposed regulations to any ownership change occurring during a taxable year with respect to which the period described in section 6511(a) has not expired, so long as the taxpayers and all of their related parties consistently apply the rules of these proposed regulations to such ownership change and all subsequent ownership changes that occur before the applicability date of final regulations.

Effect on Other Documents

The following publications are proposed to be withdrawn and obsoleted effective the day after the date the Treasury decision adopting these proposed regulations as final regulations is published in the *Federal Register*:

Notice 87-79 (1987-2 C.B. 387)

Notice 90-27 (1990-1 C.B. 336)

Notice 2003-65 (2003-2 C.B. 747)

Notice 2018-30 (2018-21 I.R.B. 610)

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 12866 and 13563 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including (i) potential economic, environmental, and public health and safety effects, (ii) potential distributive impacts, and (iii) equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

These proposed regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) (MOA) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these proposed regulations as significant under section 1(b) of the MOA. Accordingly, the OMB has reviewed these proposed regulations.

A. Background

In general, section 382 limits the usage of a corporation's tax attributes after that corporation experiences an ownership change. Limited tax attributes include, among other items, NOLs and built-in losses. The limit equals the product obtained by multiplying a prescribed interest rate by the value of the stock of the corporation (referred to as the "old loss corporation") on the change date. This product represents a proxy for the amount of income created by the assets held by the corporation prior to the ownership change. The section 382 limit reflects Congress's intent that, generally, NOLs should not be more valuable to an acquirer than to the going concern that created them. In the conference report to the Tax Reform Act of 1986, Congress expressed that the previously described formula "is necessary to ensure that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation." H.R. Rep. No. 99-841, at II-185 (1986).

Section 382(h) specifies the treatment of gains and losses accrued by a corporation prior to a change in ownership. As explained in the legislative history, the rules are intended to treat built-in gains and losses that are recognized after the ownership change the same as if they had been recognized before the ownership change. As described by Congress, "[i]f built-in losses were not subject to limitations, taxpayers could reduce or eliminate the impact of the general rules by causing a loss corporation (following an ownership change) to recognize its built-in losses free of the special limitations (and then invest the proceeds in assets similar to the assets sold)." Joint Committee on Tax'n, General Explanation of the Tax Reform Act of 1986 (Pub. L. 99-514) (May 4, 1987), JCS-10-87, at p. 298. The neutral treatment of gains and losses

recognized before and after a change in ownership is accomplished by allowing the recognition of built in gain to increase the section 382 limitation whereas the recognition of built in loss is subject to the section 382 limitation.

The following example (Example 1) illustrates this principle. Assume that a loss corporation (LossCorp), as of the change date, has \$500 in NOL carryforwards and holds only one asset (Asset A) with a fair market value of \$100 and a basis of \$120. If LossCorp disposed of Asset A immediately prior to the ownership change, a \$20 loss would be recognized. Additionally, assuming the taxpayer made a closing-of-the-books election under §1.382-6(b), the amount of the NOL carryforwards would be \$520. If instead, Asset A was disposed of after the change date, then sections 382(h)(1) and 382(h)(2) recognize that the \$20 loss is attributable to the period prior to the ownership change and therefore subject it to a section 382 limitation in the same manner as if it was an NOL carryforward (disregarding a de minimis threshold rule set forth in section 382(h)(3)(B)). In the language of section 382, the \$20 loss would be RBIL (that is, recognized built-in loss). These rules operate to eliminate the significance of the disposition's timing and preserve neutrality.

Alternatively, assume in this example (Example 2) that Asset A's fair market value on the change date were \$150, and thus LossCorp had a built-in gain on the asset. If LossCorp disposed of Asset A prior to the change date, assuming the taxpayer made a closing-of-the-books election under §1.382-6(b), then the \$30 in income would reduce its NOL carryforward to \$470. If instead Asset A were disposed of after the change date, then sections 382(h)(1) and 382(h)(2) recognize that the \$30 gain is attributable to the period prior to the ownership change and therefore increases

LossCorp's section 382 limitation for the year (disregarding the de minimis threshold rule set forth in section 382(h)(3)(B)), thereby allowing LossCorp to freely use the pre-change NOLs to offset the \$30 in income. In the language of section 382, the \$30 in income would be RBIG (that is, recognized built-in gain). In this fact pattern, the rules under section 382 would eliminate the significance of the disposition's timing and preserve neutrality by allowing the NOLs to be applied following the ownership change with respect to gain that was "built-in" prior to the ownership change.

Under section 382(h), the total amount of RBIL must not exceed NUBIL (that is, net unrealized built-in loss) and the total amount of RBIG must not exceed NUBIG (that is, net unrealized built-in gain). More precisely, at the change date, a loss corporation must compute the difference between the aggregate fair market value and aggregate basis of all of its assets. In general, (i) to the extent that this difference is positive, a NUBIG results; and (ii) to the extent that the difference is negative, a NUBIL results. Both NUBIG and NUBIL are adjusted by section 382(h)(6)(C), as discussed below. NUBIG and NUBIL act as limitations to the aggregate amount of RBIG and RBIL recognized during the recognition period. For illustration, if Example 2 were modified so that LossCorp owned additional assets such that it had NUBIL, the disposition of Asset A would not create RBIG.

These proposed regulations would primarily address the subcomponents of RBIL, RBIG, NUBIL, and NUBIG that are provided for by section 382(h)(6). Specifically, section 382(h)(6)(A) provides that income items that are "properly taken into account during the recognition period," but which are "attributable to periods before the change date," are treated as RBIG. Section 382(h)(6)(B) provides a similar rule for deductions

to be treated as RBIL. Section 382(h)(6)(C) provides that the amount of potential income items under section 382(h)(6)(A) increases NUBIG (or reduces NUBIL), whether or not the income items were actually taken into account during the recognition period. Analogously, section 382(h)(6)(C) provides that the amount of potential deduction items under section 382(h)(6)(B) increases NUBIL (or reduces NUBIG), whether or not the deduction items were actually allowable as a deduction during the recognition period. The proposed regulations clarify the definition and calculation of these components.

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

In response to substantial uncertainty regarding which income and deduction items qualify under section 382(h)(6), the IRS issued Notice 2003-65. Generally, Notice 2003-65 provides two safe harbors for computing these items. The first safe harbor, referred to as the “1374 approach” (named after section 1374, which addresses tax consequences regarding built-in gains of C corporations that become S corporations), relies generally on accrual method of accounting principles. The second safe harbor, referred to as the “338 approach,” compares actual amounts of income and deductions to the amounts that would have been realized had a section 338 election been made with respect to a hypothetical stock purchase on the change date. Notice 2018-30

amended Notice 2003-65 by reversing an unintended change to both safe harbors that resulted from TCJA amendments to section 168(k).

Broadly, for reasons discussed below, these proposed regulations would make mandatory the 1374 approach with certain adjustments. These adjustments include technical fixes to calculations involving COD income (that is, cancellation of indebtedness income), deductions for contingent liabilities, and cost recovery deductions. Additionally, these proposed regulations clarify that carryovers of section 163(j) disallowed business interest are counted only once for the purpose of section 382.

B. No-action Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

C. Economic Analysis of Proposed Regulations

1. Framework

In evaluating the economic efficiency of these proposed regulations, this analysis considers two main factors. The first factor regards compliance and administration costs. Mergers and acquisitions can be very complicated transactions; thus, compliance with certain aspects of Federal income tax law can be onerous for taxpayers, and examination can be difficult for the IRS. As discussed further below the Treasury Department projects that the proposed regulations will reduce compliance and enforcement costs relative to the baseline primarily by eliminating duplicative and potentially complicated calculations required to apply the 338 approach. Greater

efficiencies will also be gained under the proposed regulations by reducing taxpayer disputes with the IRS regarding the application of the 1374 approach.

The second factor considered is whether changes in mergers and acquisitions potentially induced by the proposed regulations are likely to be efficiency-enhancing or efficiency-reducing. If a merger increases value only because of increased potential NOL usage, then that merger would be economically inefficient (even ignoring antitrust concerns). Section 382 attempts to ensure that the NOLs of the loss corporation can be used to the same extent whether or not the loss corporation is acquired by another corporation, which implies that no transaction would take place solely to increase NOL use. However, currently issued guidance regarding section 382 may not strike that balance perfectly. It is the determination of the Treasury Department and the IRS that, for the reasons discussed below, the currently issued guidance on section 382(h) allows too much NOL usage relative to the neutral baseline. These proposed regulations would modestly restrict NOL usage by reducing the amount that would qualify as RBIG, reducing the incentive to engage in inefficient, tax-motivated mergers and acquisitions.

The Treasury Department and the IRS have not quantified the expected gains to the U.S. economy arising from the discretionary aspects of the proposed regulations but expect them to be less than \$100 million per year (\$2019), a threshold established by the MOA and Executive Order 12866. For reasons discussed further in section C.2. of the analysis, the Treasury Department and IRS project that the effect of the proposed regulations on the number of mergers and acquisitions will be small. The Treasury Department and the IRS additionally project that the change (that is, reduction) in compliance costs will also be modest. The Treasury Department and the IRS solicit

comments on this conclusion and particularly solicit comments that provide data, evidence, or models that would enhance the rigor by which the non-revenue economic effects might be determined for the final regulations.

2. Making the 1374 approach mandatory

The Treasury Department and the IRS have determined that the 1374 approach would be simpler for taxpayers to comply with, and simpler for the IRS to administer. Under Notice 2003-65, as modified by Notice 2018-30, taxpayers subject to section 382 would typically compute estimates of NUBIG/NUBIL and RBIG/RBIL under both the 1374 and 338 approaches to determine which approach would provide the more favorable result. Such duplicative compliance costs are inherently economically wasteful, even if they may have been privately optimal (in other words, they generated expected tax savings for the corporation in excess of compliance costs). Under these proposed regulations, taxpayers would make computations under only one approach, thereby reducing inefficient compliance burdens.

In addition, the 1374 approach has lower compliance costs than the 338 approach. Under the 1374 approach, taxpayers need only record items of income and deductions that they already account for under well-known accrual method of accounting principles. Furthermore, the IRS can easily verify such amounts during an examination. Under the 338 approach, taxpayers must consider a hypothetical transaction involving deemed asset sales. With respect to tiered corporate structures, an ownership change of the corporate parent would require the analysis of deemed asset sales not only at the corporate-parent level, but also an analysis of deemed asset

sales at every lower corporate level. The 338 approach would pose significant, iterative complexity for corporate structures with several tiers of subsidiaries.

The Treasury Department and the IRS have determined that between 7,000 and 15,000 firms per year will be affected by these proposed regulations, based on the checkbox on Line 16 of Form 1120, Schedule K and other tax attributes. These firms will see a reduction in compliance costs under the 1374 approach, if they were using the 338 approach or performing calculations under both approaches under the baseline. The Treasury Department and the IRS request public comment on any anticipated changes in compliance costs due to the proposed elimination of the 338 approach.

The Treasury Department and the IRS project that the adoption of the 1374 approach as the sole approach under section 382(h) will not have a large effect on the number of mergers and acquisitions that take place. Such adoption of the 1374 approach will make certain mergers and acquisitions somewhat less attractive. However, the Treasury Department and the IRS have determined that, historically, most acquiring corporations behave as if section 382 will limit the ability to utilize substantially all pre-change NOLs. This heuristic behavior implies that firms will not be highly responsive to the changes set forth by these proposed regulations.

It is important to note that any merger or acquisition dissuaded by these proposed regulations would tend to have been economically inefficient not have been undertaken except for the purpose of reducing tax liability. Recall from Part C.1 of this section that the goal of section 382 is to ensure that NOL usage is approximately unaffected when a loss corporation is acquired by a profitable corporation. The Treasury Department and the IRS have determined that the ability to toggle between

the 338 approach and the 1374 approach allows more NOL usage in the case of an acquisition than would be the case if the loss corporation continued independently. By eliminating the 338 approach, these proposed regulations move closer to a neutral, economically efficient position.

In particular, the most notable feature of the 338 approach is that assets with built-in gains can generate RBIG even without a realization event. This is generally advantageous for taxpayers. This treatment follows from the logic that such built-in gain assets would have generated income in subsequent years; in the absence of an acquisition, such income could have been offset freely by the old loss corporation's NOLs. The 338 approach prescribes a proxy for that excess income amount: the extent to which cost recovery deductions (disregarding bonus depreciation under section 168(k), per Notice 2018-30) under a hypothetical purchase of each asset at its current fair market value exceed actual allowable cost recovery deductions.

The Treasury Department and the IRS have determined that this treatment of built-in gain assets under the 338 approach is problematic for two reasons. First, the schedules for cost recovery deductions were never intended to match the production of income from each asset; rather, they were intended to accelerate cost recovery to stimulate investment. Thus, this proxy is likely to, on average, overstate income created by those assets, further increasing NOL usage beyond the neutral baseline. Second, such an adjustment for income created by built-in gain assets is unnecessary, as it is already taken into account by section 382. Section 382 provides that the NOLs of the old loss corporation can be used by the new loss corporation up to the annual limit. This annual limit is equal to a prescribed interest rate multiplied by the value of the stock

of the old loss corporation, and serves as a proxy for the income created by the assets of the old loss corporation. Thus, to the extent that the appreciated value of a built-in gain asset is reflected in the value of the stock, the general rule of section 382 allows for the NOLs of the old loss corporation to offset the flow of income created by that asset. Therefore, the treatment created by the 338 approach creates a double benefit. By eliminating this treatment, the proposed regulations reduce the attractiveness of inefficient, tax-motivated acquisitions, which enhances economic efficiency.

3. Modification to treatment of COD income

The proposed regulations also modify the treatment of COD income under the 1374 approach. The baseline rules provide that COD income enters into the NUBIG/NUBIL calculations without regard to whether that income was ultimately included in, or excluded from, income by the new loss corporation under the rules of section 108. This issue is especially relevant under the consolidated return regulations regarding the application of section 108. Such regulations provide that, generally, when a member leaves its consolidated group, excluded COD income will be taken into account by the consolidated group and not the new loss corporation. Therefore, inclusion of the COD amount in the NUBIG/NUBIL calculations does not reflect the economic reality of the taxpayer and may inappropriately influence a taxpayer's decision of whether to voluntarily enter into bankruptcy. The proposed regulations address this issue by ensuring that COD income enters into the RBIG and NUBIG/NUBIL calculations only to the extent actually taken into account by the new loss corporation. The Treasury Department and the IRS have determined that this revision will treat different types of transactions more neutrally. Such treatment will increase economic

efficiency by causing taxpayers to choose transactions that are optimal for non-tax reasons rather than for tax reasons.

4. Modification to treatment of contingent liabilities

These proposed regulations would revise the 1374 approach with respect to the treatment of contingent liabilities. Under Notice 2003-65, the estimated value of contingent liabilities (as of the change date) was included in the NUBIG/NUBIL calculation. However, the ultimate payment of such liability did not give rise to RBIL. This asymmetry violates the principle of neutrality between pre-change and post-change deductions. If the old loss corporation were able to pay a third party to assume the liability prior to the ownership change, it would generate a deduction that increases the pre-change NOLs, which would be limited after the ownership change. If the liability were not treated as RBIL, the post-change realization of that liability could freely offset other sources of income. This non-neutrality may distort decision-making and reduce economic efficiency.

These proposed regulations would address this issue by providing that payments of contingent liabilities represent RBIL to the extent of the estimated value of the contingent liability as of the change date.

5. Modification to treatment of cost recovery deductions

Section 382(h)(6)(B) provides that cost recovery deductions during the recognition period are treated as RBIL, except to the extent that the new loss corporation can establish that the deduction is not attributable to a built-in loss. Intuitively, RBIL includes cost recovery deductions taken against assets whose depreciation deductions are too large relative to the value of the asset. Under the

baseline rules of Notice 2003-65, the suggested approach is to compare (1) actual depreciation deductions on a given asset to (2) the depreciation deductions that would be allowable (disregarding bonus depreciation under section 168(k), per Notice 2018-30) if the asset were hypothetically purchased at the change date from a third party at its fair market value. The excess of (1) over (2) is treated as RBIL. 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. In particular, it is possible to create RBIL even when the fair market value is equal to the adjusted basis.

These proposed regulations would abandon that 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. This will generally narrow the role of such RBIL treatment to taxpayers with an asset with a fair market value that is less than adjusted basis. Given the front-loading of depreciation schedules (including under section 168(k)), the Treasury Department and the IRS project that the new rule will cause RBIL to be calculated for far fewer taxpayers and thus the change will reduce compliance burden. Additionally, the new rule will generally cause an increase in allowable NOLs by reducing RBIL, contrary to the other rule changes in these proposed regulations. However, the Treasury Department and IRS project that the effect of this change (in terms of generated RBIL/RBIG) will be quantitatively less significant than other modifications, such as the elimination of the section 338 approach.

6. Clarification of treatment of disallowed business interest expense

Section 382(d)(3) provides that carryovers of disallowed interest under section 163(j) (as amended by the TCJA) are to be treated analogously to NOLs, meaning that their use would be limited after an ownership change. Additionally, the general rules of section 382(h)(6) could be interpreted to cause such disallowed interest to be RBIL if recognized during the recognition period, as they may be “allowable as a deduction during the recognition period” but “attributable to periods before the change date.” Such treatment would cause section 163(j) carryovers to be counted twice for the purpose of section 382.

These proposed regulations would preclude this possibility by clarifying that the use of section 163(j) carryovers during the recognition period would not give rise to RBIL. This proposed clarification would provide certainty to taxpayers that section 382 will operate as intended in this regard.

II. Paperwork Reduction Act

Pursuant to §1.382-11, a loss corporation must include a statement on or with its tax return for each taxable year that it is a loss corporation in which an owner shift, equity structure shift, or other transaction described in §1.382-2T(a)(2)(i) occurs. The statement must include, among other things, attributes described in §1.382-2(a)(1)(i) that caused the corporation to be a loss corporation. One of the attributes described in §1.382-2(a)(1)(i) is a loss corporation’s NUBIL (that is, net unrealized built-in loss), if any. The existing collection of information under §1.382-11 has been reviewed and approved by the OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (PRA) under OMB control number 1545-2019. The collection of

information is necessary to enable the IRS to verify the amount of any attributes that are subject to section 382.

These proposed regulations provide guidance regarding the calculation of built-in gains and losses under section 382, including whether a corporation has a NUBIL. Therefore, these proposed regulations could cause a corporation to have a NUBIL when they would not have had one in the absence of these proposed regulations. As a result, a corporation would have to file a statement under §1.382-11, or include an item on its statement under §1.382-11, when the corporation would not have had to do so in the absence of these proposed regulations. The §1.382-11 statement is a one-time paperwork burden that is required to be filed in the taxable year during which an owner shift, equity structure shift, or other transaction described in §1.382-2T(a)(2)(i) occurs. On the other hand, these proposed regulations, if finalized, also could cause some firms to no longer have a NUBIL, thereby eliminating their requirement to file a statement under §1.382-11. Furthermore, by eliminating the 338 approach, the Treasury Department and the IRS project that compliance burdens will fall for most existing filers of the §1.382-11 statement. The Treasury Department and the IRS have based this projection on their observations that (i) taxpayers currently incur costs to compute their NUBIG/NUBIL under each of the two methods in order to be able to choose the more beneficial method, and (ii) the 338 approach requires taxpayers to determine hypothetical amounts (for example, what depreciation would have been available in the case of a deemed asset sale under section 338). As a result, removing the hypothetical computations, as well as the optionality, will reduce compliance burden.

For purposes of the PRA, the reporting burden associated with these proposed

regulations will be reflected in the collection of information under §1.382-11 (OMB control number 1545-2019). The aggregate estimates for all collection of information conducted under OMB control number 1545-2019, including the §1.382-11 statement and other statements, are that 225,000 respondents will require 1 hour and 40 minutes per response for a total annual reporting burden of 375,000 hours and total annual monetized costs of \$15,930,000 (2016 dollars). The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under these proposed regulations.

Based on the checkbox on Line 16 of Form 1120, Schedule K and other tax attributes, the Treasury Department and the IRS estimate that between 7,000 and 15,000 firms per year will be affected by these proposed regulations. The Treasury Department and the IRS estimate that these proposed regulations will, if anything, cause a slight reduction in the total amount of paperwork burden for most affected taxpayers. This reduction in burden is driven by the elimination of the 338 approach. As a result of such elimination, taxpayers may perform fewer calculations when complying with section 382. The Treasury Department and the IRS, however, have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

The IRS has posted information for taxpayers on their recordkeeping requirements at <https://www.irs.gov/taxtopics/tc305>. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

The Treasury Department and the IRS request comments on all aspects of information collection burdens relating to these proposed regulations, including (i) estimates for how much time it would take to comply with the paperwork burdens described earlier for each relevant form and (ii) ways for the IRS to minimize the paperwork burden. Proposed revisions to the information collections contained in these proposed regulations will not be finalized until after these regulations take effect and have been approved by OMB under the PRA. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates would capture both changes made by the TJCA and those that arise out of discretionary authority exercised in the proposed regulations.

III. Regulatory Flexibility Act

As described in more detail in this section, pursuant to the Regulatory Flexibility Act (RFA), 5 U.S.C. chapter 6, the Treasury Department and the IRS hereby certify that these proposed regulations will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments on any impact that these regulations would have on small entities.

These proposed regulations, if finalized, would amend the calculation of certain

items under section 382, which pertains to the tax attributes of certain acquired corporations (known as “loss corporations”) in the hands of the acquiring corporation after an ownership change. Broadly, the proposed regulations, if finalized, would (i) eliminate one safe harbor under which firms were formerly entitled to calculate items of income and deduction under section 382(h)(6), and (ii) make a number of other conforming changes. In particular, these regulations could change the amount of net unrealized built-in gain or loss (NUBIG and NUBIL, respectively) computed by the loss corporation. Importantly, section 382(h)(3)(B) provides a de minimis rule for which it is expected that substantially all small entities will qualify. Specifically, if a loss corporation’s NUBIG or NUBIL is not greater than the lesser of (i) 15 percent of the fair market value of the loss corporation’s non-cash corporate assets on the ownership change or (ii) \$10 million, then the loss corporation’s NUBIG or NUBIL is deemed to be zero. Furthermore, these proposed regulations would not change this de minimis rule. Therefore, to the extent that small firms understood that they historically qualified for the de minimis rule, substantially all of them could determine, with little burden, that they will qualify as well under these proposed regulations (if finalized). The Treasury Department and the IRS invite comments on the impact of these proposed rules on small entities.

Comments and Requests for Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "**ADDRESSES**" heading. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be

available at www.regulations.gov for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, then notice of the date, time, and place for the public hearing will be published in the *Federal Register*.

Drafting Information

The principal authors of this notice of proposed rulemaking are Kevin M. Jacobs and Marie C. Milnes-Vasquez of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.382-7 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.382-7 also issued under 26 U.S.C. 382(h)(3)(B)(ii) and (m).

* * * * *

Par. 2. Section 1.382-1 is amended by:

- a. Under §1.382-2, adding reserved entries for (a)(7) and (8) and entries for (a)(9) through (13), and (b)(4); and
- b. Revising the entry for §1.382-7.

The additions and revision read as follows:

§1.382-1 Table of contents.

* * * * *

§1.382-2 General rules for ownership change.

(a) * * *

(7) [Reserved]

(8) [Reserved]

(9) Net unrealized built-in gain.

(10) Net unrealized built-in loss.

(11) Recognized built-in gain.

(12) Recognized built-in loss.

(13) Section 382 regulations.

(b) * * *

(4) Rules provided in paragraphs (a)(9) through (13) of this section.

* * * * *

§1.382-7 Built-in gains and losses.

(a) Overview.

(b) Definitions.

(1) Change year.

(2) Cost recovery deduction.

(3) First-year nonrecourse COD income.

(4) First-year recourse COD income.

(5) Inadequately secured nonrecourse liabilities.

(6) Negative section 163(j) expense.

(7) Nonrecourse liabilities.

(8) Pre-change excess recourse liabilities.

(9) Recognition period.

(10) Section 382 asset.

(11) Section 382 excess business interest expense.

(12) Taxable income or timing limitation.

(c) Net unrealized built-in gains and losses.

(1) In general.

(2) Consistency rules.

(i) In general.

(ii) Members of consolidated groups.

- (3) Computation of net unrealized built-in gain and net unrealized built-in loss.
 - (i) In general.
 - (ii) Adjustments related to discharge of indebtedness.
 - (A) In general.
 - (B) Exception for first-year recourse COD income.
 - (1) Discharge of indebtedness income included in gross income.
 - (2) Excluded discharge of indebtedness income reducing post-ownership change attributes.
 - (3) Excluded discharge of indebtedness income reducing basis.
 - (iii) Additional operating rules.
 - (A) Value of contingent liabilities.
 - (B) Inventory.
 - (C) Limitation on total amount of adjustment to NUBIL/NUBIG regarding recourse COD income.
 - (D) Timing of adjustments described in paragraphs (c)(3)(ii)(B)(1) through (3) of this section.
 - (E) Adjusted basis of the loss corporation's section 382 assets.
 - (F) [Reserved]
 - (d) Recognized built-in gain and loss.
 - (1) In general.
 - (2) Recognized built-in gain.
 - (i) In general.
 - (ii) Disposition of an asset.
 - (iii) Income from discharge of indebtedness attributable to certain recourse liabilities.
 - (iv) Income from discharge of indebtedness attributable to certain nonrecourse liabilities.
 - (A) Treatment as RBIG.
 - (B) Adjustment to basis.
 - (C) Limitation on total amount of RBIG regarding nonrecourse COD income.
 - (D) No adjustment to the NUBIG/NUBIL computation.
 - (v) Installment method.
 - (vi) Prepaid income.
 - (3) Recognized built-in loss.
 - (i) In general.
 - (ii) Disposition of an asset.
 - (iii) Cost recovery deductions.
 - (iv) Bad debt expense.
 - (v) Deductions for payments on certain liabilities.
 - (vi) Deduction for section 382 excess business interest expense.
 - (A) In general.
 - (B) No adjustment to the NUBIG/NUBIL computation.
 - (4) Additional recognized built-in gain and loss items.
 - (5) Section 382 disallowed business interest carryforwards.
 - (e) General operating rules.
 - (1) Anti-duplication rule.
 - (2) References to the principles of regulations under section 1374.
 - (f) Examples.

- (g) Applicability dates.
 - (1) In general.
 - (2) Paragraph (d)(2)(vi) of this section.
- * * * * *

Par. 3. Section 1.382-2 is amended by adding reserved paragraphs (a)(7) and (8) and paragraphs (a)(9) through (13) and (b)(4) to read as follows:

§1.382-2 General rules for ownership change.

(a) * * *

(7) - (8) [Reserved]

(9) Net unrealized built-in gain. The term net unrealized built-in gain means a positive amount determined under §1.382-7(c)(3).

(10) Net unrealized built-in loss. The term net unrealized built-in loss means a negative amount determined under §1.382-7(c)(3).

(11) Recognized built-in gain. The term recognized built-in gain has the meaning provided in §1.382-7(d)(2).

(12) Recognized built-in loss. The term recognized built-in loss has the meaning provided in §1.382-7(d)(3).

(13) Section 382 regulations. The term section 382 regulations means this section and §§1.382-3 through 1.382-12.

(b) * * *

(4) Rules provided in paragraphs (a)(9) through (13) of this section. The rules of paragraphs (a)(9) through (13) of this section apply to any ownership change occurring after date of publication of Treasury decision adopting these proposed regulations as final regulations in the *Federal Register*. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of paragraphs

(a)(9) through (13) of this section to any ownership change occurring during a taxable year with respect to which the period described in section 6511(a) has not expired, so long as the taxpayers and their related parties consistently apply the rules of paragraphs (a)(9) through (13) of this section and §1.382-7 to such ownership change and all ownership changes occurring in subsequent taxable years.

Par. 4. Section 1.382-7 is revised to read as follows:

§1.382-7 Built-in gains and losses.

(a) Overview. This section provides rules governing the determination of a loss corporation's net unrealized built-in gain or net unrealized built-in loss, as well as its recognized built-in gains and recognized built-in losses for purposes of section 382 and the section 382 regulations. Paragraph (b) of this section provides definitions of terms used for purposes of this section. Paragraph (c) of this section provides the rules regarding the determination of a loss corporation's net unrealized built-in gain or net unrealized built-in loss. Paragraph (d) of this section provides the rules regarding the determination of a loss corporation's recognized built-in gain or recognized built-in loss. Paragraph (e) of this section provides an anti-duplication rule to prevent duplicate inclusion of items in the computation of net unrealized built-in gain or net unrealized built-in loss, or in the computation of recognized built-in gain or recognized built-in loss. Paragraph (f) of this section provides examples illustrating the rules of this section. Paragraph (g) of this section provides applicability dates for the rules of this section.

(b) Definitions. The following definitions apply for purposes of this section.

(1) Change year. The term change year has the meaning provided in §1.382-6(g)(1).

(2) Cost recovery deduction. The term cost recovery deduction means any deduction for depreciation under section 167 or section 168, any deduction for the amortization of intangibles (for example, under section 167 or 197) and amortizable expenditures (for example, under section 195(b)(1)(B), section 248 or section 1245(a)(2)(C)), or any deduction for depletion under section 611.

(3) First-year nonrecourse COD income. The term first-year non-recourse COD income means any income from discharge of indebtedness that the loss corporation recognizes (including income that is excluded from gross income under section 108(a)(1)) during the first twelve months of the recognition period on inadequately secured nonrecourse liabilities.

(4) First-year recourse COD income. The term first-year recourse COD income means any income from discharge of indebtedness (including from liabilities described in paragraph (c)(3)(i)(C) of this section) that the loss corporation recognizes (including income that is excluded from gross income under section 108(a)(1)) during the first twelve months of the recognition period on all of the loss corporation's liabilities immediately before the ownership change (excluding nonrecourse liabilities) to the extent of its pre-change excess recourse liabilities.

(5) Inadequately secured nonrecourse liabilities. The term inadequately secured nonrecourse liabilities means any nonrecourse liability of which, immediately before the ownership change:

(i) The adjusted issue price (within the meaning of §1.1275-1(b)) of the nonrecourse liability; exceeds

(ii) The fair market value of the property (determined without regard to section 7701(g) and §1.1001-2(a)(4)(i)) which secures such nonrecourse liability.

(6) Negative section 163(j) expense. The term negative section 163(j) expense has the meaning provided in §1.163(j)-6(h)(1).

(7) Nonrecourse liabilities. The term nonrecourse liabilities has the same meaning as the term nonrecourse liability has in §1.1001-2(a)(4)(i).

(8) Pre-change excess recourse liabilities. The term pre-change excess recourse liabilities means:

(i) If the loss corporation is under the jurisdiction of a court under title 11 of the United States Code on the change date, in an action that results in a discharge of recourse liabilities of the loss corporation, then the amount of all of the loss corporation's liabilities immediately before the ownership change (excluding nonrecourse liabilities) that are discharged by order of the court in that action; or

(ii) In all other cases, an amount equal to the excess, if any, of:

(A) The aggregate adjusted issue price (within the meaning of §1.1275-1(b)) of the loss corporation's liabilities immediately before the ownership change, excluding--

(1) Recourse liabilities to the extent that they would not be included in the determination of whether the loss corporation is insolvent within the meaning of section 108(d)(3), and

(2) Nonrecourse liabilities; over

(B) The sum of the fair market value of the assets that the loss corporation owns immediately before the ownership change, reduced, but not below zero, by the amount

of nonrecourse liabilities that is secured by such assets immediately before the ownership change.

(9) Recognition period. The term recognition period has the meaning provided in section 382(h)(7)(A).

(10) Section 382 asset. The term section 382 asset means any asset that the loss corporation owns immediately before the ownership change, including goodwill and other intangible assets, but excluding those assets described in section 382(h)(3)(B)(ii). For purposes of this definition, all accounts receivable, other than those that were acquired in the ordinary course of the loss corporation's business, are treated as items described in section 382(h)(3)(B)(ii).

(11) Section 382 excess business interest expense. The term section 382 excess business interest expense means the amount of business interest expense of a partnership for a taxable year that was disallowed under §1.163(j)-2(b) but not suspended under section 704(d).

(12) Taxable income or timing limitation. The term taxable income or timing limitation means:

(i) A limitation set forth in the Internal Revenue Code of 1986, as amended (Code), on the amount of a deduction that may otherwise be claimed by a loss corporation, based on, or derived from, any amount of a loss corporation's taxable income (see, for example, section 170(b)(2)(A)); or

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

(c) Net unrealized built-in gains and losses--(1) In general. This paragraph (c) provides rules regarding the calculation of a loss corporation's net unrealized built-in gain or net unrealized built-in loss for purposes of section 382 and the section 382 regulations. See paragraph (e)(1) of this section (regarding anti-duplication).

(2) Consistency rules--(i) In general. No amount is included in the calculation of net unrealized built-in gain or net unrealized built-in loss if the amount is properly allocable to the pre-change period (within the meaning of §1.382-6(g)(2)) pursuant to §1.382-6 and is included in the determination of the loss corporation's taxable income or net operating loss for the change year.

(ii) Members of consolidated groups. If a loss corporation enters or leaves a consolidated group on the date of an ownership change for purposes of section 382, the principles of §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 (within the meaning of §1.1502-76(b)(1)(ii)(A)) or otherwise) in the taxable year that ends as a result of the change in status of a loss corporation (S) are not treated as recognized or taken into account during the recognition period for purposes of section 382 and the section 382 regulations. See §1.1502-28(b)(11) (regarding allocation of excluded COD income under end of the day rule principles). Moreover, no such item is included in the determination of net unrealized built-in gain or net unrealized built-in loss. For example, if income from the discharge of indebtedness is includable in the taxable year that ends as a result of S's change in status, that income is neither treated as taken into account during the recognition period nor included in the determination of net unrealized built-in gain or net unrealized built-in loss. Further, the determination of

net unrealized built-in gain or net unrealized built-in loss excludes the fair market value and basis of any asset that is disposed of on the change date if the gain or loss from that asset is includible in the taxable year that ends as a result of S's change in status. In contrast, items that are includible (under the next day rule (within the meaning of §1.1502-76(b)(1)(ii)(B)) or otherwise) in the taxable year that begins as a result of S's change in status are treated as occurring in the recognition period, and those items (and the basis and fair market value of any assets that generate those items) are among the amounts included in the determination of net unrealized built-in gain or loss.

(3) Computation of net unrealized built-in gain and net unrealized built-in loss--(i)

In general. A loss corporation's net unrealized built-in gain, if positive, or net unrealized built-in loss, if negative, is the amount equal to--

(A) The sum of the amount that would be realized (taking into account section 382(h)(8)) if, immediately before the ownership change, the loss corporation--

(1) Had satisfied each inadequately secured nonrecourse liabilities by surrendering to the creditor all of the assets securing that debt; and

(2) Had sold all of its section 382 assets (other than those assets described in paragraph (c)(3)(i)(A)(1) of this section) at fair market value to an unrelated third party with the hypothetical buyer assuming no liabilities; 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 liability of the loss corporation immediately before the ownership change for which the loss corporation would be allowed a

deduction (including a deduction for a capital loss) on payment of the liability (determined without regard to any taxable income or timing limitation); decreased by

(D) The estimated value of any liability of the loss corporation that is contingent immediately before the ownership change, for which, upon the removal of the contingency, the loss corporation would be allowed a deduction (including a deduction for a capital loss) on payment or accrual (determined without regard to any taxable income or timing limitation); increased or decreased by

(E) The loss corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (c)(3)(i)(A) of this section; increased by

(F) The amount that would be treated as recognized built-in gain under paragraph (d)(2) of this section if all amounts (except for amounts described in paragraph (d)(2)(ii) of this section) were properly taken into account during the recognition period; decreased by

(G) The amount that would be treated as recognized built-in loss under paragraph (d)(3) of this section if all amounts (except for amounts described in paragraph (d)(3)(ii) of this section) were properly taken into account during the recognition period.

(ii) Adjustments related to discharge of indebtedness--(A) In general. Except as provided in paragraph (c)(3)(ii)(B) of this section, no amount of discharge of indebtedness income recognized during the recognition period that is included in gross income under section 61(a)(12) or excluded under section 108(a) is added to the computation of the loss corporation's net unrealized built-in gain or net unrealized built-in loss. See paragraphs (c)(2) and (c)(3)(iii)(C) of this section for limitations on amounts

that can be included in the computation of net unrealized built-in gain and net unrealized built-in loss.

(B) Exception for first-year recourse COD income. A loss corporation may apply the provisions of this paragraph (c)(3)(ii)(B) to all of its first-year recourse COD income, subject to the timing rules of paragraphs (c)(3)(iii)(D) of this section. An adjustment that is made pursuant to this paragraph (c)(3)(ii)(B) can cause a loss corporation that would otherwise have a net unrealized built-in loss to have a net unrealized built-in gain or to meet the requirements of section 382(h)(3)(B) such that the loss corporation's net unrealized built-in gain or net unrealized built-in loss is zero. See paragraphs (c)(2) and (c)(3)(iii)(C) of this section for limitations on amounts that can be included in the computation of net unrealized built-in gain and net unrealized built-in loss.

(1) Discharge of indebtedness income included in gross income. The amount calculated under paragraph (c)(3)(i) of this section is increased by the amount of all first-year recourse COD income that is included in gross income under section 61(a)(12). This amount of first-year recourse COD income is treated as recognized built-in gain. See paragraph (d)(2)(iii) of this section.

(2) Excluded discharge of indebtedness income reducing post-ownership change attributes. The amount calculated under paragraph (c)(3)(i) of this section is increased by the amount of all first-year recourse COD income that is excluded under section 108(a), to the extent section 108(b) reduces attributes that are not pre-change losses, as defined in §1.382-2(a)(2), including reduction under section 1017(a) of the basis of the loss corporation's assets that were not held at the time of the ownership change. This amount of first-year recourse COD income is treated as recognized built-in gain.

See paragraph (d)(2)(iii) of this section. This paragraph (c)(3)(ii)(B)(2) does not apply to amounts of first-year recourse COD income corresponding to debt whose discharge results in reduction under section 1017(a) of the basis of the loss corporation's assets that were held at the time of the ownership change.

(3) Excluded discharge of indebtedness income reducing basis. A loss corporation decreases the amount of basis that is described in paragraph (c)(3)(i)(B) of this section by the amount of first-year recourse COD income that is excluded under section 108(a), to the extent that section 1017(a) reduces the basis of the loss corporation's section 382 assets. No other adjustment to the computation in paragraph (c)(3)(i) of this section is made with respect to the first-year recourse COD income described in this paragraph (c)(3)(ii)(B)(3), and this amount of first-year recourse COD income is not treated as recognized built-in gain.

(iii) Additional operating rules--(A) Value of contingent liabilities. If any liability described in paragraph (c)(3)(i)(C) of this section is reflected on the face of the most recently issued applicable financial statement, within the meaning of section 451(b)(3) and the regulations in this part under section 451 of the Internal Revenue Code (determined without regard to whether the taxpayer has another statement described in section 451(b)(3) and the regulations in this part under section 451 of the Internal Revenue Code), then the estimated value of a liability is the amount of such liability reflected on the most current applicable financial statement as of the change date. The estimated value of any liability described in paragraph (c)(3)(i)(C) of this section is not adjusted to reflect the actual amount of liability that is established on removal of the contingency.

(B) Inventory. The principles of §1.1374-7 apply to determine the amount realized under paragraph (c)(3)(i)(A) of this section with regard to inventory.

(C) Limitation on total amount of adjustment to NUBIL/NUBIG regarding recourse COD income. The total amount of increases in the calculation of net unrealized built-in gain or loss under paragraph (c)(3)(i) of this section related to first-year recourse COD income under paragraph (c)(3)(ii)(B) of this section is limited to the loss corporation's liabilities immediately before the ownership change (excluding nonrecourse liabilities) to the extent of its pre-change excess recourse liabilities defined in paragraph (b)(8)(i) or (ii) of this section, as applicable.

(D) Timing of adjustments described in paragraphs (c)(3)(ii)(B)(1) through (3) of this section. If a loss corporation chooses to apply the provisions of this paragraph (c)(3)(iii)(D) to all of its first-year recourse COD income, then it must make the adjustments described in paragraphs (c)(3)(ii)(B)(1) through (3) of this section, in their entirety as of the change date. However, a loss corporation may make these adjustments only if--

(1) The statement described in §1.382-11 reflects such adjustments or;

(2) The loss corporation files an amended return for the taxable year that includes the change date and includes an amended §1.382-11 statement (entitled "AMENDED STATEMENT PURSUANT TO §1.382-11(a) BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF TAXPAYER], A LOSS CORPORATION,") to reflect such adjustments.

(E) Adjusted basis of the loss corporation's section 382 assets. The adjustments of this paragraph (c)(3)(iii)(E) apply for purposes of determining the adjusted basis of

loss corporation's assets under section 382(h)(2)(A)(ii)(II) and (B)(ii)(I) and the computation of net unrealized built-in gain and loss under section 382(h)(6)(C) and paragraph (c)(3)(i)(B) of this section. The loss corporation's basis in its section 382 assets is adjusted immediately before the ownership change by the amount of any adjustment that would apply if the section 382 asset were sold immediately before the ownership change. For example, the loss corporation's basis in a partnership interest is adjusted to the extent §1.163(j)-6(h)(3)(i) would have required an adjustment if the loss corporation had disposed of all or substantially all of its partnership interest immediately before the ownership change.

(F) [Reserved]

(d) Recognized built-in gain and loss--(1) In general. This paragraph (d) provides rules for determining whether an item is recognized built-in gain or recognized built-in loss for purposes of section 382(h) and the section 382 regulations . Except as expressly provided in this paragraph (d), no amount is treated as recognized built-in gain or recognized built-in loss if that amount was not properly included in the computation of the loss corporation's net unrealized built-in gain or net unrealized built-in loss pursuant to paragraph (c)(3) of this section.

(2) Recognized built-in gain--(i) In general. Except as otherwise provided in this paragraph (d)(2) and in paragraph (d)(4) of this section, subject to section 382(h)(1)(A)(ii), an item of income that is properly taken into account during the recognition period is a recognized built-in gain only if the item would have been properly included in gross income before the change date by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be

made unless the taxpayer actually elected that method). As a result, for example, cost recovery deductions on an appreciated asset claimed during the recognition period are not treated as generating recognized built-in gain.

(ii) Disposition of an asset. The gain recognized on the disposition of an asset during the recognition period is recognized built-in gain to the extent provided in section 382(h)(2)(A). Income included as a dividend under section 61(a)(7) (including amounts treated as dividends under section 1248) and inclusions of income with respect to stock (excluding gain recognized on the disposition of stock), for example under section 951(a) and 951A(a), are not treated as recognized built-in gain.

(iii) Income from discharge of indebtedness attributable to certain recourse liabilities. If a loss corporation chooses to apply the provisions of paragraph (c)(3)(ii)(B) of this section, then the amounts described in paragraphs (c)(3)(ii)(B)(1) and (2) of this section are treated as recognized built-in gain on the date recognized. Otherwise, no income from the discharge of indebtedness attributable to recourse liabilities is recognized built-in gain.

(iv) Income from discharge of indebtedness attributable to certain nonrecourse liabilities. Except as provided in this paragraph (d)(2)(iv), no income from the discharge of indebtedness attributable to nonrecourse liabilities is recognized built-in gain.

(A) Treatment as RBIG. Notwithstanding paragraph (d)(2)(i) of this section, the amount of all first-year nonrecourse COD income that is included in gross income under section 61(a)(12) or first-year nonrecourse COD income that is excluded under section 108(a), to the extent section 108(b) reduces attributes that are not pre-change losses, as defined in §1.382-2(a)(2), is recognized built-in gain on the date recognized. This

paragraph (d)(2)(iv)(A) does not apply to amounts of first-year nonrecourse COD income corresponding to debt whose discharge results in reduction of basis described in section 1017(a).

(B) Adjustment to basis. First-year nonrecourse COD income that is excluded under section 108(a) and reduces the basis of the loss corporation's assets that the loss corporation owned immediately before the ownership change is not recognized built-in gain. However, first-year nonrecourse COD income that is excluded under section 108(a) and reduces the basis of assets that the loss corporation did not own immediately before the ownership change is recognized built-in gain.

(C) Limitation on total amount of RBIG regarding nonrecourse COD income. The amount of first-year non-recourse COD income treated as recognized built-in gain under this paragraph (d)(2)(iv) is limited to the excess of adjusted issue price of debt over fair market value of property measured under paragraph (e)(5) of this section.

(D) No adjustment to the NUBIG/NUBIL computation. The computation under paragraph (c)(3)(i) of this section is not adjusted to reflect recognized built-in gain amounts related to this paragraph (d)(2)(iv). Nonetheless, for purposes of determining the limitations on amounts of recognized built-in gain or loss under section 382(h)(2)(A)(ii)(II) and (B)(ii)(I), the adjusted basis of the loss corporation's section 382 assets reflects the reduction, if any, described in paragraph (d)(2)(iv)(B) of this section.

(v) Installment method. The amount of income reported under the installment method (see section 453) that is treated as recognized built-in gain is determined under the principles of §1.1374-4(h) (determined without regard to §1.1374-2(a)(2)). Further, if a loss corporation that is a member (selling or distributing member) of a consolidated

group (as defined in §1.1502-1(h)) transfers a built-in gain asset to a member of the same consolidated group (transferee member) before or during the recognition period, the gain is deferred under §1.1502-13, and before the close of the recognition period, the transferee member sells the built-in gain asset in a sale reportable under the installment method, then any deferred gain is RBIG when taken into account by the selling or distributing member, even if the gain is taken into account after the close of the recognition period.

(vi) Prepaid income. Any amount received prior to the change date that is attributable to performance occurring on or after the change date is not recognized built-in gain. Examples to which this paragraph (c)(2)(vi) applies include income received prior to the change date that is deferred under sections 451(c) or 455.

(3) Recognized built-in loss--(i) In general. Except as otherwise provided in paragraphs (d)(3) and (4) of this section, subject to section 382(h)(1)(B)(ii), any deduction properly allowed during the recognition period is treated as recognized built-in loss if an accrual-method taxpayer would have been allowed a deduction for the item against gross income before the change date (taking into account any additional methods of accounting actually used by the loss corporation). For purposes of this paragraph (d)(3), in determining whether an accrual-method taxpayer would have been allowed a deduction before the change date, no taxable income or timing limitation applies. See paragraph (e) of this section for an anti-duplication rule.

(ii) Disposition of an asset. The loss recognized on the disposition of an asset during the recognition period is treated as a recognized built-in loss to the extent provided in section 382(h)(2)(B).

(iii) Cost recovery deductions. The amount of cost recovery deductions with respect to any section 382 asset for any taxable year during the recognition period is treated as recognized built-in loss to the extent of the excess, if any, of--

(A) The greater of the amount of cost recovery deductions allowed or allowable with respect to the period; over

(B) The amount of cost recovery deductions that would have been allowable if the adjusted basis on the change date equaled the fair market value of the section 382 asset, taking into account the depreciation or amortization method, as applicable; the useful life; the recovery period or amortization period, as applicable; and the convention (cost recovery schedule) actually used by the loss corporation.

(iv) Bad debt expense. Any bad debt deduction under section 166 that arises during the recognition period from debt owed to the loss corporation immediately before the ownership change is a recognized built-in loss to the extent it does not exceed the amount described in section 382(h)(2)(B)(ii).

(v) Deductions for payments on certain liabilities. A deduction for the payment of a liability that is described in paragraph (c)(3)(i)(C) or (D) of this section is a recognized built-in loss to the extent of the amount or the estimated amount of the liability, as applicable, immediately before the ownership change, that was included in the loss corporation's computation of net unrealized built-in loss or net unrealized built-in gain under paragraph (c)(3) of this section.

(vi) Deduction for section 382 excess business interest expense--(A) In general. A deduction attributable to section 382 excess business interest expense during the recognition period is recognized built-in loss to the extent the section 382 excess

business interest expense is allocated to the loss corporation pursuant to §1.163(j)-6(f)(2) and is attributable to either a pre-change period (within the meaning of §1.382-6(g)(2)) or a taxable year prior to the ownership change. Solely for purposes of determining whether this paragraph (d)(3)(vi) applies;

(1) The principles of §1.382-6(a) apply (unless the taxpayer made an election pursuant to §1.382-6(b), in which case the principles of §1.382-6(b) apply) to determine the extent the section 382 excess business interest expense is attributable to a pre-change period and

(2) Section 1.163(j)-6(g)(2)(i) applies to section 382 excess business interest expense that was allocated to the loss corporation in the order of the taxable years in which the section 382 excess business interest expense was allocated to the loss corporation pursuant to §1.163(j)-6(f)(2), beginning with the earliest taxable year.

(B) No adjustment to the NUBIG/NUBIL computation. The computation of a loss corporation's net unrealized built-in gain or net unrealized built-in loss is not adjusted to reflect recognized built-in loss amounts related to this paragraph (d)(3)(vi).

(4) Additional recognized built-in gain and loss items. The following additional items of income, gain, deduction, or loss are treated as recognized built-in gain or recognized built-in loss, as applicable:

(i) Positive and negative section 481(a) adjustments, to the extent provided in §1.1374-4(d)(1);

(ii) Any item of income properly taken into account during the recognition period under the completed contract method (as described in §1.460-4(d)) and similar items of deduction, to the extent provided in §1.1374-4(g); and

(iii) The distributive share of a partnership item to the extent provided by the principles of §1.1374-4(i).

(5) Section 382 disallowed business interest carryforwards. Section 382 disallowed business interest carryforwards are not treated as recognized built-in losses.

(e) General operating rules--(1) Anti-duplication rule. Appropriate adjustments must be made in applying the provisions of this section to ensure that no item of economic gain or loss is duplicated in the computation of net unrealized built-in gain or net unrealized built-in loss, or in the computation of recognized built-in gain or recognized built-in loss. Additionally, appropriate adjustments must be made in applying the provisions of this section to ensure that no amount of net unrealized built-in gain or net unrealized built-in loss is utilized in a duplicative manner, and that the limitations on the total amount of adjustment to net unrealized built-in loss and net unrealized built-in gain take into account amounts of income from discharge of indebtedness that are excluded under section 108(a) and reduce the basis of the loss corporation's assets.

(2) References to the principles of other regulatory provisions under section 1374. All references in this section to the principles cross-referenced in other regulatory provisions in this part under section 1374 of the Internal Revenue Code must be interpreted, as necessary, to be consistent with the requirements and principles of this section.

(f) Examples. The examples in this paragraph (f) illustrate the application of the provisions of this section. For purposes of the examples in this paragraph (f), LossCo is a loss corporation that files its return on a calendar year basis, that uses the accrual

method of accounting, and that has an ownership change on the last day of the taxable year (Year 0). Further, LossCo satisfies the threshold requirement of section 382(h)(3)(B)(i). Additionally, the stated facts of the example include all relevant corporate activity, property, and taxable items.

(1) Example 1. Impact of certain liabilities on computation of net unrealized built-in loss and amount treated as recognized built-in loss--(i) Facts. Immediately before the ownership change, LossCo has a section 382 asset with a fair market value of \$100 and an adjusted 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). In Year 1, LossCo settles and pays off the contingent liability for \$25. In Year 2, LossCo pays off the fixed liability for \$30.

(ii) Analysis--(A) Computation of net unrealized built-in loss. Under paragraph (c)(3)(i) of this section, LossCo has a net unrealized built-in loss of \$40 (\$100, the amount LossCo would realize if it sold all its assets to an unrelated third party (paragraph (c)(i)(A)(2) of this section), decreased by \$140 (the sum of the fixed liability (\$30) (paragraph (c)(i)(B) of this section), the estimated value of the contingent liability (\$20) (paragraph (c)(i)(C) of this section) and the aggregate adjusted basis in the asset (\$90) (paragraph (c)(i)(D) of this section)).

(B) Settlement of the contingent liability. Upon settlement and payment of the contingent liability in Year 1, LossCo is entitled to a deduction of \$25 (disregarding application of any limitation). Under paragraph (d)(3)(vi) of this section, \$20 of the deduction (the estimated value of the liability at the time of the ownership change) is recognized built-in loss and \$5 is not subject to section 382. After Year 1, pursuant to section 382(h)(1)(B)(ii), the maximum amount of recognized built-in loss that LossCo can have is \$20 (\$40 net unrealized built-in loss, less the \$20 recognized built-in loss in Year 1).

(C) Payment of the fixed liability. Upon paying the fixed liability in Year 2, LossCo is entitled to a deduction of \$30 (disregarding application of any limitation). Under paragraph (d)(3)(vi) of this section, \$30 of the deduction would have been recognized built-in loss, but the amount of recognized built-in loss is limited by section 382(h)(1)(B)(ii). As a result, of the \$30 deduction, \$20 is a recognized built-in loss and \$10 is not subject to section 382.

(2) Example 2. Cost recovery deductions--(i) Facts. Immediately before the ownership change, LossCo has a net unrealized built-in loss of \$300 that is attributable to a non-depreciable asset with a fair market value of \$500 and an adjusted basis of \$650, and a patent with a fair market value of \$125 and an adjusted basis of \$275. The patent is an "amortizable section 197 intangible" as defined in section 197(c) and has a

15-year amortization period. As of the change date in Year 0, the patent has a remaining amortization period under section 197 of 5 years. For Year 1, LossCo calculates a \$55 amortization deduction for the patent.

(ii) Analysis. Under paragraph (d)(3)(iii) of this section, the amount of cost recovery deduction on the patent that is a recognized built-in loss is the excess, if any, of the amount of cost recovery deductions allowed or allowable over the amount of cost recovery deductions that would have been allowable if the adjusted basis on the change date had equaled the fair market value of the patent, taking into account the amortization method, amortization period, and convention (cost recovery schedule) actually used by the loss corporation. LossCo would have been allowed a cost recovery deduction of \$25 if the adjusted basis of the patent on the change date had equaled its fair market value taking into account the cost recovery schedule actually used by LossCo, (\$125 fair market value divided by remaining amortization period of 5 years). Accordingly, \$30 of the Year 1 cost recovery deduction is recognized built-in loss (\$55 allowed and allowable cost recovery deduction, less the \$25 cost recovery deduction that would have been allowable if the adjusted basis on the change date equaled the fair market value of the patent). The remaining \$25 is not subject to section 382.

(3) Example 3. Forgiveness of pre-change excess recourse liabilities--(i) Facts. On Date 1, immediately before the ownership change, LossCo has two assets: Asset 1, which has a fair market value of \$100, an adjusted basis of \$80, and is subject to a nonrecourse liability with an adjusted issue price of \$120 (Liability 1); and Asset 2, which has a fair market value of \$100, an adjusted basis of \$90, and is subject to a nonrecourse liability with an adjusted issue price of \$60 (Liability 2). Additionally, LossCo has a recourse liability with an adjusted issue price of \$60. On Date 2, eleven months after the change date, the creditor forgives \$20 of the recourse liability, which gives rise to discharge of indebtedness income that is excluded under 108(a), and for which LossCo elects to reduce the basis of Asset 1 and Asset 2 pursuant to section 108(b)(5).

(ii) Analysis--(A) Calculation of net unrealized built-in gain. The nonrecourse liability to which Asset 1 is subject is an inadequately secured nonrecourse liability, because the adjusted issue price of the liability (\$120) exceeds the fair market value of the property securing the liability (\$100). As a result, pursuant to paragraph (c)(3)(i)(A)(1) of this section, in determining its net unrealized built-in gain, LossCo is treated as satisfying Liability 1 by surrendering to the creditor Asset 1, resulting in an amount realized of \$120. Additionally, pursuant to paragraph (c)(3)(i)(A)(2) of this section, LossCo is treated as selling Asset 2 and having an amount realized of \$100. As a result, LossCo has a net unrealized built-in gain of \$50 (\$120 amount realized on Asset 1, plus the \$100 amount realized on Asset 2, less the \$170 aggregate adjusted basis of LossCo's section 382 assets). See paragraph (c)(3)(i) of this section.

(B) Forgiveness of the recourse liability. Pursuant to paragraph (c)(3)(ii)(A) of this section, the forgiveness of the recourse liability will not impact the calculation of LossCo's net unrealized built-in gain, unless it chooses to apply the provisions of

paragraph (c)(3)(ii)(B) of this section to all of its first-year recourse COD income. The recourse liability is a pre-change excess recourse liability to the extent its adjusted issue price (\$60) exceeds the fair market value of LossCo's section 382 assets, reduced, but not below zero, by the amount of nonrecourse liability that is secured by such assets immediately before the ownership change (\$0 for Asset 1 and \$40 for Asset 2), or \$20. As a result, the first-year recourse COD income is \$20 (the \$20 income to the extent of the pre-change excess recourse liability). If LossCo chooses to apply the provisions of (c)(3)(ii)(B) of this section, then, pursuant to paragraph (c)(3)(ii)(B)(3) of this section, LossCo decreases by \$20 the amount of basis it uses to compute its net unrealized built-in gain. As a result, LossCo has a net unrealized built-in gain of \$70 (\$120 amount realized on Asset 1, plus \$100 amount realized on Asset 2, less \$150 aggregate adjusted basis of LossCo's section 382 assets. See paragraph (c)(3)(i)(D) of this section. The first-year recourse COD income is not recognized built-in gain.

(4) Example 4. Forgiveness of a recourse liability that is not a pre-change excess recourse liability--(i) Facts. The facts are the same as in paragraph (f)(3)(i) (Example 3) of this section, except that, as of the date of the ownership change, LossCo also owns Asset 3, which has a fair market value of \$80 and an adjusted basis of \$50. Additionally, LossCo includes the \$20 of cancellation of indebtedness income in gross income that was recognized on Date 2 under section 61(a)(12).

(ii) Analysis--(A) Calculation of net unrealized built-in gain. As in paragraph (f)(3)(ii)(A) (Example 3) of this section, the nonrecourse liability on Asset 1 is an inadequately secured nonrecourse liability, and as a result, pursuant to paragraph (c)(3)(i)(A)(1) of this section, the amount realized with respect to Asset 1 is \$120. Additionally, pursuant to paragraph (c)(3)(i)(A)(2) of this section, LossCo is treated as selling Asset 2 and Asset 3 for an amount realized of \$180 (\$100, plus \$80). As a result, LossCo has a net unrealized built-in gain of \$80 (\$120 amount realized on Asset 1, plus \$100 amount realized on Asset 2, plus \$80 amount realized on Asset 3, less \$220 aggregate adjusted basis of LossCo's section 382 assets. See paragraph (c)(3)(i)(D) of this section.

(B) Forgiveness of the recourse liability. The forgiveness of the recourse liability will not impact the calculation of LossCo's net unrealized built-in gain under paragraph (c)(3)(ii)(A) of this section. The adjustment provided under paragraph (c)(3)(ii)(B) of this section for certain recourse liabilities is not available (and the cancellation of indebtedness is not recognized built-in loss) because the recourse liability does not constitute a pre-change excess recourse liability. See paragraph (b)(4) and (8) of this section. The recourse liability is not a pre-change excess recourse liability because its adjusted issue price (\$60) does not exceed the fair market value of the LossCo's section 382 assets, reduced, but not below zero, by the amount of nonrecourse liability that is secured by such assets immediately before the ownership change (\$0 for Asset 1, \$40 for Asset 2, and \$80 for Asset 3).

(5) Example 5. Computing net unrealized built-in gain or loss of a partner that is allocated section 382 excess business interest expense--(i) Facts. LossCo and

unrelated Corp A are equal partners in partnership PRS. LossCo has a basis of \$100 in its PRS interest, which has a fair market value of \$90. In Year 1, PRS pays or accrues \$100 of section 382 excess business interest expense, which is allocated equally to LossCo and Corp A. At the end of Year 1, LossCo has an ownership change. In Year 2, PRS has \$80 of excess taxable income (within the meaning of §1.163(j)-1(b)(15)), of which \$40 is allocated to LossCo pursuant to §1.163(j)-6(f)(2). LossCo's section 163(j) limitation (within the meaning of §1.163(j)-1(b)(31)) for Year 2 is \$25, and LossCo pays or accrues \$60 of other business interest expense in Year 2. LossCo's section 382 limitation for Year 2 is \$30.

(ii) Analysis--(A) Year 1--(1) Basis reduction to reflect allocation of excess business interest expense. Pursuant to section 163(j)(4) and §1.163(j)-6, a partner in a partnership reduces its adjusted basis in its partnership interest by the amount of excess business interest expense allocated to that partner. As a result, LossCo's basis in its PRS interest is reduced from \$100 to \$50 in Year 1.

(2) Calculation of net unrealized built-in gain or loss. LossCo experiences an ownership change at the end of Year 1. Paragraph (c)(3)(iii)(E) of this section provides that, in computing a loss corporation's net unrealized built-in gain or loss, the amount of the corporation's basis in its section 382 assets is adjusted immediately before the ownership change by the amount of any adjustment that would apply if the section 382 asset were sold immediately before the ownership change. If LossCo had sold its PRS interest immediately before the ownership change, §1.163(j)-6(h)(3)(i) would have required LossCo to increase its basis in the PRS interest by \$50, the amount of its remaining excess business interest expense. As a result, for purposes of section 382(h)(6)(C) and paragraph (c)(3)(i)(B) of this section, LossCo's basis in its PRS interest is adjusted by the same amount. Thus, for purposes of computing LossCo's net unrealized gain or loss, LossCo's basis in its PRS interest is increased to \$100 immediately before the ownership change.

(B) Year 2--(1) Treatment of excess business interest expense as paid or accrued. Pursuant to §1.163(j)-6(g)(2)(i), because LossCo is allocated \$40 of excess taxable income from PRS in Year 2, LossCo treats \$40 of its excess business interest expense (from Year 1) as paid or accrued in Year 2. LossCo's remaining \$10 of excess business interest expense from Year 1 continues to be characterized as excess business interest expense in succeeding years. See §1.163(j)-6(g)(2)(ii).

(2) Section 163(j) deduction. In Year 2, LossCo is treated as having paid or accrued \$100 of business interest expense (\$40 of excess business interest expense that is treated as business interest expense under §1.163(j)-6(g)(2)(i), and \$60 of business interest expense that LossCo actually paid or accrued in Year 2). Because LossCo has a section 163(j) limitation of \$25, LossCo can deduct only \$25 of its \$100 Year 2 business interest expense (see §1.163(j)-2(b)). Pursuant to §1.383-1(d)(1)(ii), LossCo is treated as deducting \$25 of its section 382 excess business interest expense that is treated as business interest expense in Year 2, because this amount is a recognized built-in loss. No adjustment is made to the computation of LossCo's net

unrealized built-in gain or loss to reflect the \$25 of LossCo's recognized built-in loss. See paragraph (c)(3)(vi) of this section. Both LossCo's \$15 of Year 1 excess business interest expense that was treated as business interest expense in Year 2 and the \$60 of other business interest expense that was paid or accrued in Year 2 is disallowed in Year 2 under §1.163(j)-2(b). These amounts are treated as disallowed business interest expense carryforwards into Year 3 under §1.163(j)-2(c), with the \$15 carryforward being subject to section 382 limitation. See paragraph (d)(3)(vi) of this section.

(g) Applicability dates--(1) In general. This section applies to any ownership change occurring after date of publication of Treasury decision adopting these proposed regulations as final regulations in the *Federal Register*. For ownership changes occurring on or before the date the Treasury decision adopting these proposed regulations as final regulations is published in the *Federal Register*, see §1.382-7 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to any ownership change occurring during a taxable year with respect to which the period described in section 6511(a) has not expired, as long as the taxpayers and their related parties consistently apply the rules of this section and §1.382-7(a)(9) through (13) to such ownership change and all subsequent ownership changes that occur before the applicability date of final regulations.

(2) Paragraph (d)(2)(vi) of this section. Paragraph (d)(2)(vi) of this section applies to loss corporations that have undergone an ownership change on or after June 11, 2010. For loss corporations that have undergone an ownership change before June 11, 2010, see §1.382-7T as contained in 26 CFR part 1, revised April 1, 2009.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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