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In this article, the authors examine the new section 174 capitalization rules and how they interact with section 382.

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I. Introduction

The Tax Cuts and Jobs Act amended section 174 for tax years beginning after December 31, 2021. Under the amended provision, specified research and experimental expenditures under section 174 are no longer immediately deductible.[1] Rather, these expenditures are chargeable to a capital account and amortized over a five-year period (a 15-year period for some expenditures attributable to foreign research).[2] Also, section 174 costs are treated as a single asset (or capital account). Thus, taxpayers may not write off unamortized section 174 costs merely because the project or activity attributable to the expenditures was disposed of, retired, or abandoned.[3]

The new section 174 capitalization rules can affect taxpayers in several ways, and it is important to consider the new provision's interaction with other tax rules. One area of interaction is the application of the section 382(h) net unrealized built-in gain (NUBIG) and loss rules to unamortized section 174 costs that arise in a pre-change period.[4]

Taxpayers that undergo an ownership change as defined by section 382 and that have unamortized section 174 costs must consider — under the safe harbor methods of Notice 2003-65, 2003-40 IRB 747 — the extent to which the section 174 costs serve to increase or decrease the taxpayer's annual section 382 limitation for recognized built-in gains (RBIG). Just as important, taxpayers must consider whether the unamortized section 174 costs constitute a recognized built-in loss (RBIL).

Barring congressional action on section 174, many taxpayers that underwent an ownership change in 2022 or that will undergo an ownership change will find themselves with tax basis in unamortized section 174 costs. This article addresses the interplay of this unamortized tax basis with the safe harbor methods for determining NUBIG/NUBIL (net unrealized built-

[1] Section 13206(a) of P.L. 115-97 amended section 174, applicable to amounts paid or incurred in tax years beginning after December 31, 2021.

[2] Section 174(a).

[3] Section 174(d).

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

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in loss) and RBIG/RBIL under the section 338 and section 1374 approaches of Notice 2003-65.

Items that we highlight include:

- The analysis regarding the application of the section 338 approach to section 174 costs differs from the analysis regarding the application of the section 1374 approach to section 174 costs.
- Regarding the section 338 approach: Section 174 costs likely do not constitute an asset a taxpayer would acquire in a taxable asset acquisition but instead may facilitate the development of a separate, self-created asset (for example, software); thus, the normal adjusted grossed-up basis and residual allocation rules under section 338 should apply to the hypothetical section 338 transaction without modification.
- Regarding the section 1374 approach: It is unclear whether section 174 amortization deductions should generate RBIL. The most reasonable approach, in our opinion, is that section 174 amortization deductions do not generate RBIL under the section 1374 approach.

II. Section 382 Limitation in General

Section 382 provides that upon an ownership change, the amount of the loss corporation's pre-change losses that may offset taxable income for a post-change tax year cannot exceed the section 382 limitation for that year.[5] Pre-change losses include net operating losses, various credit carryforwards, and section 163(j) interest carryovers.[6]

A. Calculating the Base Section 382 Limitation

The annual section 382 limitation equals the value of the stock of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt rate.[7]

The value of stock of the loss corporation for section 382 limitation purposes begins with the equity value of the company immediately before the ownership change and is adjusted for various items, such as corporate contractions and the existence of substantial nonbusiness assets.[8] If a corporation is unable to use the annual limitation, it can carry over the unused limitation to a later year.[9]

As illustrated below, the cumulative nature of any unused limitation combined with the application of Notice 2003-65 means that the total amount of available NOLs is often much larger than many taxpayers realize.

B. Calculating NUBIG and NUBIL

In addition to the general annual limitation under section 382(b)(1), the annual limitation may be increased if the loss corporation is a NUBIG corporation.[10] If the loss corporation is a NUBIL corporation, however, some post-change losses and deductions may become subject to the annual limitation.[11]

A loss corporation has a NUBIG if the excess of the fair market value of its assets immediately before an ownership change over those assets' aggregate adjusted basis exceeds a threshold amount of the lesser of $10 million or 15 percent of the FMV of the corporation's assets on the change date. Conversely, a loss corporation has a NUBIL if the excess of the aggregate adjusted basis of its assets over such assets' FMV exceeds that threshold.[12]

If the loss corporation has a NUBIG, the annual limitation is increased by the built-in gain recognized in the tax year to the extent the built-in gain is recognized within the recognition period and does not exceed the NUBIG reduced by prior recognition of built-in gains.[13] A loss corporation's NUBIG equals the excess, if any, of the aggregate FMV of its assets immediately before an ownership change over the assets' aggregate adjusted basis at that time, adjusted by the

[5] Section 382(a).

[6] Section 382(d)(1) and (3).

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

[8] Section 382(l)(4)(D) (loss corporation value reduced for substantial nonbusiness assets); section 382(e)(2) (loss corporation value reduced by amount of redemption or other contraction occurring in connection with ownership change); and section 382(l)(1) (pre-change capital contributions effected to increase section 382 limitation are disregarded).

[9] Section 382(b)(2).

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

[11] Section 382(h)(1)(B).

[12] Section 382(h)(3)(B).

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

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amount of specific items of income or deduction described in section 382(h)(6)(C).[14]

Recognition of a built-in gain (1) occurs upon the disposition of an asset during the recognition period that was held on the change date and (2) is limited to the excess of the FMV over the adjusted basis of the asset on the change date.[15]

If the loss corporation has a NUBIL, "the recognized built-in loss for any recognition period taxable year shall be subject to limitation under section 382 in the same manner as if such loss were a pre-change loss," limited to the loss corporation's NUBIL reduced by prior recognition of built-in losses.[16]

Recognition of a built-in loss occurs when an asset is disposed of within the recognition period, the asset was held on the change date, and the loss does not exceed the excess of the adjusted basis over the FMV of the asset on the change date.[17] The recognition period is the five-year period beginning on the change date.[18] To the extent a built-in loss is disallowed in a tax year, the disallowed portion is allowed as a carryforward subject to a similar limitation as to those applicable for NOLs.[19]

C. Notice 2003-65

In Notice 2003-65, the IRS provided that a loss corporation may use one of two alternative approaches — one based on section 338 and one based on section 1374 — in its calculation of its built-in gains or losses.[20] These methods are considered safe harbors and not the exclusive means of identifying built-in items under section 382(h). Each approach incorporates the rules of reg. section 1.1374-3, determining NUBIG or NUBIL as:

- the amount that would be realized immediately before the ownership change as if the loss corporation sold all its assets, including goodwill, at FMV to a third party that assumed all the corporation's liabilities;
- decreased by the sum of the loss corporation's aggregate adjusted basis in its assets and the amount of deductible liabilities that would be included in the gross amount realized;
- increased or decreased by the corporation's section 481 adjustments that would be taken into account; and
- increased by any RBILs that would not be allowed as a deduction under section 382, 383, or 384.[21]

For a loss corporation with a NUBIG, the section 338 approach treats specific built-in gain assets of the loss corporation as generating RBIG even if those assets are not disposed of during the recognition period. The section 338 approach assumes that, for any tax year, an asset that had a built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for the asset under the applicable code section if an election under section 338 had been made regarding the hypothetical purchase.

For an asset that had a built-in gain on the change date, therefore, the section 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable on the asset had an election under section 338 been made for the hypothetical purchase over the loss corporation's actual allowable cost recovery deduction.

The cost recovery deduction that would have been allowed to the loss corporation had an election under section 338 been made for the hypothetical purchase is based on the asset's FMV on the change date and a cost recovery period that begins on the change date. The excess amount is RBIG regardless of the loss corporation's gross income in any specific tax year during the recognition period.[22]

The section 1374 approach, by contrast, identifies RBIG and RBIL at the time of the disposition of a loss corporation's assets and recognized built-in items of income and

[14] Section 382(h)(3).

[15] Section 382(h)(2)(A).

[16] Section 382(h)(1)(B)(i) and (ii).

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

[18] Section 382(h)(7).

[19] Section 382(h)(4).

[20] 2003-2 C.B. 47.

[21] Notice 2003-65, Section III.A.

[22] *Id.*, Section IV.B.2.

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deductions during the recognition period. Generally, this approach relies on the accrual method of accounting principles to identify built-in income and deduction items at the time of the ownership change, with some exceptions.[23] However, the section 1374 approach differs from section 1374 rules by including amortization or depreciation as RBIL in some circumstances.[24]

Loss corporations that have a NUBIG typically choose to apply the section 338 approach because that often produces a greater amount of RBIG than the section 1374 approach. Loss corporations that have a NUBIL typically choose to apply the section 1374 approach.

III. Section 174 Costs and Notice 2003-65

A. Applying the Section 338 Approach

The section 338 approach involves the hypothetical acquisition of all of the loss corporation's assets (a deemed sale of the corporation's assets by Old T corporation to New T corporation). The question applicable to a loss corporation with capitalized section 174 costs is whether those costs represent an asset purchased by New T from Old T in a taxable asset acquisition.

Like capitalized start-up expenditures, section 174 costs are chargeable to a separate capital account and have tax basis. Section 174 costs do not, however, appear to constitute an asset a buyer would acquire in a fully taxable applicable asset acquisition.[25] Instead, to the extent that a loss corporation's section 174 costs created a separate and distinct asset (for example, software), it is that asset a purchaser would acquire under the normal seven asset class residual method.[26]

The below example illustrates this approach. Assume the following facts:

- LossCo stock has an FMV of $50 million immediately before the transaction causing a section 382 ownership change.
- LossCo has $29 million in liabilities, and $9 million of those are deductible liabilities.
- LossCo's tax basis in its assets is $43 million, which includes $20 million in section 174 costs.
- LossCo has no tax basis in any section 197 intangible assets or goodwill.
- The acquirer of the loss corporation stock incurred $1 million in transaction fees.
- The FMV of LossCo's section 197 intangibles and goodwill are $27 million and $30 million, respectively.
- The FMV of LossCo's accounts receivable and inventory equals their tax basis.

Using those facts, the figure shows the RBIG amounts.

The example allocates zero adjusted grossed-up basis to the capitalized section 174 costs,[27] in line with the approach that those costs do not represent an asset but instead create value, if any, in a separate section 197 intangibles. Thus, the amount of RBIG in the self-created section 197 intangibles and goodwill is higher by $3.8 million per year.

Over the entire five-year recognition period, therefore, LossCo has $19 million in additional section 382 limitation under that approach. Because the total RBIG of $19 million during the recognition period is less than LossCo's $27 million of NUBIG, all $19 million may serve to increase the total section 382 limitation. Because LossCo has a NUBIG, it is unnecessary to consider whether the unamortized section 174 costs constitute RBIL.[28]

If, on the other hand, value were ascribed to the section 174 costs — which we believe is incorrect — that allocation would reduce the value ascribed to goodwill and therefore reduce the RBIG recognized.

[23] *Id.*, Section III.B.

[24] *Id.*, Section III.B.2.a.

[25] Significantly, section 195(b)(2) explicitly permits a taxpayer to deduct remaining start-up expenditures as a section 165 loss if the taxpayer disposes of the trade or business. Thus, it stands to reason that a taxpayer may similarly write off section 174 costs if the taxpayer disposes of the relevant trade or business, so the acquirer would not acquire such asset.

[26] *See* sections 1060(a) and 338(b)(5); reg. section 1.338-6.

[27] Under the residual method of section 338, adjusted grossed-up basis is allocated to assets in classes II-VII in proportion to their relative FMVs. Reg. section 1.338-6(b)(2)(i).

[28] A loss corporation's RBIL is treated as a pre-change loss under section 382 only if the corporation has a NUBIL immediately before the ownership change. *See* section 382(h)(1)(B).

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Section 338 Approach

NUBIG/NUBIL Determination	
FMV of assets in sale	79,000,000
Less deductible liabilities	(9,000,000)
+/- Sec 481 adj	-
RBIL increases	-
Tax basis in assets	(43,000,000)
NUBIG	27,000,000

Section 338 AGUB	
Grossed-up stock price	50,000,000
Liabilities assumed	29,000,000
Transaction costs	1,000,000
AGUB	80,000,000

	Tax Basis	AGUB	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Cash	5,000,000	5,000,000						
A/R	10,000,000	10,000,000						
Inventory	8,000,000	8,000,000						
Section 174 costs	20,000,000	-						
Section 197 intangibles		27,000,000	1,800,000	1,800,000	1,800,000	1,800,000	1,800,000	9,000,000
Goodwill		30,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	10,000,000
Total	43,000,000	80,000,000	3,800,000	3,800,000	3,800,000	3,800,000	3,800,000	19,000,000

B. Applying the Section 1374 Approach

The treatment of unamortized section 174 costs under the section 1374 approach does not necessarily follow from the treatment under the section 338 approach. Also, the treatment is somewhat complex and involves several distinct questions. We have assumed that a loss corporation applying the section 1374 approach is a NUBIL corporation because most NUBIG corporations apply the section 338 approach.

1. Are section 174 costs attributable to a pre-change period?

Section 382 provides that for a NUBIL corporation, the loss on a sale of any asset after a section 382 ownership change is treated as an RBIL unless the corporation establishes that (1) it did not hold the asset immediately before the change date, or (2) the loss is not attributable to built-in loss existing as of the change date.[29] The term "RBIL" includes deductions taken during the recognition period for depreciation, amortization, or depletion, except to the extent the amount is not attributable to an excess of basis over value that existed at the time of the ownership change.[30] Section 382 further provides that RBIL includes any amount "allowable as a deduction during the recognition period" that is "attributable to periods before the change date."[31]

It seems reasonable to treat deductions arising from section 174 costs as not "attributable to" a pre-change period. The notice explains that under the section 1374 approach, items of deduction allowed during the recognition period are attributable to a pre-change period if an accrual-method taxpayer would have been permitted a deduction for the item before the change date.[32] Under an overall accrual method of accounting, deductions taken for section 174 costs do not constitute items a taxpayer would be entitled to deduct during a pre-change period. Also, they do not appear to represent built-in deductions attributable to an earlier period because the costs are capitalized under a specific provision of the code deferring the deductions. Moreover, section 174 costs likely do not constitute an economic asset held by the corporation on the change date, but a capitalized cost.

[29] Section 382(h)(2)(B)(ii)(II).

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

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

[32] Notice 2003-65, Section III.B.2.a (*citing* section 382(h)(6)(B)).

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2. Can RBIL arise through the actual sale or exchange of a section 174 capital account?

Next, consider whether section 174 costs could generate RBIL through the actual sale or exchange of an asset to which a section 174 account relates. As noted, RBIL includes losses recognized during the recognition period from the sale or exchange of an asset.[33] However, unamortized section 174 costs are not truly assets bought, sold, or exchanged.[34] Also, although section 174 costs often enhance or produce an intangible asset, the intangible asset is separate from the section 174 costs. On the other hand, although the section 174 account is not sold or exchanged, the account can perhaps generate a deduction for the tax basis remaining in the account through abandonment or a sale of all assets and cessation of the business — perhaps this event can generate RBIL.[35]

3. Amortization of section 174 costs — further considerations.

The area in which perhaps the most significant application of the section 1374 approach to unamortized section 174 costs could occur is in the treatment of amortization deductions regarding built-in loss assets.[36] For amortization expense on an asset or capitalized cost, section 382 provides that amounts constitute RBIL except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its FMV on the change date.[37] When considering the mass asset rule of section 174 that requires capitalization of all costs into a single asset, and the section 174(d) rule that disallows the write-off or abandonment of costs before the five-year amortization period, it is difficult to determine the FMV, if any, attributed to the section 174 costs.

When assessing the value ascribed to section 174 costs, can the taxpayer look at the value of intangibles that were created by the section 174 costs? Should unamortized section 174 costs simply be viewed as tax basis in deferred deductions? Perhaps taxpayers should view unamortized section 174 costs as having zero (or minimal) value, given that they do not appear to create a separate section 174 asset that can be bought or sold. Section 174's statutory history suggests that section 174 costs have a long-term benefit that extends beyond the year, but how would a taxpayer identify that value?[38]

Must a taxpayer find an appraiser that would value the annual incurred section 174 costs separately from any intangible or other asset created by the costs? This seems like quite an administrative burden, even assuming it is feasible. Capitalized section 174 costs are unlike a mass asset, such as goodwill, that can grow or shrink annually based upon the business activity and investment. Rather, section 174 uses the annual accounting period, an arbitrary period, to capitalize costs. Therefore, costs incurred in 2023, for example, should have no impact on the 2022 costs even if they were attributable to the same projects.

Would using unamortized tax basis as a proxy for the value provide a better approach, given that Congress established the recovery period? If so, under the section 1374 approach, section 174 amortization from capitalized costs pre-change would not generate RBIL (because value would always equal tax basis, and there would be zero built-in gain or loss). This position (value equals tax basis) appears similar to an argument under which section 174 costs are not subject to the wasting asset rule. Finally, the section 174(d) rule barring a taxpayer from writing off a section 174 cost upon an event of worthlessness or abandonment implies that post-change section 174 amortization deductions do not relate to pre-

[33] Section 382(h)(2)(B); reg. section 1.1374-4(a)(1).

[34] Note that under section 174(d), the sale of disposition or abandonment of an item of property to which a section 174 account relates does not generate a deduction for the remainder of the section 174 account's tax basis.

[35] For example, the sale of all of a business's assets may cause the unamortized section 174 costs to have no further value to the seller, arguably constituting a fixed, identifiable event permitting the write-off of those remaining costs under section 165. *See* reg. section 1.165-1(b)(1).

[36] Section III.B.2.ii of Notice 2003-65 has a full discussion on how depreciation, amortization, and depletion deductions for built-in loss assets are treated under the section 1374 approach.

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

[38] Previously, section 174 allowed taxpayers to elect to currently deduct the section 174 costs paid or incurred in connection with a trade or business. Noting that fact, the TCJA's legislative history pointed out that business expenses associated with the development or creation of an asset with a useful life beyond one year are generally capitalized (and then depreciated) under sections 167 and 263(a). *See* H.R. Rep. No. 115-486 (2022).

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change periods and are simply treated as current period costs.

Ultimately, the TCJA mandates that taxpayers capitalize section 174 costs to a separate capital account and amortize them separately from any assets they create or develop. The section 1374 approach set forth in the notice is a safe harbor, and, by its nature, a simplifying convention. Taxpayers are not bound by the notice's safe harbors and could look to a position such as those discussed earlier and argue that section 174 amortization does not create RBIL for section 382 purposes.

IV. Concluding Thoughts

The discussion on the application of Notice 2003-65 to unamortized section 174 costs accentuates the differences between the notice's section 338 and section 1374 approaches. The two approaches provided in the notice can play out very differently, and their application to section 174 costs highlights this divergence. As such, the treatment of section 174 costs requires a separate analysis under each approach.

The section 338 approach is typically more advantageous to a corporation with a NUBIG because of the wasting asset concept, while the section 1374 approach is typically more advantageous to a corporation with a NUBIL, although this method lacks clarity regarding section 174 costs. However, as noted, taxpayers are not bound by the notice's approaches because they are merely safe harbors.

As with so many areas concerning the application of section 382, absent guidance from Treasury or the IRS, it is difficult to draw firm conclusions on the treatment of section 174 costs upon a section 382 ownership change. ■

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