Built-in Gains and Losses Under Section 382(h)

Notice 2003–65

I. Purpose

The Internal Revenue Service (IRS) is studying the circumstances under which items of income, gain, deduction, and loss that a loss corporation recognizes after an ownership change should be treated as recognized built-in gain (RBIG) and recognized built-in loss (RBIL) under section 382(h) of the Internal Revenue Code. This notice provides guidance regarding the identification of built-in items and requests comments on this subject. As described below under the heading Reliance on Notice, taxpayers may rely upon this guidance until the IRS and Treasury Department issue temporary or final regulations under section 382(h). This notice discusses two alternative approaches for the identification of built-in items for purposes of section 382(h): the 1374 approach and the 338 approach.

II. Background

Section 382 provides that, after an ownership change, the amount of a loss corporation's taxable income for any post-change year that may be offset by pre-change losses shall not exceed the section 382 limitation for that year. The section 382 limitation generally equals the fair market value of the old loss corporation multiplied by the long-term tax-exempt rate. A loss corporation is any corporation that has a net operating loss, a net operating loss carryforward, or a net unrealized built-in loss for the taxable year in which the ownership change occurs. An ownership change is a greater than 50-percentage-point increase in ownership by 5-percent shareholders during the testing period, which is generally three years. Congress intended the section 382 limitation to apply when shareholders that did not bear the economic burden of the losses acquire a controlling interest in the loss corporation. *See* H.R. Rep. No. 99–426, 1986–3 C.B. (Vol. 2) 256; S. Rep. No. 99–313, 1986–3 C.B. (Vol. 3) 232.

Section 382(h) provides rules for the treatment of built-in gain or loss recognized with respect to assets owned by the loss corporation at the time of its ownership change. Section 382(h), as described below, reflects that, as a general matter, losses that offset built-in gain should not be subject to the section 382 limitation merely because the gain is recognized after an ownership change because if the gain had been recognized before the ownership change, it would have been offset without limitation by the loss corporation's net operating losses. Similarly, built-in loss should not escape the section 382 limitation merely because it is recognized after an ownership change because if the loss had been recognized before the ownership change, it would have been subject to the section 382 limitation.

The question of whether RBIG increases the section 382 limitation or whether RBIL is subject to the section 382 limitation begins with a determination of whether the loss corporation has a net unrealized built-in gain (NUBIG) or a net unrealized built-in loss (NUBIL). Pursuant to section 382(h)(3), a loss corporation's NUBIG equals the excess, if any, of the aggregate fair market value of its assets immediately before an ownership change over the assets' aggregate adjusted basis at that time, adjusted by the amount of certain items of income or deduction described in section 382(h)(6)(C) (described below). In addition, a loss corporation's NUBIL equals the excess, if any, of the aggregate adjusted basis of its assets immediately before an ownership change over the assets' aggregate fair market value at that time, adjusted by the amount of certain items of income or deduction described in section 382(h)(6)(C). Under section 382(h)(3)(B), if a loss corporation's NUBIG or NUBIL does not exceed a threshold amount (the lesser of $10,000,000 or 15% of the fair market value of its assets immediately before the ownership change), the loss corporation's NUBIG or NUBIL is zero. Thus, a loss corporation cannot have both a NUBIG and a NUBIL, but it can have neither.

If a loss corporation has a NUBIG, pursuant to section 382(h)(1)(A), any RBIG for any taxable year within the 5-year recognition period following the ownership change increases the section 382 limitation for that year. Similarly, if a loss corporation has a NUBIL, pursuant to section 382(h)(1)(B), any RBIL for any taxable year within the 5-year recognition period following the ownership change is treated as a pre-change loss subject to the section 382 limitation. Thus, only a loss corporation with a NUBIG can increase the section 382 limitation by RBIG, and only a loss corporation with a NUBIL can have RBIL that is treated as a pre-change loss.

In the case of dispositions of assets during the recognition period, section 382(h)(2) places the burden on the loss corporation to establish that any gain recognized is RBIG, and, conversely, that any loss recognized is not RBIL. Section 382(h)(2)(A) defines RBIG as any gain recognized during the 5-year recognition period on the disposition of any asset to the extent the new loss corporation establishes that (i) it held the asset on the change date and (ii) such gain does not exceed the asset's built-in gain on the change date. Furthermore, section 382(h)(2)(B) defines RBIL as any loss recognized during the 5-year recognition period on the disposition of any asset except to the extent the new loss corporation establishes that (i) it did not hold the asset on the change date or (ii) such loss exceeds the asset's built-in loss on the change date.

Section 382(h)(6) and the second sentence of section 382(h)(2)(B) provide rules treating certain items of income or deduction as RBIG or RBIL. Specifically, section 382(h)(6)(A) provides that any item of income "properly taken into account during the recognition period" is treated as RBIG if the item is "attributable to periods before the change date." Section 382(h)(6)(B) provides that any item of deduction "allowable as a deduction during the recognition period" is treated as RBIL if the item is "attributable to periods before the change date." In addition, the second sentence of section 382(h)(2)(B) provides that allowable depreciation, amortization, or depletion deductions are treated as RBIL except to the extent the loss corporation establishes that the amount of the deduction is not attributable to the asset's built-in loss on the change date. Finally, section 382(h)(6)(C) provides that NUBIG or NUBIL shall be properly adjusted for items of income and deduction that would be treated as RBIG or RBIL under section 382(h)(6) if they were properly taken into account or allowable as a deduction during the recognition period.

The IRS has issued two notices concerning guidance under section 382(h). In Notice 87–79, 1987–1 C.B. 388, the IRS announced that it anticipated that regulations under section 382 would permit income from a discharge of indebtedness that is integrally related to a transaction resulting in an ownership change to be allocated to the pre-change period. In Notice 90–27, 1990–1 C.B. 336, the IRS announced that it would promulgate regulations providing that, if a taxpayer that sells a built-in gain asset either prior to or during the recognition period reports the gain using the installment method under section 453, the provisions of section 382(h) will continue to apply to RBIG from the installment sale after the recognition period (including any gain recognized from the disposition of the installment obligation).

III. The 1374 Approach

The 1374 approach generally incorporates the rules of section 1374(d) and §§1.1374–3, 1.1374–4, and 1.1374–7 of the Income Tax Regulations in calculating NUBIG and NUBIL and identifying RBIG and RBIL. The following sections describe the application of those rules in the context of section 382(h) and describe those areas in which the 1374 approach departs from those rules.

A. *Calculation of NUBIG and NUBIL*

Under the 1374 approach, NUBIG or NUBIL is the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change. Specifically, NUBIG or NUBIL is calculated by determining the amount that would be the amount realized if immediately before the ownership change the loss corporation had sold all of its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities, decreased by the sum of any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale and the loss corporation's aggregate adjusted basis in all of its assets, increased or decreased by the corporation's section 481 adjustments that would be taken into account on a hypothetical sale, and increased by any RBIL that would not be allowed as a deduction under section 382, 383, or 384 on the hypothetical sale. *See* §1.1374–3(a) (regarding the calculation of NUBIG). The amount by which this result exceeds $0 is the loss corporation's NUBIG; the amount by which $0 exceeds this result is the loss corporation's NUBIL.

For all of the examples in this notice, unless otherwise noted, LossCo is a loss corporation (as defined in section 382(k)) that is a calendar year basis taxpayer that uses the accrual method of accounting and that has an ownership change on the last day of a taxable year.

Example 1. Immediately before an ownership change, LossCo has one asset with a fair market value of $100 and an adjusted basis of $10, and a deductible liability of $30. Disregarding the threshold requirement of section 382(h)(3)(B), LossCo has a NUBIG of $60 ($100, the amount LossCo would realize if it sold all its assets to a third party that assumed all of its liabilities, decreased by $40, the sum of the deductible liability ($30) and the aggregate basis in the assets ($10)).

Example 2. The facts are the same as in Example 1 except that the asset has an adjusted basis of $90 instead of $10. Disregarding the threshold requirement of section 382(h)(3)(B), LossCo has a NUBIL of $20 (the amount by which $0 exceeds -$20 ($100, the amount LossCo would realize if it sold all its assets to a third party that assumed all of its liabilities, decreased by $120, the sum of the deductible liability ($30) and the aggregate basis in the assets ($90))).

B. *Calculation of RBIG and RBIL*

1. *Gain and Loss from Sales or Exchanges of Assets*

Under the 1374 approach, the amount of gain or loss recognized during the recognition period on the sale or exchange of an asset is RBIG or RBIL, respectively, subject to the limitations described in section 382(h)(2)(A) or (B). The sum of the RBIG or RBIL (including deductions that are treated as RBIL as described below) attributable to an asset cannot exceed the unrealized built-in gain or loss in that asset on the change date.

With respect to gain from sales reported under the section 453 installment method, the 1374 approach follows the section 1374 regulations and Notice 90–27, which treat built-in gain recognized from installment sales that occur before or during the recognition period as RBIG, even if recognized after the recognition period. *See* §1.1374–4(h); *see also* Notice 90–27, 1990–1 C.B. 336.

In addition, as set forth in Notice 90–27, if a corporation transfers a built-in gain asset to an affiliated corporation, the gain is deferred under the consolidated return regulations, and, before the close of the recognition period, the affiliated corporation sells the built-in gain asset in a sale reportable under the installment method, such deferred gain is RBIG when such gain is taken into account by the selling or distributing member, and will cause an increase in the section 382 limitation for the taxable year of payment, even if the gain is taken into account after the recognition period. *See* Notice 90–27, 1990–1 C.B. 336, 338.

2. *Items of Income and Deduction*

a. *In General*

In cases other than sales and exchanges, the 1374 approach generally relies on the accrual method of accounting to identify income or deduction items as RBIG or RBIL, respectively. Under this approach, items of income or deduction properly included in income or allowed as a deduction during the recognition period are considered "attributable to periods before the change date" under sections 382(h)(6)(A) and (B) and, thus, are treated as RBIG or RBIL, respectively, if an accrual method taxpayer would have included the item in income or been allowed a deduction for the item before the change date. However, for purposes of determining whether an item is RBIL, section 461(h)(2)(C) and §1.461–4(g) (concerning certain liabilities for which payment is economic performance) do not apply. *See* §§1.1374–4(b)(1) and (2).

Example 3. Immediately before an ownership change, LossCo, which uses the cash method of accounting, has a $50 account receivable with a fair market value of $40 and a basis of $0. In Year 2 of the recognition period, LossCo sells the account receivable for $40 before collecting any part of it. LossCo has $40 of RBIG in Year 2.

Example 4. The facts are the same as in *Example 3*, except that instead of selling the account receivable, LossCo collects $50 on the account receivable in Year 2 of the recognition period. LossCo has $50 of RBIG in Year 2, because that is the amount that accrued immediately before the ownership change. *See* §1.1374–4(b)(3), Example 1.

Example 5. The facts are the same as in *Example 3*, except that LossCo collects $25 on the account receivable in Year 2 of the recognition period and then sells the remainder of the account receivable for $20 in Year 3 of the recognition period. LossCo has $25 of RBIG in Year 2, and $15 of RBIG in Year 3 ($40 of built-in gain on the change date decreased by $25 of income previously treated as RBIG in Year 2).

(i) *Income Generated by Built-in Gain Assets*

In general, the 1374 approach does not treat income from a built-in gain asset during the recognition period as RBIG because such income did not accrue before the change date.

Example 6. LossCo has a NUBIG of $300,000 that is attributable to several non-amortizable assets with an aggregate fair market value of $650,000 and an aggregate adjusted basis of $500,000, and a patent with a fair market value of $170,000 and an adjusted basis of $20,000. The patent is an "amortizable section 197 intangible" as defined in section 197(c). In Year 1 of the recognition period, LossCo has gross income of $75,000, $20,000 of which is attributable to royalties collected in connection with the license of the patent. No part of the $20,000 attributable to the royalties is RBIG in Year 1 because the income would not have been properly taken into account before the change date by an accrual method taxpayer. Accordingly, LossCo's section 382 limitation for Year 1 is not increased by any part of that amount.

(ii) *Depreciation, Amortization and Depletion Deductions with Respect to Built-in Loss Assets*

The 1374 approach departs from the tax accrual rule and the regulations under section 1374 in its treatment of amounts allowable as depreciation, amortization, or depletion (collectively, "amortization") deductions during the recognition period. In accordance with the second sentence of section 382(h)(2)(B), except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its fair market value on the change date, these amounts are treated as RBIL, regardless of whether they accrued for tax purposes before the change date. A loss corporation may use any reasonable method to establish that the amortization deduction amount is not attributable to an asset's built-in loss on the change date. One acceptable method is to compare the amount of the amortization deduction actually allowed to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its fair market value on the change date. The amount by which the amount of the actual amortization deduction does not exceed the amount of the hypothetical amortization deduction is not RBIL.

Example 7. LossCo has a NUBIL of $300,000 that is attributable to several non-amortizable assets with an aggregate fair market value of $500,000 and an aggregate adjusted basis of $650,000, and a patent with a fair market value of $125,000 and an adjusted basis of $275,000. The patent is an "amortizable section 197 intangible" as defined in section 197(c). As of the change date, the patent has a remaining useful life for tax purposes of 5 years. On its tax return for Year 1, LossCo claims a $55,000 amortization deduction for the patent. If LossCo had purchased the patent for its fair market value on the change date, it would have been allowed an amortization deduction in the amount of $8,333 on that return. Accordingly, LossCo is able to establish that $8,333 of the amortization deduction for that taxable year is not attributable to the patent's built-in loss on the change date. Therefore, $46,667 of the actual amount of the amortization deduction in Year 1 is RBIL. On the first day of Year 2, LossCo sells the patent for $70,000 and recognizes $150,000 of loss. Of LossCo's $150,000 loss from the sale, $103,333 is RBIL under section 382(h)(2)(B) ($150,000 built-in loss on the change date decreased by the $46,667 deduction attributable to the patent previously treated as RBIL).

b. *Discharge of Indebtedness Income and Bad Debt Deductions*

The 1374 approach generally treats as RBIG or RBIL any income or deduction item properly taken into account during the first 12 months of the recognition period as discharge of indebtedness income ("COD income") that is included in gross income pursuant to section 61(a)(12) or as a bad debt deduction under section 166 if the item arises from a debt owed by or to the loss corporation at the beginning of the recognition period. *See* §1.1374–4(f). Any reduction of tax basis under sections 108(b)(5) and 1017(a) that occurs as a result of COD income realized within the first 12 months of the recognition period is treated as having occurred immediately before the ownership change for purposes of determining whether a recognized gain or loss is an RBIG or an RBIL under section 382(h)(2). However, the reduction of tax basis does not affect the loss corporation's NUBIG or NUBIL under section 382(h)(3).

Example 8. LossCo has a NUBIG of $300,000. On the change date, LossCo has an asset with a fair market value of $200,000 and a basis of $150,000. The asset is subject to a debt with an adjusted issue price of $98,000. During Year 1 of the recognition period, LossCo satisfies the debt by paying the lender $95,000. On its tax return for Year 1, LossCo includes in gross income $3,000 of COD income. That amount is RBIG in Year 1. In Year 2, LossCo sells the asset for $200,000. The $50,000 of gain recognized on the sale of the asset is RBIG in Year 2.

Example 9. The facts are the same as in *Example 8*, except that $3,000 of the debt is discharged in a Title 11 case. LossCo excludes the $3,000 of COD income under section 108(a) and reduces the tax basis of the asset from $150,000 to $147,000 under sections 108(b)(5) and 1017(a). The $3,000 of COD income that is excluded from income is not treated as RBIG. However, because the basis reduction is treated as having occurred immediately before the recognition period for purposes of section 382(h)(2), the $53,000 of gain recognized on the sale of the asset is RBIG.

As suggested above, the treatment of COD income under the 1374 approach differs from the treatment of that item as described in Notice 87–79, which treats COD income that is "integrally related to an ownership change" but is recognized after the ownership change as RBIG. Taxpayers that otherwise follow the 1374 approach may apply the rules described in Notice 87–79, rather than the rules included in the 1374 approach, to COD income for ownership changes that occur before September 12, 2003, but may not rely on the rules described in Notice 87–79 for ownership changes that occur on or after September 12, 2003.

IV. The 338 Approach

The 338 approach identifies items of RBIG and RBIL generally by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if a section 338 election had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date (the "hypothetical purchase"). As a result, unlike under the 1374 approach, under the 338 approach, built-in gain assets may be treated as generating RBIG even if they are not disposed of at a gain during the recognition period, and deductions for liabilities, in particular contingent liabilities, that exist on the change date may be treated as RBIL.

A. *Calculation of NUBIG and NUBIL*

Under the 338 approach, NUBIG or NUBIL is calculated in the same manner as it is under the 1374 approach. Accordingly, unlike the case in which a section

338 election is actually made, contingent consideration (including a contingent liability) is taken into account in the initial calculation of NUBIG or NUBIL, and no further adjustments are made to reflect subsequent changes in deemed consideration.

Example 10. Immediately before an ownership change, LossCo has one asset with a fair market value of $100 and a basis of $10 and a deductible contingent liability estimated at $40. Disregarding the threshold requirement of section 382(h)(3)(B), LossCo has a NUBIG of $50 ($100, the amount LossCo would realize if it sold all of its assets to a third party that assumed all of its liabilities, decreased by $50, the sum of deductible liabilities ($40) and the aggregate basis of LossCo's assets ($10)). During Year 1 of the recognition period, a final legal determination fixes the contingent liability at $10. NUBIG is not readjusted to reflect the resolution of the amount of the contingent liability.

B. *Calculation of RBIG and RBIL*

The 338 approach identifies RBIG or RBIL by comparing the loss corporation's actual items of income, gain, deduction, and loss with the items of income, gain, deduction, and loss that would result if a section 338 election had been made for the hypothetical purchase. For purposes of identifying those items that would have resulted had a section 338 election been made with respect to the hypothetical purchase, after the hypothetical purchase, the loss corporation is treated as using those accounting methods that the loss corporation actually uses. The following sections describe the application of the 338 approach to certain items of the loss corporation.

1. *Gain and Loss from Sales or Exchanges of Assets*

The 338 approach identifies RBIG or RBIL from sales and exchanges of assets by comparing the loss corporation's actual item of gain or loss with the gain or loss that would result if a section 338 election had been made for the hypothetical purchase. With respect to gain from sales reported under the section 453 installment method, the 338 approach follows Notice 90–27, which, as described above, treats built-in gain recognized from installment sales that occur before or during the recognition period as RBIG, even if recognized after the recognition period. In addition, the 338 approach follows Notice 90–27 in cases in which a corporation transfers a built-in gain asset to an affiliated corporation, the gain is deferred under the consolidated return regulations, and, before the close of the recognition period, the affiliated corporation sells the built-in gain asset in a sale reportable under the installment method. In such cases, the deferred gain is RBIG when it is taken into account by the selling or distributing member, even if the gain is taken into account after the recognition period. *See* Notice 90–27, 1990–1 C.B. 336.

2. *Wasting or Consumption of Built-in Gain Assets*

As described above, for loss corporations with a NUBIG, the 338 approach treats certain built-in gain assets of the loss corporation as generating RBIG even if such assets are not disposed of during the recognition period. The 338 approach assumes that, for any taxable year, an asset that had a built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for such asset under the applicable Code section if an election under section 338 had been made with respect to the hypothetical purchase. Therefore, with respect to an asset that had a built-in gain on the change date, the 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to such asset had an election under section 338 been made for the hypothetical purchase over the loss corporation's actual allowable cost recovery deduction. The cost recovery deduction that would have been allowed to the loss corporation had an election under section 338 been made with respect to the hypothetical purchase will be based on the asset's fair market value on the change date and a cost recovery period that begins on the change date. The excess amount is RBIG, regardless of the loss corporation's gross income in any particular taxable year during the recognition period.

Example 11. LossCo has a NUBIG of $300,000 that is attributable to various non-amortizable assets with an aggregate fair market value of $710,000 and an aggregate adjusted basis of $500,000, and a patent with a fair market value of $120,000 and an adjusted basis of $30,000. The patent is an "amortizable section 197 intangible" as defined in section 197(c) for which 10 years of tax depreciation remain. In Year 1 of the recognition period, LossCo has gross income of $75,000. In Year 1, $5,000 is RBIG attributable to the patent (the excess of the $8,000 amortization deduction that would have been allowed had a section 338 election been made with respect to a hypothetical purchase of all of the stock of LossCo ($120,000 fair market value divided by 15, the amortization period) over $3,000 (the actual allowable amortization deduction)). This $5,000 of RBIG increases LossCo's section 382 limitation for Year 1.

On the first day of Year 2, LossCo sells the patent to an unrelated third party for $117,000 and recognizes $90,000 of gain. If a section 338 election had been made with respect to a hypothetical purchase of all of the stock of LossCo, LossCo would have recognized $5,000 of gain on the sale of the patent, because LossCo would have had an adjusted basis of $112,000 in the patent at the time of its sale. Therefore, LossCo has $85,000 of RBIG from the sale of the patent (the excess of LossCo's actual $90,000 of gain over the $5,000 of gain LossCo would have recognized had an election under section 338 been made with respect to a hypothetical purchase of all of the stock of LossCo). Thus, LossCo's section 382 limitation for Year 2 is increased by $85,000.

Example 12. The facts are the same as in *Example 11*, except that, as of the change date, only 2 years of tax depreciation remain for the patent. For Year 1 of the recognition period, LossCo has gross income of $75,000. No amount is RBIG attributable to the patent ($8,000, the amortization deduction that would have been allowed had a section 338 election been made with respect to the hypothetical purchase of all of the stock of LossCo, does not exceed the $15,000 actual allowable amortization deduction). In Year 3, $8,000 is RBIG attributable to the patent (the excess of the $8,000 amortization deduction that would have been allowed had a section 338 election been made with respect to the hypothetical purchase of all of the stock of LossCo over $0, the actual allowable amortization deduction (because the patent's basis is exhausted)). Thus, LossCo's section 382 limitation for Year 3 is increased by $8,000.

3. *Depreciation, Depletion, and Amortization Deductions with Respect to Built-in Loss Assets*

For loss corporations with a NUBIL, the 338 approach treats as RBIL certain deductions of the loss corporation. In particular, with respect to an asset that has a built-in loss on the change date, the 338 approach treats as RBIL the excess of the loss corporation's actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable to the loss corporation with respect to such asset had an election under section 338 been made with respect to the hypothetical purchase.

Example 13. LossCo has a NUBIL of $410,000 that is attributable to various non-amortizable assets with an aggregate fair market value of $500,000 and an aggregate adjusted basis of $850,000, and a patent with a fair market value of $90,000 and an adjusted basis of $150,000. LossCo acquired the patent in a transaction in which LossCo acquired no other intangibles. The patent is an "amortizable section 197 intangible" as defined in section 197(c) for which 10 years of tax depreciation remain. The patent generates a $15,000 amortization deduction each year. During each year of the recognition period, $9,000 of the deduction is RBIL attributable to the patent (the excess of the $15,000 actual allowable amortization deduction over the $6,000 amortization deduction that would have been allowed had a section 338 election been made with respect to the hypothetical purchase of all of the stock of LossCo ($90,000 fair market value divided by 15, the amortization period)).

On the first day of Year 2 of the recognition period, LossCo sells the patent to a third party for $80,000 and recognizes a $55,000 loss. If a section 338 election had been made with respect to a hypothetical purchase of all of the stock of LossCo on the change date, LossCo would have recognized a $4,000 loss on the patent, because, in that case, LossCo would have had an adjusted basis of $84,000 in the patent at the time of its sale. Therefore, LossCo has $51,000 of RBIL from the sale of the patent (the excess of LossCo's actual $55,000 loss over the $4,000 loss LossCo would have recognized had an election under section 338 been made with respect to a hypothetical purchase of all of the stock of LossCo).

C. *Contingent Liabilities*

The 338 approach treats a deduction for the payment of a liability that is contingent on the change date as RBIL to the extent of the estimated liability on the change date.

Example 14. LossCo has a contingent liability estimated at $25 on the change date. During Year 2 of the recognition period, LossCo pays $30 to settle the liability and claims a deduction for that amount. Of that amount, $25 is RBIL.

D. *Discharge of Indebtedness Income*

Under the 338 approach, COD income that is included in gross income under section 61(a)(12) and that is attributable to any pre-change debt of the loss corporation is RBIG in an amount not exceeding the excess, if any, of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date. The 338 approach treats a reduction of tax basis under sections 108(b)(5) and 1017(a) that occurs during the recognition period as having occurred immediately before the ownership change for purposes of section 382(h)(2) to the extent of the excess, if any, of the adjusted issue price of the debt over the fair market value of the debt on the change date. However, the reduction of tax basis does not affect the loss corporation's NUBIG or NUBIL under section 382(h)(3). As with the 1374 approach, taxpayers that otherwise follow the 338 approach may apply the rules described in Notice 87–79, rather than the rules included in the 338 approach to COD income for ownership changes that occur before September 12, 2003, but may not rely on the rules of Notice 87–79 for ownership changes that occur on or after September 12, 2003.

Example 15. LossCo has a NUBIG of $300,000 that is, in part, attributable to an asset with a fair market value of $200,000 and a basis of $150,000. The asset is subject to a debt with an adjusted issue price of $98,000, and a fair market value of $95,000. During Year 2 of the recognition period, $95,000 of the debt is satisfied and $3,000 of the debt is discharged in a Title 11 case. LossCo excludes the $3,000 COD income under section 108(a) and reduces the tax basis of the asset under sections 108(b)(5) and 1017(a) to $147,000. The tax basis of the asset does not otherwise change during the recognition period. In Year 3, LossCo sells the asset for $200,000 and recognizes $53,000 of gain. The $3,000 of COD income that is excluded from income is not RBIG. If a section 338 election had been made with respect to a hypothetical purchase of all of the stock of LossCo, LossCo would have recognized $0 of gain on the sale of the asset, because, in that case, LossCo would have had an adjusted basis of $200,000 in the asset at the time of its sale. Therefore, LossCo has $53,000 of RBIG from the sale of the asset (the excess of LossCo's actual $53,000 of gain over the $0 of gain LossCo would have recognized had an election under section 338 been made with respect to a hypothetical purchase of all of the stock of LossCo). Thus, LossCo's section 382 limitation for Year 3 is increased by $53,000.

E. *Other Items*

The 338 approach incorporates the special rules in §1.1374–4(i) concerning partnership items and §1.1374–4(d) concerning section 481 adjustments, to the extent those items are not already taken into account in the basic methodology of the 338 approach of comparing actual items of the loss corporation to those that would have resulted had a section 338 election been made with respect to the hypothetical purchase.

V. Reliance on Notice

Taxpayers may rely on the approaches set forth in this notice for purposes of applying section 382(h) to an ownership change that occurred prior to the issuance of this notice or on or after the issuance of this notice and prior to the effective date of temporary or final regulations under section 382(h). The IRS will not assert an alternative interpretation of section 382(h) against a taxpayer that consistently applies either the 1374 approach or the 338 approach described in this notice. Taxpayers may use either the 1374 approach or the 338 approach, but not elements of both, for each ownership change with respect to a loss corporation or a loss subgroup as defined in §1.1502–91(d). Although the approaches described in this notice serve as safe harbors, they are not the exclusive methods by which a taxpayer may identify built-in items for purposes of section 382(h). Other methods taxpayers use to identify built-in items for purposes of section 382(h) will be examined on a case-by-case basis.

VI. Effect on Other Documents

Notice 87–79, 1987–1 C.B. 388, is modified.

VII. Request for Comments

The IRS intends to publish, in the near future, proposed regulations providing a single set of rules for identifying built-in items for purposes of section 382(h). The IRS requests comments regarding whether one of the two approaches described in this notice should be adopted and to what extent, if any, the approaches should be combined or modified to produce a set of rules that is both reflective of statutory intent and administrable. The IRS also invites comments regarding other issues under section 382(h) that should be addressed in regulations. Finally, the IRS requests comments regarding the extent to which regulations promulgated under section 384 identifying built-in items should differ from regulations promulgated under section 382(h) identifying built-in items. Comments should refer to Notice 2003–65, and should be submitted to:

Internal Revenue Service
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Ben Franklin Station
Washington, D.C. 20044
Attn: CC:PA:LPD:PR
Room 5203

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DRAFTING INFORMATION

The principal author of this notice is Marie Byrne of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Byrne at (202) 622–7750 (not a toll-free number).