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Selected Legislative and Regulatory Developments

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IRS Releases Guidance Regarding Identification of Built-in Gains and Losses under Section 382

This afternoon the IRS released Notice 2003-65, providing guidance on the identification of built-in items under section 382(h).

For an electronic copy of the notice: Notice 2003-65.

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 may 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 (NOL), a NOL 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% shareholders during the testing period, which is generally three years.

Under section 382(h), if the corporation has a net unrealized built-in loss, some or all of its built-in losses recognized during the five-year period following the ownership change may be treated as pre-change losses, subject to limitation. If the corporation has a net unrealized built-in gain, some or all of its built-in gains recognized during the five-year period following the ownership change may increase the section 382 limitation applicable to the pre-change losses.

Section 382(h)(6) provides that certain items of post-change income or deduction “attributable to” the pre-change period are treated as recognized built-in gains or losses, and affect the determination of whether the corporation is in a net unrealized built-in gain or loss position. However, existing authorities shed little light on the meaning of the phrase “attributable to” the pre-change period.

Notice 2003-65

The notice discusses two alternative approaches for the identification of built-in items for purposes of section 382(h):

- The section 1374 approach – which identifies built-in items by incorporating the rules of section 1374, which generally pertain to the imposition of entity-level tax on net realized built-in gains of a subchapter S corporation.

- The section 338 approach – which identifies built-in items 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 outstanding stock of the loss corporation on the ownership change date.

Generally, the section 1374 approach treats items of income or deduction as attributable to the pre-change period if such items accrue for tax purposes prior to the ownership change.

Because the section 338 approach compares the actual items with items that would result from a hypothetical section 338 election, additional income resulting from foregone depreciation on a wasting asset can be treated as recognized built-in gain, and deductions for liabilities that were contingent on the change date can be treated as built-in losses, even though neither such item accrues for tax purposes prior to the ownership change.

Reliance on Notice

The Notice provides that taxpayers may rely on the approaches set forth in the notice for purposes of applying section 382(h) to an ownership change that occurs:

- Prior to the issuance of the notice, or
- On or after the issuance of the notice and prior to the effective date of temporary or final regulations under section 382(h).

The notice provides that although the alternative approaches described in the 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).

KPMG Observation

In light of the notice, taxpayers are advised to analyze carefully the two methods to determine which produces a more favorable result. For example, taxpayers seeking to treat income generated by wasting assets as recognized built-in gain would likely prefer the section 338 approach, while those seeking to avoid characterization of deductions as recognized built-in losses might prefer the section 1374 approach.

Notice 2003-35 will appear in the Internal Revenue Bulletin 2003-40, dated October 6, 2003.

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