

Modification of Notice 2003-65

Notice 2018-30

SECTION 1. PURPOSE

The purpose of this notice is to modify Notice 2003-65, 2003-2 C.B. 747. Specifically, section 3 of this notice provides that the hypothetical cost recovery deductions used in the 338 approach described in Notice 2003-65 to identify recognized built-in gain (RBIG) or recognized built-in loss (RBIL) under section 382 of the Internal Revenue Code (Code) are determined without regard to section 168(k) of the Code. Similarly, in computing the amount of cost recovery deductions that are not attributable to an asset's built-in loss on the change date under the 1374 approach described in Notice 2003-65, the hypothetical deductions that would have been allowable had the loss corporation purchased the asset for its fair market value on the change date are determined without regard to section 168(k).

SECTION 2. BACKGROUND

Section 382 generally provides that, after an ownership change (as defined in section 382(g)), the amount of taxable income of a loss corporation (as defined in section 382(k)) for any post-change year (as defined in section 382(d)(2)) that may be offset by pre-change losses (as defined in section 382(d)(1)) shall not exceed the section 382 limitation (as defined in section 382(b)) for that year.

Section 382(h) provides rules for the treatment of built-in gain or loss with respect to assets owned by the loss corporation at the time of its ownership change. Under that

provision, if, at the time of an ownership change, a loss corporation has a net unrealized built-in gain (NUBIG), any RBIG for a taxable year within the 5-year recognition period following the ownership change increases the section 382 limitation for that year, but not above the amount of the NUBIG. Similarly, if a loss corporation has a net unrealized built-in loss (NUBIL), any RBIL for a taxable year within the 5-year recognition period is a pre-change loss subject to the section 382 limitation, but not above the amount of the NUBIL.

Notice 2003-65 provides two alternative safe harbor approaches to the determination of RBIG and RBIL: the “338 approach” and the “1374 approach”.

Under the 338 approach, items of RBIG and RBIL are identified—

...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...

Notice 2003-65, 2003-2 C.B. at 749. As described in Section IV of Notice 2003-65, under the 338 approach, certain assets generate RBIG or RBIL even if not disposed of during the recognition period. Specifically, the 338 approach treats as RBIG or RBIL (as the case may be) the difference between the loss corporation’s actual allowable cost recovery deduction with respect to an asset and the hypothetical cost recovery deduction that would have been allowable with respect to the asset had an election under section 338 been made for a purchase of the loss corporation’s stock.

With respect to built-in gain assets of loss corporations with NUBIG, Notice 2003-65 explains the use of these hypothetical cost recovery deductions as follows:

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.

Notice 2003-65, 2003-2 C.B. at 750. Notice 2003-65 applies the same methodology to the determination of RBIL by loss corporations with NUBIL:

...with respect to a built-in loss asset 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.

Id.

Section 13201 of "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 (Act), amended section 168(k) to extend and modify the additional first year depreciation deduction for qualified property (as defined in section 168(k)(2)) acquired and placed in service after September 27, 2017, and before January 1, 2027. The additional first year depreciation deduction allowed under section 168(k) is equal to 100 percent for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023, and thereafter is phased down 20 percentage points each year for property placed in service through December 31, 2026. In addition, prior to the Act, for qualified property to be eligible for additional first year depreciation, the original use of the property had to commence with the taxpayer. The Act removed this requirement, thus allowing certain used property to qualify for the additional first year depreciation deduction.

Pursuant to Notice 2003-65 in its current form, the amendments to section 168(k) would have collateral consequences in connection with the 338 approach. The additional first year depreciation would increase RBIG and reduce RBIL in the first year of the recognition period. Moreover, in some situations, total RBIG would increase and total RBIL would either increase or decrease over the 5-year recognition period.

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have determined that these changes in amounts of RBIG and RBIL are not appropriate. The legislative history of the Act indicates that the amendments to section 168(k) were intended to encourage capital investment by reducing the cost of capital and simplify recordkeeping. H.R. Rep. No. 115-409 (2018) at 232. There is no indication in the Act or in the legislative history that the amendments to section 168(k) were intended to reflect an estimate of income or expense generated by an asset during any particular time.

Accordingly, the Treasury Department and the IRS have determined that the hypothetical cost recovery deduction using the additional first year depreciation allowed under section 168(k) does not provide a reasonable estimate of the income or expense produced by a built-in gain or loss asset during the recognition period. Thus, the use of this additional first year depreciation would invalidate the assumption that underlies the section 338 approach, as set forth above.

The concerns underlying the 338 approach apply equally to one portion of the 1374 approach. The 1374 approach generally incorporates the rules of section 1374(d) of the Code and §§ 1.1374-3, 1.1374-4, and 1.1374-7 of the Income Tax Regulations in identifying RBIG and RBIL. The 1374 approach relies on the accrual method of

accounting in determining whether certain items of income or deduction are RBIG or RBIL respectively. However, in accordance with section 382(h)(2)(B), the 1374 approach treats any allowable deduction for depreciation, amortization, or depletion (collectively, “amortization”) of a built-in loss asset as RBIL, except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset’s adjusted basis over its fair market value on the change date, regardless of whether the amount accrued for tax purposes before the change date. In determining the amount of amortization deduction that is not attributable to an asset’s built-in loss on the change date, Notice 2003-65 provides:

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.

Notice 2003-65, 2003-2 C.B. at 749. This method is essentially the same as the 338 approach for determining RBIL. Accordingly, the Treasury Department and the IRS have determined that a hypothetical amortization deduction using the additional first year depreciation allowed under section 168(k) does not provide a reasonable estimate of RBIL for purposes of section 382(h)(2)(B) under the 1374 approach.

SECTION 3. MODIFICATIONS TO NOTICE 2003-65 SAFE HARBOR APPROACHES

This notice modifies the 338 approach and the 1374 approach set forth in Notice 2003-65.

Pursuant to Notice 2003-65 as modified by this notice, under the 338 approach, in determining RBIG or RBIL, the hypothetical cost recovery deductions that would have

been allowable had an election under section 338 been made are determined without regard to section 168(k).

Pursuant to Notice 2003-65 as modified by this notice, under the 1374 approach, in computing the amount of cost recovery deductions that are not attributable to an asset's built-in loss on the change date, the hypothetical cost recovery deductions that would have been allowable had the loss corporation purchased the asset for its fair market value on the change date are determined without regard to section 168(k).

SECTION 4. EFFECT ON OTHER DOCUMENTS

Notice 2003-65, 2003-2 C.B. 747, is modified.

SECTION 5. REQUEST FOR COMMENTS

The Treasury Department and the IRS continue to request comments on the treatment of built-in items under section 382(h).

SECTION 6. EFFECTIVE DATE

This notice is effective for any ownership changes (as defined in section 382(g)) that occur after May 8, 2018.

SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Matt Tam of the Office of the Associate Chief Counsel (Corporate). Other personnel from the Treasury Department and the IRS also participated in its development. For further information regarding this notice, contact Matt Tam at (202) 317-5024 (not a toll-free call).