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November 18, 2019

The Honorable Commissioner Charles P. Rettig
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Proposed Regulations Issued Under Section 382 with Respect to Built-in Gains and Losses of Loss Corporations

Dear Commissioner Rettig:

Enclosed please find comments on proposed regulations under section 382 of the Internal Revenue Code of 1986, as amended. These comments represent the view of RSM US LLP ("RSM"). RSM is the fifth largest public accounting firm in the United States and is committed to guiding clients through their business challenges. RSM focuses particularly on serving clients in the middle market, which accounts for more than a third of US employment and about 40 percent of the U.S. gross domestic product.

RSM has prepared and submits these comments on its own behalf. RSM has many clients that would be affected by adoption of the proposed regulations.

Our comments cover certain specified issues arising under section 382(h), including the appropriate method for recognizing built-in gains and losses, the treatment of recourse and nonrecourse debt, and the treatment of contingent liabilities. We may at future date submit comments on additional issues such as the application of built-in gain and built-in loss rules under section 382(h) to cancellation of debt income and worthless debt deductions, and the interaction of the section 382(h) rules with the global intangible low-taxed income rules under section 951A. In addition, we urge Treasury and the Service to consider and act upon the requests for transition relief they receive from other commenters.

We would be pleased to discuss the comments with you or your staff if that would be helpful. If you would like to discuss please contact Nick Gruidl at Nick.Gruidl@rsmus.com or 202-370-8242, or Stefan Gottschalk at Stefan.Gottschalk@rsmus.com or 202-370-8171.

Sincerely,

Nick Gruidl

Enclosure

cc:
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Krishna Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
Marie C. Milnes-Vasquez, Special Counsel to the Associate Chief Counsel (Corporate), Internal Revenue Service
Kevin M. Jacobs, Senior Technician Reviewer, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service

EXECUTIVE SUMMARY

On September 10, 2019, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issued proposed regulations[1] (the "Proposed Regulations") that address section 382[2] of the Code. The Proposed Regulations address various issues relating to built-in gains and built-in losses of loss corporations.

We commend Treasury and the Service for addressing issues related to built-in gains and losses, as there are uncertainties under current law and differing views regarding previously released precedential and non-precedential guidance. However, the approach set out in the Proposed Regulations gives rise to concerns regarding equity and appropriateness, would negatively affect the United States ("U.S.") corporate equity values and markets, and would result in many more transactions substantially motivated by attainment of tax benefits under section 382 than currently occur. These concerns and effects should be addressed in order to improve the Proposed Regulations' effectiveness. We believe that the complex interaction of section 382 and the additional controlled foreign corporation tax regimes enacted in 2017 should be addressed in published guidance regarding how these provisions interact, rather than by finalizing the Proposed Regulations, which, although motivated in part by the these interactions' complexities, do not address most of these interactions in a substantive manner. Further, complexities within our existing tax system are inevitable and we do not believe that the existence of such complexities warrants elimination of a wasting asset-based approach for determination of recognized built-in gains. These comments set forth recommendations regarding certain matters addressed by the Proposed Regulations for the consideration of Treasury and the Service when re-proposing or finalizing the Proposed Regulations or issuing other related guidance (such re-proposed regulations, or finalized regulations, or other guidance "the Regulations").

In summary, our recommendations are:

1. The Regulations should adopt the 338 Approach (defined below), or another wasting assets-based approach for computations of recognized built-in gains and losses. During the recognition period, recovery of built-in gains and losses through depreciation or wasting of assets in place on the change date clearly

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[1] Notice of Proposed Rulemaking, REG-125710-18, 84 Fed. Reg. 47455 (Sep. 10, 2019) ("the NPRM").

[2] Unless otherwise stated or clear from the context, all references to "section" in this letter are to the Internal Revenue Code of 1986 (the "Code" or "IRC"), as amended, and references to "Regulation" or "Reg. section" are to regulations promulgated under the Code.

occurs in fact as a matter of economics. The Proposed Regulations' approach would deviate from the wasting asset economics only for built-in gains but not for built-in losses. This one-sided approach departs from the neutrality principle clearly expressed by Congress, is inequitable, and would adversely affect the equity value of many U.S. corporations. The Regulations should provide fair and administrable rules for applying the required wasting assets approach. For example, the wasting assets approach could require application of alternative depreciation system ("ADS") asset recovery rates to determine deemed recognized built-in gains and losses. Use of ADS is required for corporate earnings and profits ("E&P") calculations because it is considered more consistent with economics than other depreciation systems. We acknowledge that the 2017 enactment of the Public Law 115-97 ("the TCJA")[3] has made built-in gain and built-in loss calculations, along with other tax calculations, more complex. We recommend that Regulations address this increased complexity by providing appropriate computational rules relating to the TJCA's provisions, rather than by seeking to reduce the large numbers of taxpayers that must make built-in gain calculations under section 382.

2. The Regulations should not distinguish between recourse and nonrecourse liabilities for the purpose of measuring net unrealized built-in gains and losses. The Proposed Regulations would distinguish between the two, providing more favorable results for loss corporations with nonrecourse debt. This proposed rule should not be adopted, as it would encourage taxpayers to take various tax-motivated steps designed to permit classification of their liabilities as nonrecourse, require many valuations of loss corporations' assets, delay consummation of business acquisitions, and provide fodder for tax controversies.

3. The Regulations should provide, consistent with existing guidance in Notice 2003-65, that a loss corporation should not treat its contingent liabilities as recognized built-in losses when they are fixed or paid. We believe this is the most appropriate result based upon existing regulations related to prepaid income, an item analogous to contingent liabilities. In regard to both prepaid income and contingent liabilities, the income and expense items should be considered attributable to post transaction activities, resulting in a better matching of the item to the period of the loss corporation's economic outlay. Under this approach, the Regulations would continue to make the adjustment for contingent liabilities in

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[3] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (commonly referred to as the "Tax Cuts and Jobs Act" or "TCJA").

determining net unrealized built-in gain and loss as contemplated in the Proposed Regulation section 1.382-7(c)(3)(i)(D), or in a similar manner. Retention of this adjustment would appear appropriate and consistent with the treatment of other deductible liabilities as required in Proposed Regulation section 1.382-7(c)(3)(i)(C). Similarly, we do not believe the Proposed Regulations should retain the treatment of deductible liabilities as recognized built-in loss. We believe the 1374 Approach in Notice 2003-65 appropriately addressed deductible liabilities and this treatment of deductible liabilities should be retained. The Regulations should include a more specific list of deductible liabilities that would represent recognized built-in loss, and the rationale for including such liabilities. We also believe that for purposes of applying section 382(h)(1)(B)(ii), a contingent liability should only be included in net unrealized built-in loss if and when the contingent liability is satisfied.

If the Regulations do not follow the above recommendation and instead continue to treat the satisfaction of contingent liabilities and deductible liabilities as recognized built-in loss, we believe that the satisfaction of the contingent liability should represent RBIL, but only up to the estimated value of the liability immediately before the ownership change. Further, it is our recommendation that the Regulations specify that all liabilities, including deductible and contingent liabilities, should be included in the application of section 382(h)(8). We also suggest that for purposes of applying section 382(h)(1)(B)(ii), the contingent liability should only be included in net unrealized built-in loss if and when the contingent liability is satisfied.

Finally, we recommend employing or adapting the definition in Regulation section 1.752-7 to implement the rules for contingent liabilities.

We discuss each of these recommendations below.

DISCUSSION

I. Background

The Proposed Regulations address various issues arising under section 382 relating to built-in gains and losses of loss corporations.[4] Congress enacted section 382 to curtail trafficking in net operating losses ("NOLs").[5]

Section 382 imposes a limitation (the "Base Limitation") on the use of pre-change losses to offset post-change income after an ownership change (as defined under section 382(g) an "Ownership Change" or a "Change"), generally equal to the value of the stock of the loss corporation multiplied by the long-term tax-exempt rate ("LTTR") in effect on the Change date.[6] Section 382 provides for several adjustments to the Base Limitation, one of which involves the treatment of built-in gain or loss recognized during the five-year period beginning on the Change date (the "Recognition Period") with respect to assets owned by the loss corporation immediately before the Ownership Change.[7]

Generally, if the loss corporation has net unrealized built-in gain ("NUBIG") immediately before the Ownership Change, the section 382 limitation during the Recognition Period is increased by the recognized built-in gain ("RBIG"), up to the amount of the NUBIG.[8] Conversely, if the loss corporation has net unrealized built-in loss ("NUBIL") immediately before the Ownership Change, recognized built-in loss ("RBIL") during the recognition period is treated in the same manner as a pre-Change loss and is subject to the section 382 limitation to the extent of the NUBIL.[9] The rules addressing NUBIG, NUBIL, RBIG,

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[4] The term "loss corporation" generally means a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Section 382(k)(1). Carryforwards of interest disallowed under section 163(j) may also cause a corporation to be a loss corporation. Sections 382(k)(1) and 381(c)(20).

[5] H.R. Rep No. 99-426, at 250 (1985) (*citing* H.R. Rep No 83-1337 (1954)). *See also* S. Rep No. 99-313, at 225, 230 (1986).

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

[7] Section 382(h).

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

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

and RBIL stem from the neutrality principle, which seeks to treat built-in gains and losses of a loss corporation in the same manner as if they had been recognized before the Ownership Change.[10]

In 2003, the Service issued Notice 2003-65 to provide interim guidance regarding the application of the NUBIG, NUBIL, RBIG, and RBIL provisions.[11] Notice 2003-65 provides two alternative approaches: (i) the section 1374(d) method, which applies tax accrual accounting concepts (the “1374 Approach”), and (ii) the section 338 method, which contemplates a section 338 election with respect to a hypothetical sale of the corporate stock and compares the result to the corporation’s actual items of income, gain, deduction, and loss (the “338 Approach”). Like Notice 2003-65, the Proposed Regulations would address application of the NUBIG, NUBIL, RBIG, and RBIL provisions.

II. Recommendations

1. *The Regulations should adopt either the 338 Approach or a similar approach that applies the wasting assets concept*

The primary impact of the 338 Approach results from its application of the “wasting asset” concept. The 338 Approach under Notice 2003-65 authorizes increases to a loss corporation’s section 382 limitation of a corporation with NUBIG based on an approximation of the rate at which the corporation’s NUBIG assets generate income. The approximation is based on the Federal income tax cost recovery rules.

The theory underlying the 338 Approach recognizes:

1. The loss corporation’s assets have value and will produce income during the Recognition Period;
2. In some cases, the assets’ value includes NUBIG (or reflects NUBIL);
3. The neutrality principle set out by Congress recognizes that the income (or deductions) attributable to the assets’ NUBIG (or NUBIL) requires treating such income (or deductions) in the same manner as if no Ownership Change had occurred – i.e., by treating the income (or deductions) similarly to pre-Change income (or deductions).

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[10] *See* S. Rep. 99-313, at 235; H.R. Rept. 99-426, at 261 (stating that the neutrality principle is a guiding principle of section 382).

[11] I.R.S. Notice 2003-65, 2003-2 C.B. 747.

4. The Federal income tax cost recovery (i.e., amortization and depreciation rules) rules represent a reasonable, uniform, and administrable approximation of the rate that such income or deductions will occur following the Change date.

The wasting asset concept (also known as the asset consumption concept) is a recognition of two economic realities. First, most business assets produce income, directly or indirectly. Business assets generally derive their value from their ability to produce income.[12] Second, most business assets produce income over a finite period of time. The diminution of their income producing ability over time renders them "wasting assets."[13]

We recommend the Regulations require application of a wasting asset concept. We believe that retention of the 338 Approach set out in Notice 2003-65, with some modifications, is appropriate. However, requiring a wasting asset approach would not necessarily require retention of the 338 Approach as currently set forth in Notice 2003-65. We discuss several methods of applying the wasting asset concept below. First, however, we discuss why requiring a wasting asset approach is consistent with section 382 and its legislative history and is consistent with Federal tax law more generally.

a. *The 338 Approach, or a similar wasting asset approach, is consistent with the text and legislative history of section 382*

The NPRM's Preamble (the "Preamble") asserts that "the 1374 approach is more consistent with the text and the purpose of section 382 than the 338 approach" and that "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."[14] We believe that the 338

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[12] It is also true that some business assets do not produce income but are instead valuable because they are expected to produce income in the future. These include, for example, assets in a research and development phase or awaiting regulatory approval. *See, e.g.,* Internal Revenue Service Statement Regarding the Active Trade or Business Requirement for Section 355 Distributions (Sep. 25, 2018), available at the following URL: https://www.irs.gov/newsroom/irs-statement-regarding-the-active-trade-or-business-requirement-for-section-355-distributions.

[13] The 1991 enactment of section 197 was Congress' response to disputes regarding the proper tax treatment of intangible wasting assets, as discussed further below.

[14] 84 Fed. Reg. 47455, at 47458.

Approach is no less consistent with the text of the aforementioned provisions than the 1374 Approach.

As originally enacted in The Tax Reform Act of 1986 ("TRA 1986"), Section 382 limited RBIG and RBIL to amounts realized on an actual disposition of the built-in gain or built-in loss asset.[15] The 1986 Blue Book, for example, stated: "[d]epreciation deductions cannot be treated as deductions or built-in losses," accompanied with the following footnote: "Similarly, Section 382 does not provide relief for built-in income other than gain on disposition of an asset."[16]

Congress thereafter changed the Code's approach to the realization requirement question multiple times. First, in the Revenue Act of 1987 ("the 1987 Act"),[17] Congress amended section 382(h)(2)(B) to provide that the term RBIL includes "any amount allowable as depreciation, amortization, or depletion for any period within the recognition period" except to the extent that the amount is not attributable to NUBIL.[18] The Conference Report explained this change by invoking the neutrality principle with respect to losses:

> The conference agreement follows the House bill with respect to built-in depreciation being subject to the built-in loss rules of section 382…The

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[15] Section 382, as enacted in the TRA of 1986, P.L. 99-514 (1986).

[16] General Explanation of the Tax Reform Act of 1986, Staff of Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987), at 320-321. However, Section 382(h)(6) as originally enacted provided that, "[t]he Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date (e.g., deductions deferred by Section 267 or Section 465), will be treated as built-in losses." Section 382, as originally enacted in TRA 1986. This specific regulatory authority grant language was removed from section 382 by later statutory amendment. Section 382(m) now provides: "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section," and also mentions specific subject matter areas that do not include the NUBIG, NUBIL, RBIG, and RBIL rules.

[17] P.L. 100-203 (1987).

[18] Section 382(h)(2)(B), as amended by the 1987 Act. This language remains in the flush language of section 382(h)(2)(B) today. Section 382(h)(2)(B).

> preacquisition losses that may not be used to shelter built-in gains include built-in losses or items of deduction that have economically accrued prior to deduction.[19]

Congress again amended section 382 to address built-in items in the Technical and Miscellaneous Revenue Act of 1988 ("the 1988 Act").[20] As amended, section 382(h)(6)(A) then read:

> Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.[21]

Section (h)(6)(A) does not provide a recognition event as a requirement for RBIG treatment. The 1988 Act's changes included inserting the term "attributable to," to replace the term "accrue" in section 382(h)(6).[22] This statutory change should be viewed as an indicator of Congressional intent that items of income or deduction include built-in income or deduction items without reference to a tax accounting accrual requirement. It appears contrary to Congressional intent to require the accrual rule inherent in the Section 1374 Approach, considering this statutory amendment specifically removed the word "accrual" from the language of section 382(h)(6).

No precedential guidance exists regarding the meaning of the phrase "attributable to" in this context. In another Federal tax context, the Tax Court[23] concluded that "the plain meaning of 'attributable to' is simply due to, caused by, or generated by."[24]

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

[20] P.L. 100-647 (1988).

[21] Section 382(h)(6)(A), as amended by the 1988 Act. Section 382(h)(6)(A), contains the same language today.

[22] 1988 Act.

[23] Section 108(a)(1)(C) provides that gross income does not include any amount which would be includable in income by reason of a discharge of indebtedness if the indebtedness discharged is qualified farm indebtedness. "Qualified farm indebtedness" is defined in § 108(g)(2).

[24] *Lawinger v. Comm'r*, 103 T.C. 428 (1994). In reaching its conclusion, the court cited several cases including *National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810,

The Service previously recognized this Congressional intent to eliminate a realization or accrual requirement in a 1993 Field Service Advice ("FSA"), explaining that subsection (h)(6) was added to section 382(h) to expand section 382(h)'s application beyond the strict confines of a disposition.[25] This 1993 FSA states:

> As originally enacted in 1986, I.R.C. section 382(h) dealt with recognition of built-in gain or loss, focusing on "dispositions" of assets with those gains or losses. Congress realized that many other items of income and deduction could have the same effect as built-in gains or losses recognized on disposition. As a consequence, Congress enacted section [382(h)(6]. The Ways and Means Committee report explains the reason for the enactment:
>
> > The amendment clarifies that any item of income which is properly taken into account during the recognition period but that is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account…
>
> The foregoing explanation indicates that Congress was concerned with matching pre-change built-in gain with its associated income whether or not there was an actual disposition of the asset containing the built-in gain. The policy behind I.R.C. section 382(h)(6) is to treat taxpayers who effectively dispose of their built-in gain assets after the change date in the same manner they would be treated if they had disposed of those assets prior to the change date. Thus, post-change income flowing from the software should be available to offset NOLs generated by the costs of creating the software in the same manner as pre-change gain from the sale of such software would have been available.[26]

The Code does not contain express language linking the consumption or wasting of NUBIG assets to built-in income as it does for linking NUBIL assets to built-in deductions. The section 382(h)(2)(B) reference to depreciation, depletion, and amortization ("DD&A") addresses only DD&A attributable to NUBIL, and is silent with

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823 (1983) (attributable connotes causation) and *Braunstein v. Commissioner*, 374 U.S. 65, 70 (1963) (attributable means "gain caused or generated by the property in question").

[25] IRS FSA 1998-415, 1993 FSA Lexis 200 (July 8, 1993). *See also* 1998 FSA Lexis 508 (July 2, 1998) (holding similarly). *But see* TAM 200217009 (Apr. 29, 2002) (expressing a contrary view).

[26] *Id.*, citing H.R. Rep. No. 99-795, 100th Cong., 2d Sess. 46 (July 26, 1988).

respect to DD&A attributable to NUBIG. In this regard, we bear in mind that intangible assets constituted then, as they do now, the majority of business acquisition asset basis "step-up" value – i.e., the majority of the NUBIG.

Prior to the 1993 enactment of section 197, Federal tax rules generally provided that no amortization was allowed for such intangibles (with certain exceptions). As a result, a DD&A-model or foregone DD&A-based model for NUBIG was not available when Congress enacted the NUBIG, NUBIL, RBIG, and RBIL rules. Congress thus did not specify such a model in the 1987 Act or the 1988 Act. Section 382(h)(2)(B)'s omission to mention DD&A of NUBIG should not be read to permit the tax law to recognize the wasting or consumption of NUBIL assets but ignore the wasting or consumption of NUBIG assets.

Through Congress' endorsement of the neutrality principle and the symmetry of the Code's built-in income and deduction rules of section 382(h)(6), it is clear that an even-handed approach to RBIG and RBIL is what Congress intended under section 382. The Proposed Regulations would not apply an even-handed approach but would instead require realization events for RBIG while requiring none for RBIL.[27]

We also note that Congress has at no point indicated any objection to use of Notice 2003-65's 338 Approach under section 382. Given that Congress has not hesitated to express its disapproval with section 382 guidance that it views as too generous to taxpayers,[28] Congress' silence should be viewed as confirmation that the 338 Approach is consistent with the language and purpose of section 382.

Accordingly, the 338 Approach is entirely consistent with the language and purpose of section 382.

b. *The 338 Approach, or a similar wasting asset approach, is consistent with other principles of Federal tax law*

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[27] The Proposed Regulations' approach may therefore be viewed as questionable under the statutory construction principle applied by the Supreme Court in *ACF Industries*: a meaning that may appear correct when a term is viewed in isolation should not be followed if applying that meaning would be untenable in light of the statute as a whole. *Department of Revenue of Ore. v. ACF Industries, Inc.,* 510 U.S. 332 (1994).

[28] *See* P.L. 111-5, section 1261 (2009), expressing disapproval of Notice 2008-83.

While the elimination of the 338 Approach would impact issues other than the wasting asset concept, it is the proposed elimination of the wasting asset concept—where built-in gain is generated by the corporation as its assets are consumed without requiring a sale of the assets—that has the largest impact. The NPRM suggests that the wasting asset concept is not supported by the law.[29] We disagree.

i. Specific areas of Federal tax law adopt a wasting asset concept

The treatment of wasting assets has been debated for decades, and depreciation of intangible assets generated significant controversy from the 1970s through the early 1990s. Under Treasury regulations dating to the 1920s, goodwill was not depreciable,[30] and the Service applied this rule to other intangible assets as well.[31] In 1993, the Supreme Court in *Newark Morning Ledger* distinguished between goodwill and other intangibles, and held that customer lists and like intangibles could be depreciated if the taxpayer established their useful life.[32]

In *Newark Morning Ledger*, the Supreme Court held that whether intangible assets could be depreciated was “primarily a question of fact,” and that there is “no per se rule that an intangible asset is nondepreciable whenever it is related to goodwill.”[33] Rather "[t]he significant question for purposes of depreciation is ... whether the asset is capable of being valued and whether that value diminishes over time."[34] In the Supreme Court’s view, intangible assets—including goodwill—contained value that should be depreciable to the extent they could be valued and their value diminished.

The Court stated its view stemmed from the matching principle, as “the primary purpose of an annual depreciation deduction is to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use ... of the

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[29] 84 Fed. Reg. 47455, at 47458.

[30] Reg. section 1.167(a)-3 (1992).

[31] *See*, *e.g.*, *Newark Morning Ledger*, *infra*.

[32] *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993). The Court rejected the Service's long-held view that a customer list is simply one aspect of the company's goodwill.

[33] *Newark Morning Ledger Co.*, 507 U.S. at 558, citing *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, at 1250, *cert. denied*, 414 U.S. 1129 (1974).

[34] *Newark Morning Ledger Co*., 507 U.S. at 556.

asset to the periods to which it contributes," and that this should apply to intangible assets no less than to tangible assets.[35]

In a climate of federal income tax controversies and debate involving the amortization of intangible assets, the Joint Committee on Taxation requested that the United States General Accounting Office ("GAO") provide a report addressing intangible asset taxation.[36] The GAO issued the requested report in 1991. The 1991 GAO Report stated that wasting intangible assets are consumed as they produce income over time, and acknowledged that goodwill could be a wasting asset.[37] It also stated that "[d]isallowing amortization of any wasting purchased intangible asset would not result in the proper matching of business expense and revenue. The economic contribution of these intangible assets would not be recognized because amortization expenses would not be deducted from the revenue that the intangible assets helped generate."[38]

The economic and policy principles discussed in the 1991 GAO report were important elements underlying the 1993 enactment of section 197. Congress enacted Section 197 to eliminate controversies involving sorting through various intangible assets, determining which are amortizable, and determining their useful lives.[39] Section 197 has effectively achieved these purposes and implemented the economic and policy principles discussed in the 1991 GAO report.

These purposes and principles are highly relevant in regard to the wasting asset concept of the 338 Approach to RBIG. The wasting asset concept utilized in the 338 Approach is a means to match expenses with the gain on the consumption of or income

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[35] *Newark Morning Ledger Co.*, 507 U.S. at 553, citing *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960) (internal citation marks omitted).

[36] General Accounting Office, Report to the Joint Committee on Taxation: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets, at 2 (Aug. 1991) ("1991 GAO Report").

[37] 1991 GAO Report, at 5.

[38] 1991 GAO Report, at 37.

[39] *See*, *e.g.*, H. Rept. No. 103-111, at 777 (regarding P.L. 103-66). Section 197 mandates that taxpayers amortize the basis of most acquired amortizable intangible assets—including goodwill—ratably over fifteen years.

generated by the asset, and follows the principles underlying *Newark Morning Ledger* and section 197.[40]

The relationship between the costs expended to generate intangible assets and the income produced by those assets can be illustrated as follows. A corporation's value in the mergers and acquisitions ("M&A") marketplace often is determined based on a multiple of its earnings before income tax, depreciation, and amortization ("EBITDA"). Intangibles held by a company are typically valued based on the present value of the expected future profits to be generated by those intangibles. Economically, there is a clear relation between an asset's income production expectations and its value.

Acknowledging the production of income by acquired assets as RBIG follows the policy goal of section 382(h), which is to permit corporations to offset built-in-gain by pre-Change losses that generated those built-in-gains.[41] Intangible and tangible assets both fit that paradigm. The use of the depreciation and amortization schedules is a simplified manner of accomplishing this policy goal.[42]

Other areas of Federal tax law recognizing the wasting asset concept include the unified loss rule ("ULR") of Regulation section 1.1502-36 and the partnership built-in gain rules of section 704(c).

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[40] *See*, *e.g.*, GAO Report, at 37 (a law permitting amortization of all intangible assets over fourteen years would "improve the matching of business expense with revenue to the extent that (1) previously nonamortizable, wasting intangible assets become amortizable and (2) the 14-year period approximates the actual average useful life of intangible assets").

[41] *See*, *e.g.*, Field Service Advice Memorandum 1998-415 (Jul. 8, 1993) ("Congress was concerned with matching pre-change built-in gain with its associated income").

[42] The use of DD&A lives and schedules is not a precise measure, but represents a simplification that results in administrability and evenhandedness rather than precision in gauging asset consumption. *See*, *e.g.*, the 1991 GAO Report, at 33 ("While the specified cost recovery periods may not bring about perfect matches, allowing some amortization deductions over time for all wasting intangible assets could easily result in matches that are better than those that occur under current tax rules. These rules fail to give any recognition to the wasting value of some intangible assets"). *See also* Department of the Treasury, Office of Tax Analysis, A History of Federal Tax Depreciation Policy, OTA Paper 64 (May 1989) ("1989 OTA Report") (discussing, *inter alia*, Federal tax depreciation rules geared toward matching of income and expense, such as alternative depreciation system ("ADS") rules, and those geared toward incentivizing investment, such as the modified accelerated depreciation system ("MACRS") rules).

The ULR is designed to prevent taxpayers from claiming duplicated or noneconomic losses with respect to disposition of the stock of consolidated subsidiaries.[43] In promulgating the ULR, Treasury and the IRS made clear that accounting for a subsidiary's consumption of its assets via generation of income is equally important in measuring the asset's economic impact in the consolidated group as accounting for the subsidiary's gain (or loss) on disposal of the asset.[44]

A predecessor rule to the ULR, the loss disallowance rule of Regulation section 1.1502-20, similarly recognized the importance of the concepts that business assets generally are wasting assets that generate income, and that income from wasting assets should be treated as recognized built-in gain.[45]

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[43] *See* Reg. section 1.1502-36(a)(2).

[44] The Preamble to the proposed ULR states:

> [T]he Notice 2004-58 basis disconformity model, because it is an interpretation of the current loss limitation rule in § 1.337(d)-2, reflects limitations that inhibit the extent to which the rule addresses the circumvention of GU repeal and promotes the clear reflection of group income. For example, the model did not account for the consumption of unrecognized appreciation reflected in stock basis (the "wasting asset" problem). Thus, if unrealized gain reflected in stock basis was recognized as income (for example through a lease, instead of a disposition of the property), the resulting noneconomic stock loss was not disallowed under the current rule.

Notice of Proposed Rulemaking, REG-157711-02, 72 Fed. Reg. 2964, at 2972 (Jan. 23, 2007).

[45] The Preamble to the proposed loss disallowance rule stated:

> A number of commentators proposed that the loss disallowance rule be revised to disregard investment adjustments attributable to the consumption of built-in gain assets through operations ("wasting assets") . . . . The revised rules do not adopt this proposal, and all positive investment adjustments are taken into account (whether from dispositions or consumption of wasting assets). Consumption of wasting assets is not outside the scope of General Utilities repeal because dispositions and consumption may produce identical investment adjustments, as illustrated by Examples (2) and (3) in [the temporary regulations'] preamble. Failing to take wasting assets into account would treat taxpayers in similar economic circumstances differently.

55 Fed. Reg. 49075 (Nov. 26, 1990) (*reprinted in* 1990-2 C.B. 696). A portion of the loss disallowance rule was held invalid on grounds unrelated to the wasting asset concept in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001); the loss disallowance rule eventually was replaced by the ULR.

The regulations under section 704(c) are also analogous to the 338 Approach (or to other wasting asset approaches). Those regulations specifically allocate DD&A of section 704(c) property to the partner contributing the property to the partnership, generally to the extent of the built-in gain or built-in loss in the assets at the contribution date.[46] Where a partnership holds the section 704(c) assets and uses them in its operations, it must allocate items of income or deduction with respect to the contributed property to or away from the contributing partner until the contributing partner recognizes the built-in (i.e., pre-contribution) gain or loss.[47]

The regulations provide three allocation methods that can be used to account for pre-contribution gain or loss associated with section 704(c) property. The regulations' discussion of one of these, the traditional method, states that for section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to the property takes into account built-in gain or built-in loss inherent in the property at the contribution date.[48] Like the ULR, the section 704(c) regulations recognize that it is equally appropriate to account for built-in gain through consumption of an asset as it is through disposal in a taxable sale.

ii. Tax principles underlying the Code's treatment of net operating losses support the Section 338 Approach and the wasting asset concept in the section 382 context

The recognized built-in gain and loss rules of section 382(h) operate to implement the matching principle, a central principle of Federal tax: tax on income should, where possible, match the revenues and expenses that generate that income.[49] Although the matching principle sometimes defers to other principles and rules of Federal tax—such

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[46] *See generally* Reg. section 1.704-3.

[47] Reg. section 1.704-3(a).

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

[49] *See*, *e.g.*, Reg. section 1.461-5(b) (requiring matching of income and expense for adoption of the recurring item exception). *See also* FSA 1998-415 (Jul. 8, 1993) (In enacting section 382(h), "Congress was concerned with matching pre-change built-in gain with its associated income").

as the annual tax reporting system and the all-events test[50]—the matching principle remains an underlying policy goal of tax law that is adhered to where possible.[51]

The matching principle stands in contradistinction to the annual reporting system.[52] Although income earned in one year is often generated by revenues expended in a prior year, the annual accounting principle often requires that matching be sacrificed in order to tax the income in the year it arose.

In various contexts, Federal tax law recognizes the importance of matching income and expenses, notwithstanding the annual taxable income (or loss) reporting construct. For example, the earnings and profits ("E&P") rules generally look to a corporation's earnings over multiple years.[53]

Likewise, a taxpayer's ability under section 172 to offset gain earned in a future year by a loss generated in a prior year largely mitigates the annual accounting concept's deviation from the matching principle and the possible harm to the taxpayer. The wasting asset concept utilized in the 338 Approach acts to mitigate this harm.

By contrast, this mitigation would be counteracted by applying a 1374 Approach or accrual approach with respect to built-in gains attributable to wasting assets following an Ownership Change. As an economic matter, the wasting asset concept utilized in the 338 Approach adheres to and implements both the specific 60-month Recognition Period objective and the general matching principle much better than the 1374 Approach does.

iii. Elimination of the 338 Approach would harm M&A activity and the ability to raise capital, and contribute to non-economic tax-motivated transactions

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[50] *See generally* section 461 and Reg. sections 1.461-1 and 1.461-4 (a taxpayer may deduct an accrued expense only after the all-events test has been met and economic performance has occurred).

[51] *See*, *e.g.*, FSA 1224 (Mar. 23, 1994) (describing the matching principle as "fundamental") *See also* S. Rep. No. 99-313, *supra* note 8.

[52] The annual tax reporting system is also referred to as the annual accounting concept.

[53] Section 316(a)(1).

We believe elimination of the wasting asset element of the 338 Approach would have a substantial negative impact on M&A activity, and would negatively impact the U.S. economy. Finalization of the Proposed Regulations would have an immediate and significant negative impact on the equity value of many U.S corporations.[54]

Further, while the Preamble appears to focus solely on M&A transactions, the Proposed Regulations will impact every Ownership Change, not only changes occurring as a result of an M&A transaction. Ownership Changes occur frequently due to trading of publicly traded corporation stock. In addition, Ownership Changes occur frequently with both publicly and privately held corporations that fund innovative research and experimentation critical to economic growth, as well as when they fund ongoing operations. We thus believe that elimination of the wasting asset element of the 338 Approach would hurt many corporations, especially those in industries where companies typically engage in frequent capital raise transactions.

In fact, we believe adoption of the Proposed Regulations will drive investments away from the companies that need the financing most. Distressed companies will encounter difficulty raising capital or restructuring, which will result in failed companies, bankruptcy liquidations, and lost jobs. Life science and technology companies that compete for capital investments will find that their corporation's value will be significantly reduced, making it more difficult to raise necessary capital.

Moreover, the Proposed Regulations would likely lead to an increase of highly structured transactions entered into to retain the ability to utilize NOLs. Companies would attempt to alleviate the harsh impact of an Ownership Change by avoiding the Ownership Change through the use of complex equity and debt securities or complex sale and leaseback transactions prior to a corporate transaction. Such transactions would generally not be motivated by economic considerations but rather by the need to preserve NOLs.

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[54] *See, e.g.,* O'Melveny & Myers LLP, Proposed Regulations May Significantly Reduce the Value of Net Operating Loss Carryforwards and the Value of Companies with Net Operating Losses (Sep. 19, 2019), available at https://www.omm.com/resources/alerts-and-publications/alerts/proposed-regulations-may-significantly-reduce-the-value-of-net-operating-loss/; RSM US LLP, Proposed regulations would decrease acquisition value of tax losses (Sep 10, 2019), available at https://rsmus.com/what-we-do/services/tax/federal-tax/corporate-tax-services/proposed-regulations-would-decrease-acquisition-value-of-tax-los.html . *See also* Kirkland & Ellis, Proposed Regulations May Significantly Impact Tax Assets of Distressed Companies (Sep. 11, 2019), available at https://www.kirkland.com/publications/kirkland-alert/2019/09/section-382-proposed-regulations.

For example, despite the fact that the current section 382 regulations have anti-abuse provisions, taxpayers would likely explore entering into exotic financing transactions. Such transactions may include utilizing convertible debt, a simple agreement for future equity (SAFE) or similar hybrid instrument in the context of a capital raise, combinations of plain vanilla preferred stock as defined in Regulation section 1.1504-4(a)(4), options, and warrants. In the future, taxpayers may avoid traditional capital markets and instead explore the issuance of their own virtual currencies.

A proliferation of such transactions would impede economic efficiency. We disagree with the implication in the Proposed Regulations that the 338 Approach is "efficiency reducing."[55] To the contrary, we believe that the wasting asset concept of the 338 Approach is efficiency enhancing, due its standardization of a method that results in section 382 limitations that are significant, economically justifiable, and, in the case of a loss corporation that operates a valuable business, manageable without tax-impelled transactions.

We note that in our experiences many exotic, tax-motivated financing transactions were undertaken prior to the issuance of Notice 2003-65, and the issuance of Notice 2003-65 significantly reduced the number of such transactions. We believe this reduction in tax-motivated transactions occurred because the wasting asset concept provides a more accurate determination of the recognized built-in gains inherent in a corporation, and thereby, less reason to contemplate exotic tax-motivated transactions.

Furthermore, implementation of the Proposed Regulations would incentivize some loss companies and their acquirers to engage in tax-motivated income realization techniques such as sale-leaseback, sale license back, and "busted" section 351 transactions. These realization transactions would be designed to permit loss corporations to account for their assets' built-in gain under the more restrictive approach set out in the Proposed Regulations. The result would be that taxpayers and the Service would spend significant resources structuring, executing, and examining these tax-motivated realization transactions, decreasing substantially the degree of certainty and efficiency that Notice 2003-65 has provided.

Additionally, elimination of the 338 Approach would be anti-competitive. Companies in industries that typically have large start-up losses would be at a competitive disadvantage relative to other companies. Such companies would face difficulties when competing for investment dollars, as the return on investment (ROI) on the development

[55] 84 Fed. Reg. 47455, at 47463.

activities that created their NOL would be severely curtailed. Adoption of the wasting asset concept of the 338 Approach would prevent this prejudice.

Note also that elimination of the 338 Approach would bear implications beyond the realm of tax policy and procedure. For example, on September 10, 2019, the date of the Proposed Regulations' issuance, a notice was published in the Federal Register related to the bioscience industry. The United States Office of Science Technology and Policy ("OSTP") issued a request for information ("RFI") to learn how the U.S. can more effectively "support scientific discovery, the development of technological advances, and increase the impact of a vibrant bioeconomy on the Nation's vitality and our citizens' lives."[56] The RFI sought input from interested parties, including "those with capital investments ... in the field of biological sciences," in regard to opportunities for public-private partnerships and infrastructure investments in biotechnology.[57] As discussed above, elimination of the wasting asset concept utilized in the 338 Approach would harm the ability of biotechnology companies to raise capital and thus run counter to this express desire of the Federal government to support the industry.

RSM focuses particularly on serving clients in the middle market, which accounts for more than a third of U.S. employment and about 40 percent of U.S. gross domestic product. In our experience, acquisitions of and investments in middle market corporations that result in Ownership Changes are almost never tax motivated. Acquirers and investors value these corporations based predominately on the businesses they operate. Business valuations typically are based on EBITDA multiples, although adjustments related to tax benefits or detriments are often made.

In the middle market M&A sphere, Notice 2003-65 sets out a standardized and accepted procedure for computing built-in gain and loss items. The 338 Approach under Notice 2003-65 provides a fixed ceiling for tax benefits from pre-Change carryovers. Calculation of that fixed ceiling is somewhat complex, but it is not disruptive to the M&A marketplace.

By contrast, if the Proposed Regulations' approach is adopted, substantial time and resources will be directed to assessing and potentially executing tax-motivated

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[56] 84 Fed. Reg. 47561 (Sep. 10, 2019), *available at* https://www.federalregister.gov/documents/2019/09/10/2019-19470/request-for-information-on-the-bioeconomy. The bioeconomy includes "innovation, products, technology, and data ... that drive economic growth, promote health, and increase public benefit." *Id.*

[57] *Id.*

transactions geared toward avoiding Ownership Changes or toward realizing gain with respect to assets that the target corporation following its wnership Change weither will still use, or will need to replace with like assets. The Proposed Regulations' adverse impact on M&A markets therefore would go far beyond its negative impact to tax attribute values. Adopting the Proposed Regulations would have the undesirable results of adding to the corporate acquisition process the delays and inefficiencies associated with these tax-motivated steps, and would add examining these transaction steps to the Service's income tax examination tasks.

iv. Concerns articulated in the Preamble are overstated, inapposite, or inaccurate

The Preamble explains why Treasury and the Service believe the 338 Approach should be eliminated. The explanation includes numerous assertions regarding the 338 Approach, many of which we believe are overstated, inapposite, or inaccurate. These include: (a) the 338 Approach creates an unwarranted double benefit for taxpayers, (b) the 338 Approach is less consistent with the text of the statue than is the 1374 Approach, (c) the 338 Approach is likely not tenable with changes to the Code enacted in the TCJA, (d) the 338 Approach involves unnecessary complexity, (e) the 338 Approach encouraged NOL trafficking, and (f) elimination of the 338 Approach will not substantially affect M&A activity. Below we discuss each of these assertions in turn.

The Preamble asserts that the 338 Approach's application of RBIG is duplicative with the Base Limitation.[58] Additionally, the Preamble asserts the cost recovery rules cause the 338 Approach to overstate income and increase NOL usage "beyond the neutral baseline."[59]

The 338 Approach does not create a double benefit. The base limitation does not overlap with RBIG, as is evident from section 382(h). The Base Limitation's use of the LTTR was intended to stop NOL trafficking, and is therefore pegged to provide a return

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[58] 84 Fed. Reg. 47455, at 47464 ("the treatment created by the 338 approach creates a double benefit" and "such an adjustment for income created by built-in gain assets is unnecessary, as it is already taken into account by section 382").

[59] 84 Fed. Reg. 47455, at 47464 ("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.").

generally similar to what could be earned on tax-exempt bonds.[60] RBIG, in contrast, was intended to enable the loss corporation to retain the application of its pre-Change NOLs against its built-in gain. The 338 Approach simply acknowledges the fact that where the loss corporation's business assets have value, including NUBIG value, their value will produce income, including RBIG income.

The Preamble raised a further concern that use of the accelerated cost recovery schedules to approximate income allocable to particular assets would have the effect of overstating income, and thus overstating RBIG.[61] We make two points in response.

First, the vast majority of built-in gain assets whose value typically drives RBIG under the 338 Approach are intangible assets that are wasting assets. Amortization of these intangibles for Federal income tax purposes is straight-line amortization over a fifteen-year period. The amortization of these assets is not accelerated and was not enacted as an investment incentive, but rather reflects Congress's determination that the costs associated with purchasing these assets are best associated with the benefits received from them during the first fifteen years after the purchase.[62]

Second, the Preamble's concern can be alleviated by adopting the straight-line method for all assets for purposes of computing RBIG and RBIL, including assets generally eligible for accelerated recovery, similar to how these assets are treated for purposes of calculating earnings and profits under ADS.[63] The straight-line method is used for E&P

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[60] *See*, *e.g.*, H. Rept. No. 99-841 (PL 99-514), 317. The rate utilized is less than the long-term Federal rate to keep someone from acquiring a loss corporation, selling all the assets and investing in long-term Treasury obligations and the long-term tax-exempt rate is generally between 66 percent and 100 percent of the long-term Federal rate.

[61] 84 Fed. Reg. 47455, at 47464 ("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.").

[62] *See, e.g.,* GAO Report, at 37 ("the 14-year period approximates the actual average useful life of intangible assets."). The legislation as originally proposed designated a fourteen-year recovery period rather than the fifteen-year recovery period eventually enacted in section 197.

[63] *See* section 312(k)(3)(A).

purposes because it better reflects the life of the asset,[64] and the same would hold true for RBIG and RBIL purposes.

If, after further study, Treasury and the IRS conclude that ADS cost recovery, while sufficiently economic for use in E&P calculations, is inadequate for use in RBIG and RBIL calculations, the Regulations could provide a separate RBIG- and BIL-specific standard NUBIG and NUBIL recovery system or schedule.

As discussed above, language in section 382(h) supports the argument that RBIG does not require an actual recognition event: Although the definition for RBIL parallels that of RBIG,[65] section 382(h)(2) explicitly states that DD&A—not generally considered a "recognition" event or "disposition"— can constitute RBIL.[66] If, under the language of section 382(h)(2), DD&A is an equivalent of a disposition and recognition event for purposes of RBIL, there is no reason it should not constitute the same for purposes of RBIG.[67]

Given the strong policy arguments for the 338 Approach based on the Code, legislative history, and policy, as described above, it is appropriate to read section 382(h) as authorizing a wasting asset concept such as is utilized in the 338 Approach.

The Preamble asserts that the interaction between the 338 Approach and the TJCA creates undue complexity.[68] The Preamble provides examples, including: the

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[64] *See generally* Bittker & Lokken*, Federal Taxation of Income, Estates & Gifts* § 92.1.3.

[65] Section 382(h)(2)(B) ("Recognized built-in loss. The term 'recognized built-in loss' means any loss recognized during the recognition period on the disposition of any asset....").

[66] *Id.* (RBIL "includes any amount allowable as depreciation, amortization, or depletion for any period within the recognition period.").

[67] *See* FSA 1998-415, *supra* note 35 ("Under I.R.C. section 382(h)(2), post-change depreciation that is attributable to pre-change built-in loss is treated as recognized built-in loss. The flip side to this situation is that post-change income attributable to pre-change depreciation, which generated the built-in gain, should be treated as recognized built-in gain.").

[68] 84 Fed. Reg. 47455, at 47458 ("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."). See also *Id.* at 47457 ("the Treasury Department and the IRS have identified

accelerated depreciation rules,[69] sections 163(j) and 172,[70] and section 951A (which requires income inclusion by U.S. shareholders of global intangible low-taxed income ("GILTI") of controlled foreign corporations).[71] We believe these concerns are misplaced.

In the TCJA, Congress enacted a new regime for controlled foreign corporation taxation – the GILTI regime – without removing the prior regimes. Congress also enacted a new business interest deduction limitation provision – section 163(j) – that applies more broadly than any of the Code's other business interest deduction limitations and generates carryforwards, which Congress expressly made subject to section 382. Congress clearly intended to make affected taxpayers' tax calculations more complex. The regulations should address this complexity and provide guidance regarding the calculations necessitated by the TCJA provisions, such as the Proposed Regulations' rule preventing double counting with respect to disallowed business interest carryforwards under section 163(j).[72]

The Regulations should address the application of built-in gain and loss provisions to U.S. loss corporations that own stock of controlled foreign corporations ("CFCs"). For over 20 years, such corporations have faced complex section 382 issues not addressed in any precedential guidance. Following enactment of the TCJA, taxpayers are presented with these issues more frequently and with increased complexity.

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numerous issues that would arise from the interaction of the 338 Approach with various provisions of the Code following the TCJA's enactment.").

[69] 84 Fed. Reg. 47455, at 47458 ("The accelerated depreciation rules required the issuance of Notice 2018-30 to prevent application of first year cost-recovery deduction within the 338 Approach.").

[70] 84 Fed. Reg. 47455, at 47458 ("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.").

[71] 84 Fed. Reg. 47455, at 47458 ("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.").

[72] Prop. Reg. section 1.382-7(d)(5).

The Regulations should mitigate the additional complexity by addressing computations with respect to CFC items. The Proposed Regulations' approach, however, would not provide specific guidance for CFCs' items but would instead apply an inequitable, one-sided, taxpayer-unfavorable approach requiring realization events to trigger built-in gains but not built-in losses.

As discussed above, the Proposed Regulations would impel taxpayers to engage in realization transactions such as sale-license back, sale-leaseback, or busted section 351 transactions to recognize built-in gain. Once a taxpayer has recognized the built-in gain, it will have reached the same place it can reach under current law –it will be faced with complex built-in gain calculations related to CFCs with no precedential guidance to follow. The Proposed Regulations would of course place Service personnel in a similar position; they would first need to examine tax-motivated realization transactions, then they would need to examine the calculations relating to CFCs with no precedential guidance available to enforce.

Regulations can provide simplifications as well as clarifications regarding how to apply these TCJA provisions for purposes of calculations under the 338 Approach. We note that prior to the enactment of the TCJA, various limitations to tax deductions such as the applicable high yield obligation ("AHYDO"),[73] corporate equity reduction transaction ("CERT"),[74] and former section 163(j) rules[75] generally were ignored for purposes of calculations under the 338 Approach even though they impacted taxable income. Similarly, calculations under the 338 Approach did not include the 50 percent or 100 percent bonus depreciation on applicable property, regardless of whether the taxpayer actually did or did not claim bonus depreciation deductions.[76] Similarly, in our experience, corporate taxpayers eligible to claim the former section 199 domestic production activities deduction did not calculate this deduction separately for purposes of the 338 Approach.

The Regulations should provide additional clarifications and simplifications of this sort. Section 382 built-in gain and built-in loss calculations are of course not intended to implement a parallel alternative minimum (or alternative maximum) tax system. Instead,

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[73] Sections 163(e)(5) and 163(i).

[74] Section 172(m), as in effect prior to the TCJA.

[75] Section 163(j), as in effect prior to the TCJA.

[76] Notice 2018-30.

these calculations, best implemented through the 338 Approach, would merely operate to provide a framework for identifying the recognition of RBIG or RBIL. For example, the Regulations could provide that the hypothetical asset basis computed for purposes of NUBIG, NUBIL, RBIG, or RBIL calculations will not affect interest apportionment under the section 163(j) [77] or foreign tax credit rules[78] even though such calculations generally rely on asset tax basis.

The Preamble asserts that the 338 Approach is complex while the approach of the Proposed Regulations would provide "simplicity, objectivity, and administrability."[79] Furthermore, the Preamble asserts that taxpayers typically compute estimates of RBIG/RBIL under both the 338 Approach and 1374 Approach, which is duplicative.[80]

Based on our experience, taxpayers do not compute two sets of estimates in practice but instead perform a single calculation. Taxpayers utilize the 338 Approach for transactions involving NUBIG, and the 1374 Approach for transactions involving NUBIL. Additionally, taxpayers are well acquainted with the section 338 calculations and perform them quite often, as such calculations are necessary in order to calculate gains, losses and asset tax basis on every applicable asset acquisition.[81]

Furthermore, we note the Proposed Regulations would add significant complexity to the calculations of NUBIG and NUBIL—they require an examination of the assets of the loss corporation to determine whether they fall short of the recourse debt they are subject to, which likely requires a taxpayers to perfrom or obtain a valuation.[82] That would be a very burdensome exercise. The Proposed Regulations also provide new and complex rules for the treatment of cancellation of debt income, while leaving

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[77] *See* Prop. Reg. § 1.163(j)-10.

[78] *See generally* section 861 and the Regulations thereunder.

[79] 84 Fed. Reg. 47455, at 47457.

[80] *Id.* at 47465 ("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.")

[81] *See* Section 1060(a)(2) (incorporating by reference the allocation rules of section 338(b)(5)).

[82] Prop. Reg. § 1.382-7(c)(3)(i)(A)(1)

unaddressed the complex questions raised with respect to loss corporations affected by section 951A or section 250.

The Preamble asserts, without adducing support, 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.”[83] As described above, we believe that, to the contrary, such adoption will have a significant effect on M&A activity. In fact, these regulations, if finalized without change, will significantly impede the M&A activity of certain companies, such as those in the life science and technology industries, distressed companies, and any company that invests heavily in early tax years, thereby creating large NOLs. We base this assessment on our collective experience and on discussions we had with taxpayers, particularly those operating in the aforementioned industries.

The Preamble implies that the section 338 Approach encourages taxpayers to enter into transactions solely for tax purposes and is abusive.[84] We believe the current anti-abuse provisions of section 382 sufficiently prevent abuse. Such provisions include the continuity of business enterprise requirement (“COBE”)[85] and Sec. 382(k)(6)(B).[86] Section 269 also serves to prevent tax-motivated transactions,[87] and tax penalties under section 6662, including the increased penalties under section 6662(i) for nondisclosed noneconomic substance transactions, dissuade particularly aggressive transactions. If

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[83] 84 Fed. Reg. 47455, at 47464.

[84] 84 Fed. Reg. 47455, at 47464 (“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”).

[85] Section 382(c)(1) (if a new loss corporation does not continue the old loss corporation's business for at least two years after the change date, the section 382 limitation generally is zero).

[86] Under section 382(k)(6)(B), the IRS has authority to issue whatever regulations may be necessary to treat “warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and ... to treat stock as not stock.” *See also* Reg. section 1.382-2T(f)(18)(ii) (regulations issued thereunder).

[87] *See* section 269(a). Under section 269, where any person acquired control of a corporation, ‘‘and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed.’’ Section 269(a).

additional anti-abuse provisions are needed, they should be targeted at abusive transactions rather than at the economically-based wasting asset concept.

Based on our collective experience advising taxpayers since the issuance of Notice 2003-65, including many who have utilized the 338 Approach, we believe the vast majority of transactions are not entered into for NOL trafficking purposes, due to the COBE limitations and very low LTTR rate utilized for determining the annual limitation. Rather, acquisitions generally occur in the context of either strategic business expansions, or where financial buyers acquire an operating company as a portfolio asset with the intent to strengthen it and supplement it with other similar businesses. Accordingly, requiring taxpayers to use the 338 Approach will not encourage NOL trafficking.

For the reasons stated above, the Regulations should require either the 338 Approach or a similar approach that applies the wasting assets concept. Below we provide two straightforward approaches that could accomplish this.

Approach 1: Retain the section 338 methodology to determine built-in gain in depreciable and wasting assets without full adoption of the current 338 Approach for all items of income and deduction. This approach could adopt either the straight-line depreciation lives, as discussed above, or retain the current 338 Approach utilizing tax lives excluding bonus depreciation. This approach would continue to compare hypothetical to actual depreciation and amortization to identify RBIG.

Approach 2: Adopt a method utilizing concepts and rules similar to those found in sections 755, 754 and 743. This method would diverge from the current 338 Approach and simplify the necessary calculations by creating a new asset equal to the built-in gain in the wasting asset and treat the hypothetical depreciation or amortization on that asset as RBIG. This approach would again retain the section 338 methodology to determine the built-in gain in the wasting assets. We do not believe this approach would add undue complexity as it would apply existing concepts that taxpayers and the Service are generally familiar with due to their long-standing use under subchapter K of the Code.

The following examples illustrate the difference between our suggested approaches.

Example 1: Lossco incurs an Ownership Change and has a NUBIG of $30,000. Lossco performs an AGUB calculation, which shows goodwill of $60,000. Lossco has existing purchased goodwill of $30,000 with two years remaining.

Under the first approach, Lossco would compare hypothetical to actual amortization for each year and would generate $12,000 over the recognition period.

Goodwill	Basis	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Hypothetical	60,000	4,000	4,000	4,000	4,000	4,000	
Purchased	30,000	15,000	15,000	-	-	-	
		-	-	4,000	4,000	4,000	12,000

Example 2: Lossco incurs an Ownership Change and has a NUBIG of $30,000. Lossco performs an AGUB calculation, which shows goodwill of $45,000. Lossco has existing purchased goodwill of $15,000 with two years remaining.

Under the first approach, Lossco would compare hypothetical to actual amortization for each year and would generate $9,000 over the recognition period.

Goodwill	Basis	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Hypothetical	45,000	3,000	3,000	3,000	3,000	3,000	
Purchased	15,000	7,500	7,500	-	-	-	
		-	-	3,000	3,000	3,000	9,000

Under the second approach, Lossco would calculate $2,000 in RBIG during each year of the five-year recognition period ($30,000 NUBIG in the goodwill asset divided by 15 years), leading to $10,000 in total RBIG.

These examples illustrate that each of our two suggested approaches could result in higher or lower RBIG during the recognition period, based upon the taxpayer's specific facts. While the second approach adds simplification to the calculation, neither the taxpayer nor the government necessarily benefit from or are harmed.

Simplifications such as these are commonly found in regulations, notwithstanding that the simplification gained could result in a benefit or detriment to a particular taxpayer. An example is the ULR, which establish rules for identifying non-economic losses in shares of subsidiary stock in Regulation section 1.1502-36(c).

We understand that under both of the aforementioned approaches certain clarifications would be needed to address items such as GILTI and other rules implemented in the TCJA. However, as we noted above, although various complexities existed prior to the enactment of the TCJA, the wasting asset approach of Notice 2003-65 was widely implemented and relatively well understood.

2. Regulations should treat recourse and nonrecourse debt similarly in computing net unrealized built-in gain and loss

For the purpose of computing NUBIG and NUBIL, the Proposed Regulations would significantly change the 1374 Approach's treatment of liabilities, particularly nonrecourse liabilities[88] and the requirement to value all assets of the business. This proposed approach would add significant unnecessary administrative burden and complexity. The Regulations should not adopt this approach.

The Proposed Regulations would appear to require an examination of each asset of the loss corporation to determine whether the value is less than the amount of the liabilities to which the asset is subject. As a result, taxpayers that undergo an Ownership Change at a time when they own property subject to nonrecourse liabilities may be required to obtain valuations of the applicable assets.

The Proposed Regulations' apparent requirement that a loss corporation value all of its assets (with the potential exception of those assets associated with nonrecourse liabilities) would be problematic. As we have discussed previously, Ownership Changes often occur outside of an M&A transaction, in a situation where there may be no reason for a company to value its assets. Notice 2003-65 essentially provided a safe harbor to value assets equal to the value paid for the equity of the loss company plus the liabilities assumed, under the reasonable assumption that what was paid for the equity would equal what someone would pay for the assets if that person assumed all of the liabilities. The language in the Proposed Regulations appears to jettison that idea and generally requires the taxpayer to value all assets and ignore the debt.

We understand the concerns of the government regarding Ownership Changes that occur when a company has essentially no equity value. In these situations it is possible that the value of the company's assets is less than its equity value plus liabilities. However, we believe the Proposed Regulations would result in undue burden on taxpayers and would lead to significant controversy with the Service. As a result, we believe that the Regulations should adopt a safe harbor that determines the value of the

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[88] Prop. Reg. §1.382-7(c)(3)(i)(A).

assets as equal to the value of the equity plus the liabilities assumed. This safe harbor could be provided in transactions where there is more than a de minimis amount of consideration paid for (or value of) the equity, which would limit the requirements to perform otherwise unnecessary valuations to the situations with which the government is concerned.

The Proposed Regulations' approach generally would treat loss corporations owing recourse debt less favorably than those owing nonrecourse debt. Loss corporations generally could avoid the valuation issues described above, and potentially achieve a more favorable tax result by taking action to change the nature of their debt from recourse to nonrecourse. In many cases, a loss corporation's debt could be changed from recourse debt to nonrecourse by taking action that has little or no impact on its creditor's economic position. The change could be accomplished, for example, by amending the terms of the debt, or by engaging in a corporate reorganization. The Proposed Regulations' approach thus encourages transactions that are entirely or substantially tax-motivated.

The Proposed Regulations, by generally requiring either multiple valuations or tax-motivated transaction steps, would delay and make more expensive the process of raising capital for a loss corporation, or planning the acquisition of a loss corporation. Imposing these delays and costs on capital and M&A markets would place undue burden on loss corporations' stakeholders such as creditors and equity investors.

In addition, the Proposed Regulations would depart from the Federal income tax rules generally applicable to debt that is not cancelled.[89] The proposal would instead apply rules to non-cancelled debt that generally parallel the rules applicable to cancelled debt.[90] A stated objective for this approach is to provide transparency and clarity.[91] Its effect, however, would be to impose burdens on taxpayers, stakeholders, and the Service, as described above.

Notwithstanding the increased burdens that the Proposed Regulations would have on loss corporations, their creditors and equity investors, the preamble to the NPRM touts the Proposed Regulations as simplifying the application of section 382.[92] In context of the proposed rules for the treatment of liabilities, the Proposed Regulations' consistency

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[89] *Compare* Reg. section 1.1001-2(a)(1) *with* Reg. section 1.382-7(c)(3)(i)(A).

[90] *Compare* Reg. section 1.1001-2(a)(2) *with* Reg. section 1.382-7(c)(3)(i)(A).

[91] NPRM, 84 Fed. Reg., at 47458.

[92] NPRM, 84 Fed. Reg., at 47457.

with the simplification objective is not apparent. We recommend that the Regulations do not apply any disparate treatment of recourse and nonrecourse debt and provide a safe harbor for valuing assets equal to the value of the equity plus liabilities assumed.

3. Treatment of contingent liabilities

With respect to the treatment of contingent liabilities, we believe that in determining NUBIG and NUBIL the approach described in Notice 2003-65 is appropriate.[93] The use of the rules under section 1374 remain appropriate and administrable. These rules, consistent with those in the Proposed Regulations, would continue to treat contingent liabilities like other deductible liabilities in the determination of NUBIG and NUBIL.

If the approach to of contingent liabilities set out in the Proposed Regulations is adopted, we believe certain adjustments are necessary. The Proposed Regulations' version of the 1374 Approach would treat contingent liabilities both as a component of both NUBIL and RBIL. This approach to contingent liabilities is in conflict with the tax accrual concept generally underlying the 1374 Approach that the NPRM seeks to adopt.

Accordingly, we recommend one of the following two alternatives.

Alternative 1: Adopt an accrual approach for the treatment of contingent liabilities.

Our first recommendation is to exclude post-Ownership Change deductions related to contingent liabilities from the definition of RBIL. In essence this would follow tax accrual principles. Under this approach, the Regulations would continue to make the adjustment for contingent liabilities in determining NUBIG and NUBIL as contemplated in the Proposed Regulations, or in a similar manner.[94] Retention of this adjustment is consistent with the treatment of other deductible liabilities, as contemplated by the Proposed Regulations.[95]

However, under this approach a contingent liability would not be included in RBIL because it is not attributable to the pre-Change period. In determining whether an amount recognized post-Change represents RBIL, legislative history instructs that "any

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[93] Notice 2003-65, section IV.

[94] *See* Prop. Reg. section 1.382-7(c)(3)(i)(D).

[95] Prop. Reg. section 1.382-7(c)(3)(i)(C).

amount which is allowable as a deduction during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction."[96] The only remaining question is thus whether a contingent liability is attributable to the pre-Change or post-Change period. We believe it is attributable to the post-Change period.

Regulations state that prepaid income is not RBIG,[97] and contingent liabilities should be treated no differently. Contingent liabilities are analogous to prepaid income in that both represent items of income or loss that will be realized by the loss corporation after the Change date and result from events that occurred prior to the Change date. This is evident when considering the rationale for the prepaid income rule under Regulation section 1.382-7. The preamble to the Temporary Regulation section 1.382-7T explained why Treasury and the Service concluded that prepaid income is not RBIG.[98] The Treasury Decision finalizing that rule states that prepaid income is not attributable to the period prior to the Ownership Change because recognition post-Change is a "better match to the taxpayer's income with the expenses incurred to earn the income."[99]

The term prepaid income was defined as an amount received prior to the Change and attributable to performance occurring after the Change date. Based upon this definition, Treasury and the Service determined that treating prepaid income as RBIG is inconsistent with the purposes of section 382(h).[100] It follows from this line of reasoning that contingent liabilities should be excluded from treatment as RBIL. Analogous to the recognition of prepaid income, the tax deduction (or tax basis allowance) for most contingent liabilities is deferred until the liability is fixed or paid, to better match the true economic outlay for the expenses. As with prepaid income, the taxpayer is aware of the item and an event has occurred pre- Change; however, as with prepaid income, the recognition of the item is better matched with the post-transaction activity. Accordingly, contingent liabilities should not be treated as RBIL when fixed or paid.

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[96] H.R. Rept. No. 100-795, 46 (1988); S. Rept. No. 100-445, 48 (1988).

[97] Reg. section 1.382-7(a).

[98] T.D. 9330, 72 Fed. Reg. 32792 (June 14, 2007), discussing Temp. Reg. section 1.382-7T(a). This rule was finalized in Reg. section 1.382-7(a) by T.D. 9487, 75 Fed Reg. 33992 (June 16, 2010).

[99] T.D. 9487.

[100] *See id.*

This conclusion can be illustrated most clearly when considering the inequitable treatment of prepaid income with the costs associated with earning that income. In general, when a company receives prepaid income there is also a corresponding cost associated with earning that income. That cost represents a contingent liability. Although the prepaid income is not RBIG,[101] the Proposed Regulations would treat the cost to earn the income as RBIL. This result is clearly inequitable. A more symmetrical approach is appropriate. We believe the correct approach is that neither prepaid income nor contingent liabilities represent recognized built-in items of income or deduction.

Alternative 2: Adopt an approach in which contingent liabilities would be included in RBIL with certain adjustments.

If the Regulations determine that an accrual approach, such as we are suggesting above, is not appropriate, we believe the Regulations should adopt a rule that treats contingent liabilities as RBIL when fixed or paid (except to the extent that the amount of such liability when it is fixed or paid exceeds the amount included as an adjustment in Proposed Regulation section 1.382-7(c)(3)(i)(D)). We also believe a rule should be included for purposes of applying section 382(h)(1)(B)(ii), which would clarify that the contingent liability should only be included in NUBIL if and when the contingent liability is satisfied. In addition, we believe it is important that the Regulations specify that in the application of section 382(h)(8), all liabilities, including deductible and contingent liabilities, should be included. Much like with a taxable asset acquisition, the assumption of contingent liabilities is a component of the overall asset value, and the Regulations should leave no doubt as to inclusion of these amounts in the application of section 382(h)(8).

We also believe that an exception to the general rule, that contingent liabilities are RBIL, should be made where there is a compelling policy objective. Exclusion of the deduction of payments made on qualified pension liabilities as RBIL is one such example.[102] Likewise, the costs associated with earning prepaid income, despite representing a contingent liability as of the Ownership Change date, should be excluded from RBIL.

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[101] Reg. section 1.382-7(a).

[102] *See*, *e.g.*, TAM 8436002 (Mar. 23, 1984) (payment of qualified pension liabilities assumed in an asset acquisition represented ongoing ordinary expenses, rather than payment of liabilities assumed in the acquisition).

Finally, as discussed in detail below, we believe that the Regulations should provide guidance limiting the definition of contingent liabilities to true contingent liabilities. Contingent liabilities are generally liabilities that have not met the Federal income tax standards for accrual.[103] We recommend that the Regulations define contingent liabilities. We recommend employing or adapting the definition in Regulation section 1.752-7 to do so. We believe it is important that the amount of a contingent liability for section 382 purposes reflect its true effect on fair market value of the asset or assets associated with it. Regulation section 1.752-7(b)(3)(ii) uses precisely this concept; the liability amount is the amount that a willing assignor would pay to a willing assignee to assume the liability.[104]

We believe that the approach to identify contingent liabilities should also be consistent with existing authorities related to assumption of liabilities in a taxable asset acquisition, which should closely mirror NUBIG and NUBIL. In the context of a taxable asset acquisition, whether a liability is assumed in the transaction does not depend on whether the liability is fixed or contingent. Rather, the existence of a liability is generally enough to require capitalization.[105] To determine whether a liability exists at the time of a transaction, courts have generally looked to a number of factors, including:

1. Did the liability result from the buyer's post-acquisition operations?
2. What post acquisition events occurred related to the liability?
3. Was the buyer aware of the liability?
4. When did the legal liability arise?
5. Was assumption of the liability reflected in the purchase price?
6. Was the liability expressly assumed by the buyer? and
7. Other various factors.[106]

In defining contingent liabilities it is important for taxpayers and Service personnel to bear in mind that not every item recorded as a liability on a taxpayer's financial statement is considered a liability for Federal income tax purposes. In general, financial accounting rules require a more conservative approach to recording income and assets

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[103] *See generally* section 461.

[104] Reg. section 1.752-7(b)(3)(ii).

[105] *See*, *e.g.*, *Illinois Tool Works, Inc.*, 355 F3d 997 (7th Cir. 2004); *David R. Webb Co.*, 708 F2d 1254 (7th Cir. 1983).

[106] Keyes, "The Treatment of Contingent Liabilities in Taxable Acquisitions," in *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* (Practising Law Institute, 2007), vol. 5, pp. 27, 40–46.

than Federal tax accounting rules do. As a corollary, the financial accounting rules favor recording of liabilities in situations the Federal income tax rules do not.

Anticipated restructuring expenses are such an example. If Company 1 is in the process of acquiring Company 2, Company 1 may plan to shut down redundant plants, warehouses, branches, or retail locations. Financial accounting rules may require Company 1 to record a provision for the estimated amount of the anticipated restructuring costs. These expected future costs should not be treated as liabilities for Federal income tax purposes merely because Company 1 plans to incur them when it has taken no action that would obligate it to pay any of these costs either in the present or the future.

Financial statements typically are highly probative in performing NUBIG and NUBIL calculations. Most items shown as liabilities on financial statements are properly treated as liabilities or contingent liabilities for Federal income tax purposes. However, because there are exceptions, as described above, the financial statements should not be determinative. The Proposed Regulations would make financial statement amounts determinative.[107]

The more conservative approach to recording income and assets, as discussed above, may result in recording contingent liabilities in amounts that exceed their fair market value under the principles of Regulation section 1.752-7. As noted above, we recommend using the rule for contingent liability measurement set out in Regulation section 1.752-7 because it is economically based. Making financial statement amounts determinative could lead to noneconomic NUBIG, NUBIL, and RBIL amounts – generally understatements of NUBIG and overstatements of NUBIL and RBIL – due to the conservative approach of financial accounting. Further, financial accounting approaches to recording contingent liabilities may change over time,[108] and neither such changes nor the timing or accuracy of a taxpayer's adoption of such changes, should determine the proper application of the NUBIG, NUBIL, RBIG, and RBIL rules.

We accordingly recommend that the preamble to the Regulations expressly note that an item does not constitute a contingent liability for purposes of the Regulations merely because it is properly recorded as a liability on a taxpayer's financial statements.

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[107] Prop. Reg. section 1.382-7(c)(3)(iii)(A).

[108] *See, e.g.,* FASB Invitation to Comment, Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805 (Feb. 14, 2019) (regarding proposed changes to measurement of certain amounts shown as liabilities on financial statements).

III. Conclusion

We commend Treasury and the Service for addressing issues related to built-in gains and losses, as there are uncertainties under current law and differing views regarding previously released precedential and non-precedential guidance. As described above, the approach set out in the Proposed Regulations gives rise to concerns regarding equity and appropriateness, would have significant deleterious effects on U.S. corporate equity values and markets, and would result in the implementation of many more transactions substantially motivated by attainment of tax benefits limited by section 382 than currently occur. These concerns and effects should be addressed in order to improve the Regulations' administrability and effectiveness. We are pleased to offer these Comments setting forth recommendations regarding certain matters addressed by these regulations.