

WNTS Insight



Two recent PLRs address important technical issues under section 382

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Section 382, which limits the use of net operating losses (NOLs) and certain built-in losses following a corporate "ownership change," has taken on added importance due to the economic conditions that began in 2008. Fortunately, the IRS continues to issue formal and informal guidance under section 382, including two recent private letter rulings (PLRs) that address significant technical issues under section 382(h), which provides numerous special rules for built-in gains and losses. While a letter ruling cannot be relied on except by the particular taxpayer to which it was issued, PLRs may offer important insights into current IRS National Office thinking.

One section 382 PLR issued late last year -- PLR 201051019 -- addressed the application of net unrealized built-in gain and loss rules to liabilities discharged in bankruptcy. The other -- PLR 201051020 -- confirmed recognized built-in gain treatment for section 1248 dividends from the sale or exchange of controlled foreign corporation (CFC) stock after multiple ownership changes.

Background

Section 382 imposes an annual limitation on the amount of taxable income of a "loss corporation" that can be offset by pre-change losses. In general, the section 382 limitation for any post-change year equals the value of the loss corporation (reduced by certain items) multiplied by the long-term tax-exempt rate.

An ownership change is defined generally as a greater-than-50-percentage-point increase (by value) in the ownership of stock by five-percent shareholders over a three-year period. The testing period ends after three years whether or not the ownership shifts result in an ownership change.

A five-percent shareholder is defined, under very complex rules, as any person or group holding five percent or more of the loss corporation's stock at any time during the testing period. Ownership changes are based on changes (by value) in the percentage of stock owned by five-percent shareholders.

When determining the annual section 382 limitation, the taxpayer first must calculate any net unrealized built-in gain (NUBIG) or net unrealized built-in loss (NUBIL), which is generally the amount by which the fair market value (FMV) of assets of the loss corporation immediately before the ownership change is more or less, respectively, than the aggregate adjusted basis of such assets at the time of the ownership change.

Generally, if a loss corporation has a NUBIG, the section 382 limitation for any recognition period tax year is increased by any recognized built-in gains (RBIG) for the tax year. Conversely, if a loss corporation has a NUBIL, the recognized built-in loss (RBIL) for any recognition period tax year is subject to the same section 382 limitation as if it were a pre-change loss.

The IRS issued Notice 2003-65 to address certain built-in gain and built-in loss issues presented by section 382(h). The Notice allows taxpayers to choose between two different nonexclusive approaches -- "the 338 approach" and "the 1374 approach" -- that can be used as safe harbors by taxpayers in determining RBIG and RBIL items.

PLR 201051019: Liabilities discharged in bankruptcy included in NUBIG/NUBIL calculation

In this PLR, the IRS ruled that in applying Notice 2003-65 to the calculation of NUBIG or NUBIL, all liabilities held immediately before the ownership change date should be taken into account at their adjusted issue price, regardless of whether they were subsequently discharged in whole or in part during the recognition period (which includes the change date).

Parent and a disregarded entity owned by one of its subsidiaries filed for bankruptcy protection under Chapter 11. Upon their emergence from bankruptcy, Parent underwent an ownership change. The IRS ruled on various issues the taxpayer faced in calculating its section 382 limitation, including the potential application of a special rule for bankruptcy transactions under section 382(l)(6).

The second issue involved the common situation in which liabilities are discharged coincident with an ownership change. This discharge generally results in cancellation of indebtedness (COD) income. The IRS concluded, under the facts of the PLR, that in determining NUBIG or NUBIL in the hypothetical sale of all assets to a third party that assumes all liabilities under Notice 2003-65, "all liabilities" means the issue price of liabilities immediately before the ownership change and not fair value, even in the case of liabilities that are discharged on the ownership change date.

PLR 201051020: IRS applies section 382 to built-in gain on CFC stock

This PLR illustrates that section 1248 gain from the sale or exchange of CFC stock may be treated as RBIG for purposes of increasing a section 382 limitation and that gain from the same asset sale can increase the section 382 limitations for two successive ownership changes under section 382.

Company is the common parent of an affiliated group of corporations (the Affiliated Corporations) formed upon its acquisition of Sub1 (Ownership Change 1). Sub1 wholly owns Sub2, which wholly owns FSub, a CFC. Following a second ownership change (Ownership Change 2), Sub1 and Sub2 filed for bankruptcy under Chapter 11.

Pursuant to the court-approved plan, Sub2 transferred all its shares of FSub to LLC, a newly formed disregarded domestic LLC wholly owned by Sub2. Immediately thereafter, Sub2 transferred its entire interest in LLC to the Affiliated Corporations' creditors in a fully taxable transaction in full satisfaction of their claims. Sub2 will recognize gain on the transaction (the Exchange Gain) that is expected to be recharacterized as a dividend under section 1248(a).

The IRS ruled under the facts of the PLR that the Exchange Gain, including any resulting section 1248(a) dividend, will be treated as RBIG for purposes of calculating the section 382 limitations for both Ownership Change 1 and Ownership Change 2.

Observations

The treatment of COD income under section 382(h) is a common and complex topic. Unfortunately, Notice 2003-65 does not provide completely clear guidance on aspects of this issue, so PLR 201051019 provides welcome guidance by shedding some light on the IRS's view that, at least in the fact pattern presented, "all liabilities" -- even those that are discharged on the date of the ownership change -- should be included in any NUBIG or NUBIL calculation under the Notice. The ruling does not address the important related issue of how and whether to treat COD income as RBIG -- either directly, or indirectly, e.g., as a wasting asset intangible.

PLR 201051020 indicates that RBIG treatment under section 382(h) will apply to built-in gain in CFC stock that was subject to dividend recharacterization under section 1248(a). This conclusion is not surprising because in this case the built-in gain asset, i.e. the CFC stock, was disposed of in a taxable transaction. A similar but more difficult fact pattern presents the question whether post-ownership change CFC dividends constitute RBIG. The recent PLR does not answer this question.

Finally, PLR 201051020 apparently represents the first time the IRS has addressed in guidance the question of how section 382(h) operates when there are successive ownership changes and overlapping five-year recognition periods. The ruling reflects the view that gain from the sale of a single asset (as long as it is held on each change date and does not exceed the individual change date NUBIG) constitutes RBIG that may increase the separate section 382 limitations for two successive ownership changes.

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