Office of Chief Counsel
Internal Revenue Service
Memorandum

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POSTS-140102-12

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date: November 21, 2012

to:
Internal Revenue Agent –
Large Business & International Division
Communications, Technology & Media Industry

from: Mark Jennings
Branch Chief, CC:CORP:B01
Office of Associate Chief Counsel (Corporate)

subject: POSTS-140102-12

Legend:

Taxpayer or LossCo	=
Date A	=
a	=
b	=
c	=
d	=
e	=
Year X	=

Dear :

You requested assistance with preparing a response to the protest of the Taxpayer of July 9, 2012 (Protest). Below is our response.

ISSUE

Whether section 382 treats a loss corporation's recognized built-in loss (RBIL)[1] as a net operating loss for the year in a determination separate from the computation of taxable income or net operating loss for that year under sections 63(a) and 172(c) (the "annual tax computation")[2] so that the NOL can be carried back to a pre-change year

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[1] RBIL is defined in sections 382(h)(2)(B) and (h)(6)(B). Section 382(h)(2)(B) provides:

> The term 'recognized built-in loss' means any loss recognized during the recognition period on the disposition of any asset except to the extent the new loss corporation establishes that—
>
> (i) such asset was not held by the old loss corporation immediately before the change date, or
> (ii) such loss exceeds the excess of—
>
> (I) the adjusted basis of such asset on the change date, over
> (II) the fair market value of such asset on such date.
>
> Such term includes any amount allowable as depreciation, amortization, or depletion for any period within the recognition period except to the extent the new loss corporation establishes that the amount so allowable is not attributable to the excess described in clause (ii).

Section 382(h)(6)(B) provides:

> Deduction items. Any amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) 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.

[2] Section 63(a) provides:

> Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

Subsection (b) refers to individuals who do not itemize their deductions and is not relevant to this discussion.

Section 172(c) provides:

> For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

without limitation under section 382 or whether the RBIL is taken into account in the annual tax computation as limited under section 382 so that the taxable income or net operating loss for the year is a higher or lower amount than otherwise, as the case may be, and thereafter any resulting net operating loss can be carried to either a pre-change or post-change year without limitation under section 382.[3]

CONCLUSION

Nothing in section 382 treats an RBIL as a net operating loss for the year in a determination separate from the annual tax computation for the year. Section 382(a) provides: "The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year."[4] The section 382 limitation applies to an RBIL in the same manner as it does to loss carryforwards but in the RBIL's capacity as an item of deduction in a post-change tax year that is to be taken into account in that year's annual tax computation whether the limited RBIL is used to reduce taxable income or to increase net operation loss—both are examples of offsetting post-change taxable income within the meaning of section 382(a). If the result of the annual tax computation is a net operating loss then, the limited RBIL has the effect of making the net operating loss a lesser amount than it otherwise would have been. Thereafter the reduced net operating loss can be carried to either a pre-change or post-change year without limitation under section 382.

FACTS

The loss corporation (LossCo) is a C corporation and the common parent of a consolidated group. On Date A, LossCo experienced an ownership change within the meaning of section 382(g).[5] Protest at 2. LossCo had a net unrealized built-in loss

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The modifications referenced in subsection (d) include that a net operating loss deduction cannot be taken into account in the annual tax computation for the year it is being carried to.

[3] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[4] Section 382(b) provides:

(1) Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to ---

(A) the value of the old loss corporation, multiplied by

(B) the long-term tax exempt rate.

[5] Section 382(g) provides that an ownership change occurs if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift—(A) the percentage of stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage

(NUBIL) within the meaning of section 382(h)(3) in excess of $a. Id. In Year X of the recognition period (the 5-year period beginning on the change date, as defined in section 382(h)(7)(A)), LossCo had a section 382 limitation as defined in section 382(b) of $b; RBIL as defined by section 382(h)(2)(B) of $c; and RBIL in excess of the section 382(b) limitation (Excess RBIL) of $d ($c minus $b). Protest at 2. Also in Year X, LossCo incurred a net operating loss before taking any of the RBIL into account (Id.), and LossCo represents that it was eligible to elect to carryback net operating losses five years pursuant to section 172(b)(1)(H) (Protest at 1).

On its Year X tax return as originally filed, Taxpayer deducted RBILs of $b. Protest at 2. Taxpayer originally filed a carryback claim for its net operating loss of $e,[6] that included $b of RBIL, and has received refunds related to that claim. Taxpayer now seeks to obtain an additional tax refund from carrying back from Year X, Excess RBIL losses of $d.[7]

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points, over (B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.

There is an owner shift involving a 5-percent shareholder if—(A) there is any change in the respective ownership of stock of a corporation, and (B) such change affects the percentage of stock of such corporation owned by any person who is a 5-percent shareholder before or after such change.

[6] Letter of , from , Director-Taxes for Taxpayer to , IRS Agent at 1.

[7] Id.

Example Illustrating Results of IRS and Taxpayer Positions:

The following example illustrates the application of section 382 to the loss corporation's annual tax computation and shows how Taxpayer's construct departs from those rules.[8] Assume that the loss corporation has RBILs for the year of $50, the section 382 limitation is $30, and there are no NOL carryforwards or carrybacks to the Year Z tax year.

IRS - Taxable Income<loss> under sections 63(a) & 172(c): / Taxpayer's Construct:

	IRS Year Z	Taxpayer's Construct Part I Year Z	Taxpayer's Construct Part 2 Year Z
Operating income	$ 20	$ 20	
Rental income	40	40	
Royalty income	30	30	
Gross Income	90	90	
Depreciation Expense (non-RBIL)	140	140	
RBIL loss up to §382(b) limit	30	-- *	
Allowable Deductions	170	140	
Annual Tax Computation <NOL>	$ < 80>	<50>*	
RBIL/NOL			<50>*
Add RBIL/NOL		<50>*	
NOL for the year.		<100>*	

Excess RBIL (Disallowed Deduction ($50-$30)):
Carryforward under 382(h)(4) $20

Unused 382 limitation $0

Excess RBIL $0

Unused 382 lim.. . $30

* Taxpayer does not include the RBIL in its annual tax computation, but treats it as an additional NOL for the year.

The Difference —For purposes of applying the section 382 limitation, the IRS includes a limited amount of RBIL in the annual tax computation irrespective of whether that calculation apart from the RBIL produces taxable income or a net operating loss. Taxpayer does not apply the section 382 limitation to the RBIL as an item of deduction in the annual tax computation but instead in applying the section 382 limitation treats the RBIL as a separately determined NOL. All other differences between the IRS's computation and Taxpayer's computation flow from this one difference in treatment.

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8 The facts used are similar to Taxpayer's Example 6 in its Protest at 12.

As a result, the IRS's approach results in Excess RBIL that must be carried forward under section 382(h)(4)[9] subject to the section 382 limitation, whether or not the annual tax computation apart from the RBIL results in taxable income or net operating loss. With Taxpayer's approach, Excess RBIL only occurs if, apart from RBIL, the annual tax computation results in positive taxable income. If not, then Taxpayer argues that section 382(a) does not apply at all because Taxpayer is treating the RBIL as a separately determined NOL.

Taxpayer's Position

Taxpayer maintains that section 382(h)(1)(B)(i) applies to treat an RBIL"as if such loss were a pre-change loss."[10] Protest at 9. Therefore, Taxpayer does not include the RBIL in the annual tax computation, but instead applies section 382(a) "with respect to RBILs in the same fashion that it applies with respect to [net operating losses] (NOLs) that are pre-change losses." Protest at 10.

Taxpayer provides:

> Section 382(h)(1) creates no new substantive rule governing the use of pre-change losses. Rather, it affects only the scope of losses to be treated as pre-change losses (in the case of a loss corporation with a NUBIL) and the amount of the section 382 limitation (in the case of a loss corporation with a NUBIG). Treating an RBIL 'as if such loss were a pre-change loss' limits the amount of

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[9] Section 382(h)(4) provides:

If a deduction for any portion of a recognized built-in loss is disallowed for any post-change year, such portion—

> (A) shall be carried forward to subsequent taxable years under rules similar to the rules for carrying forward of net operating losses. . . but
>
> (B) shall be subject to limitation under this section in the same manner as a pre-change loss.

The Conference Report provides that:

> Under the conference agreement, the amount of any recognized built-in loss that exceeds the section 382 limitation for any post-change year must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations in the same manner as a pre-change loss.

H.R. Rep. No. 841, 99th Cong., 2nd Sess., at II-191 (1986).

[10] Section 382(h)(1)(B)(i) provides:

> If the old loss corporation has a net unrealized built-in loss, the recognized built-in loss for any recognition period taxable year shall be subject to limitation under this section in the same manner as if such loss were a pre-change loss.

> taxable income for any post-change year that such RBIL may offset under section 382(a).

Protest at 9.

Taxpayer acknowledges that taxable income should be computed under sections 63(a) and 172(c) as provided for in section 382(k) for purposes of section 382 but incorrectly assumes that section 382(h)(1) has taken RBILs out of the annual tax computation. Taxpayer therefore argues that something would have to put RBILs back in the annual tax computation, but concludes that nothing does. Taxpayer provides:

> Section 382(k)(4) does not contain or incorporate by reference a modification to the definition of 'taxable income' that adds back RBILs. Without such a modification, however, section 382(a) arguably would never limit the 'taxable income' for any post-change year that could be offset by RBILs, since the amount of such RBILs generally would have already have been taken into account in the computation of taxable income within the meaning of section 63(a). Thus, for purposes of this protest, [Taxpayer] agrees that the proper construction of section 382(k)(4) is that 'taxable income' for section 382 purposes is computed without regard to RBILs. Section 382(a) therefore applies with respect to RBILs in the same fashion that it applies with respect to NOLs that are pre-change losses.

Protest at 10.

Under Taxpayer's construction, if Taxpayer apart from its RBIL had positive taxable income as a result of its annual tax computation for the year, the RBIL being treated as an NOL carryforward would offset any of the positive taxable income subject to the section 382 limitation. If the limitation applies so that some of the RBIL could not be used in that year, the part not allowed would carry over to the next year in the same manner as an NOL carryforward. Taxpayer maintains that section 382(h)(4) does not alter any of these results and that its position is consistent with section 382. Protest at 2.

In contrast, if Taxpayer apart from its RBIL had a net operating loss as a result of its annual tax computation for the year, Taxpayer would treat the entire RBIL as a separately determined NOL for the year. Taxpayer argues that section 172(d) first applies to not allow the RBIL to be used to create or increase a net operating loss for the year, so that there is no deduction to which section 382 may apply and so section 382 is not disallowing its use. Taxpayer then combines this RBIL\NOL with the actual NOL for the year and argues that the combine NOLs for that year may be carried back or carried forward under the "normal carryback and carryover rules of section 172." Protest at 13. Taxpayer argues that section 172(b) requires the full amount of an NOL to be carried back without being subject to the section 382 limitation. Protest at 2 and 8. Taxpayer also argues it did not absorb any of its section 382 limitation for the year so that the whole limitation would carry over to the next year.

Taxpayer also argues that carrying back an RBIL from a post-change year to a pre-change year to obtain a tax refund in that pre-change year is not subject to the section 382 limitation because the section 382 limitation only applies to limit the RBIL's use against post-change income, not against pre-change income. Protest at 12-13.

Taxpayer argues:

> Section 382 is meant to restrict the trafficking of NOLs. It does so by limiting the amount of taxable income following an ownership change that can be offset with pre-change losses to an after-tax risk-free rate of return on the value of the corporation's equity. Consistent with this scheme and basic intent, the statute does not mention or even refer to carrybacks, but rather addresses only carryforwards. Section 382 as a whole is inapplicable to carrybacks to pre-change years.

Protest at 12.

<u>IRS Rebuttal</u>

Congress' intention in enacting section 382 was to address the potential for loss trafficking from the presence in the law of: (1) a Federal income tax system that requires an annual accounting period; (2) NOL carryforward and carryback rules which provide for an income and loss averaging function; and (3) the free transferability of losses.[11] The legislative history shows that while preserving the averaging function was important to the drafters, they were also concerned that "[w]ith completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system…[through which] the Federal Government would effectively be required to reimburse a portion of all corporate tax losses. . .[r]egardless of the merits of such a reimbursement program."[12]

After reviewing the various options for how best to limit loss trafficking, the drafters determined that "changes in a loss corporation's stock ownership continue to be the best indicator of a potentially abusive transaction."[13] In such cases, the new shareholders could contribute income-producing assets (or divert income opportunities) to the loss corporation and, thereby, the corporation would obtain greater utilization of

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[11] H.R. Rep. No. 426, 99th Cong., 1st Sess., at 250 (1985), citing, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 27 (1954), accord, S. Rep. No. 313, 99th Cong., 2d Sess., at 225, 230 (1986).

[12] S. Rep. No. 313, at 230-231.

[13] Id. at 232, accord, H.R. Rep. No. 426, at 256.

NOL carryforwards from pre-change years than it could have had there been no change in ownership.[14] Limiting the use of pre-change losses in the post-change period was appropriate when shareholders who bore the economic burden of the loss corporation's pre-change losses no longer held a controlling interest in the corporation.[15] Accordingly, Congress set the limitation based on an objective measure of what the assets of the loss corporation at the time of the ownership change could earn annually in the post-change period. Congress then used this amount as the limitation at which the new owners could use the losses so that the new owners would not obtain tax benefits greater than the old owners.

Because Congress was concerned with reducing the number of circumstances in which losses attributable to the period before the ownership change could be used as a device for transferring tax benefits, it also limited the use of RBILs in the post-change years as set forth under section 382(h)(1)(B)(i). The drafters reasoned that an RBIL should not escape the section 382 limitation merely because it is recognized after an ownership change because if it had been recognized before the ownership change, it would have been part of a pre-change loss carryforward and would be subject to the section 382 limitation.[16] Applying the section 382 limitation against the RBIL in the annual tax computation sets the amount of the tax benefit that the new owners can obtain from the use of the RBIL. If RBILs are wrongly excluded from the annual tax computation such that the section 382 limitation is not applied to the RBIL in its capacity as an item of deduction, what should be treated as disallowed Excess RBIL will be part of a post-change year NOL. This NOL could then be carried to another tax year (whether pre-change or post-change) to obtain a tax benefit from the use of losses in excess of the section 382 limitation.

There is no special computation of taxable income or loss under section 382 that applies in the case of RBILs. Section 382 is set forth in the Internal Revenue Code at Subtitle A, Chapter 1, Subchapter C and is subject to the definition of taxable income or net operating loss under section 63(a) and section 172(c) as confirmed by section 382(k). Nothing in section 382 takes an RBIL to the extent of the section 382 limitation (that is, to the extent of an allowed deduction) out of the loss corporation's annual tax computation for the year. Section 382(h)(4) clearly describes the Excess RBIL as a disallowed deduction making the portion of the RBIL within the limitation an allowed deduction. Section 382(h)(4) also provides that the disallowed deduction will be carried to the next tax year in the same manner as an NOL carryforward. Such a provision would be unnecessary if something had already made the RBIL a separately determined NOL. If something had made the RBIL a separately determined NOL, why can it not be carried back. Of course, the answer is nothing has made the RBIL a

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[14] H.R. Rep. No. 426, at 256, accord, S. Rep. No. 313, at 232.

[15] Id., accord, S. Rep. No. 313, at 232.

[16] H.R. Rep. No. 426, at 260.

separately determined NOL. It remains an item of deduction to which the section 382 limitation applies in the loss corporation's annual tax computation.

Whether the limited RBIL is used to reduce taxable income or to increase net operation loss—both are examples of offsetting post-change taxable income within the meaning of section 382(a). In other words, the limitation equally applies to limit the RBIL's inclusion in the annual tax computation for the year irrespective of whether that computation results in a lesser amount of taxable income or a greater amount of net operating loss for the year, and if the latter, irrespective of whether that NOL is carried back and used in a pre-change year or carried forward and used in a post-change year. Thus, the section 382 limitation as applied to RBILs is not limiting the use of loss carrybacks. Rather, the limitation applies at an earlier stage to limit the item of deduction in the annual tax computation which may result in a reduced NOL for the year. This reduced NOL can then be carried back as permitted under section 172 and be used in years preceding the change year without restriction under section 382.

The section 382 limitation applies to RBILs in the annual tax computation in the same manner as the limitation is applied to loss carryforwards from pre-change years. With RBILs, the part of the RBIL within the limitation is allowed to do what it normally does (be an item of deduction in the annual tax computation) and the part of the RBIL in excess of the limitation is not so allowed. This treatment is in the same manner or fashion as to how the limitation is applied to NOL carryforwards from pre-change years. With NOL carryforwards, the part of the loss carryforward within the limitation is allowed to do what it normally does (be part or all of an NOL deduction to whatever year it is carried to as permitted under section 172). The part of the NOL carryforward in excess of the section 382 limitation is not so allowed, and as such carries forward to the next year unless it expires.

That is why, taking all the rules together, the new loss corporation (the loss corporation after the ownership change) can use the losses of the old loss corporation (the loss corporation prior to the ownership change) only to the extent the old loss corporation could use them; that is, only in an amount equal to what Congress deemed to be the best objective measure of what the assets acquired at the time of the ownership change could earn each year following the change under section 382(b)--the cumulative amount of the section 382 limitation.

For the above reasons, Taxpayer's position as described in its Protest should be rejected and the IRS's position as described in this advice should be adopted.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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Please call (202) 622-7750 if you have any further questions.