

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to:

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Attn:

from: Mark S. Jennings
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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Buyer =

Lossco =

Subsidiary =

Merger Sub =

Services =

Cards =

Assets =

Tax Year 1 =

Tax Year 2 =

Tax Year 3 =

Change Date =

Date 1 =

Date 2 =

b =

c =

d

e =

f =

g =

h =

i =

k =

l =

m =

n =

o =

p =

q =

r =

ISSUE

Whether Lossco properly treated Deferred Revenue obligations stemming from \$b million of prepaid income Lossco received before its section 382 ownership change (occurring on Change Date) in exchange for services to be performed after Change Date in determining its net unrealized built-in gain or loss (NUBIG/NUBIL)?

CONCLUSION

We conclude that Lossco did not properly treat its claimed Deferred Revenue obligations in determining its NUBIG/NUBIL for its section 382 ownership change on Change Date.

FACTSLossco undergoes a section 382 ownership change

On Change Date, Taxpayer through Buyer, its wholly owned subsidiary, acquired all the stock of Lossco in a reverse merger of Merger Sub, a newly formed wholly owned subsidiary of Buyer, with and into Lossco with Lossco surviving the merger (the Acquisition). By virtue of the merger: (1) the outstanding stock of Lossco was cancelled and converted into the shareholders' right to receive nil (\$c) cash consideration, (2) Buyer's stock in Merger Sub was exchanged for newly issued Lossco stock, (3) Buyer paid off \$d million of Lossco's debt, and (4) \$e million of Lossco's debt was forgiven by bank lenders. Because Lossco was insolvent on Change Date, it excluded the \$e million of discharged debt from income under section 108(a)(1)(B) and 108(d)(3) on its consolidated Federal income tax return for the short tax year ending on Change Date. The debt discharge reduced Lossco's NOL carryforward by \$e million, from \$f million to \$g million.

Lossco's financial statements as of Change Date showed \$h million of liabilities consisting of Deferred Revenue obligations of approximately \$b million (stemming from payments of \$b million Lossco had received before Change Date but under Rev. Proc.

2004-34, 2004-1 C.B. 991 (June 1, 2004), deferred including in income until after Change Date), accounts payable of \$j million (which were deducted but not paid on or before Change Date), and accrued liabilities of \$k million (which also were deducted but not paid on or before Change Date).

Prior to the Acquisition, Lossco was the parent corporation of a consolidated group of corporations that included Subsidiary. Lossco and Subsidiary (together referred to as "Lossco") sold Cards to customers, which entitled them to use Lossco Assets for a specified number of hours and in connection therewith Lossco provided Services. These Cards are typically sold in l-hour and m-hour increments. Customers pay for the Cards at the time the Cards are sold. A Card holder must use up the specified number of hours within a specified number of months. Any unused hours remaining at the end of the Card term will be maintained only with the purchase of a new Card. Expired cards are nonrefundable.

Lossco filed a Treas. Reg. § 1.382-11(a) statement disclosing an ownership change with its return for its taxable year ending on Change Date. Lossco was a loss corporation as defined in section 382(k)(1) since it had an NOL carryforward on Change Date. Lossco made a closing of the books election for purposes of section 382. Lossco used the closing of the books method to determine which of the payments deferred under Rev. Proc. 2004-34 were recognized in gross income in the taxable year ending on Change Date and which were recognized in gross income in subsequent taxable years.

LAW AND ANALYSIS

Section 382 and NUBIG/NUBIL

Section 382(a) generally limits the use of pre-change NOLs of a loss corporation to offset income generated after an ownership change. A "loss corporation" is defined by section 382(k)(1) as a corporation entitled to use an NOL carryover or having an NOL

for the taxable year in which an ownership change occurs. An ownership change occurs when the percentage of stock owned by one or more five-percent shareholders increases by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by such shareholder(s) at any time during a three-year testing period. Section 382(g)(1). Determinations of the percentage of stock held by any person are made on the basis of value. Section 382(k)(6)(C).

Section 382(b)(1) provides that, for any post-change year, the section 382 limitation is the amount equal to the value of the old loss corporation multiplied by the long-term Federal tax-exempt rate. In this case, Taxpayer determined Lossco's value to be zero and therefore Lossco's annual section 382 limitation is zero. However, if a corporation has a NUBIG at the time of an ownership change, its section 382 limitation is increased by its recognized built-in gain (RBIG) each year in the 5-year recognition period beginning immediately after the ownership change. Section 382(h)(1)(A). If instead a corporation has a net unrealized built-in loss (NUBIL) at the time of the ownership change, its recognized built-in loss (RBIL) each year in the 5-year recognition period beginning immediately after the ownership change is subject to the section 382 limitation.

Section 382(h)(3)(A) provides that a corporation's NUBIG/NUBIL equals the difference between the fair market value (FMV) of all of its assets and the aggregate adjusted basis of its assets on the change date. Section 382(h)(3)(B) provides that if the NUBIG or NUBIL does not exceed the lesser of \$10 million or 15% of the FMV of the loss corporation's assets (excluding cash and cash items) immediately before the ownership change, then the NUBIG or NUBIL, as applicable, is deemed to be zero.

Section 382(h)(6)(C) provides that NUBIG is properly adjusted for items of income or items of deduction which would be treated as RBIG or RBIL if properly taken into account (or allowable as a deduction) in the recognition period. Section 382(h)(6)(A) provides that "any item of income which is properly taken into account during the

recognition period but which is *attributable to periods before the change date* shall be treated as a RBIG for the taxable year in which it is properly taken into account” (emphasis added). Section 382(h)(6)(B) provides that “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 RBIL for the taxable year for which it is allowable as a deduction” (emphasis added).

Prepaid income is an item of income that generally arises in the ordinary course of business when a customer makes a prepayment to a vendor under a contract to provide goods or services at some future time. Examples of prepaid income include, but are not limited to, income received prior to the change date that is deferred under IRC section 455, Reg. § 1.451-5, or Rev. Proc. 2004-34 (or any successor revenue procedure). See Preamble to Temp. Reg. § 1.382-7T, 2007-2 C.B. 239, 240. In this case, Lossco’s Deferred Revenue is prepaid income; that is, it is income Lossco received before the Change Date from customers buying Cards for Services to be provided after the Change Date.

Section 1.382-7 addresses such income. It provides:

Treatment of prepaid income. For purposes of section 382(h) [which, of course, includes section 382(h)(6)(C)], prepaid income is not recognized built-in gain. The term prepaid income means any amount received prior to the change date that is attributable to performance occurring on or after the change date. Examples to which this paragraph (a) will apply include, but are not limited to, income received prior to the change date that is deferred under section 455, § 1.451-5, or *Rev. Proc. 2004-34 (2004-1 C.B. 991 (June 1, 2004))* (or any successor revenue procedure).

Emphasis added.

Section 1.382-7 specifically refers to income received prior to the change date that is deferred under Rev. Proc. 2004-34. Lossco deferred income arising from the sale of the Cards under the authority of Rev. Proc. 2004-34. Lossco's Deferred Revenue therefore meets the definition of "prepaid income" described in the regulation. Prepaid income is an item of income *attributable to the post-change period* because that is the period in which performance occurred and expenses were incurred to earn the income. Preamble to T.D. 9330, 2007-2 C.B. 239, 240. Because prepaid income is an item of income attributable to the *post-change period*, it is not RBIG. Reg. § 1.382-7. Likewise, the deferred revenue obligations would not be RBIL. Therefore, neither the Deferred Revenue nor the Deferred Revenue obligations would be treated as a built-in item under section 382(h)(6)(A) or (h)(6)(B) and, therefore, an adjustment to NUBIG/NUBIL for either would not be proper under section 382(h)(6)(C).

NUBIG under Notice 2003-65

Lossco used the 338 approach authorized and described in Notice 2003-65, 2003-2 C.B. 747, to determine its NUBIG/NUBIL and RBIG/RBIL for its ownership change on Change Date. Notice 2003-65 provides two methods that taxpayers may use to identify built-in items under section 382(h): the 1374 approach and the 338 approach. The use of either approach is entirely optional. The reliance section of the notice provides:

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.

Notice 2003-65 provides that NUBIG or NUBIL is determined in the same manner as it is under § 1.1374-3 of the income tax regulations (the "1374 NUBIG/NUBIL rule") under both the 338 Approach and the 1374 Approach. The 1374 NUBIG/NUBIL rule uses a Deemed Asset Sale model; that is, a hypothetical asset sale by the loss

corporation of all of its assets at fair market value immediately before the Change Date to an unrelated buyer who assumes all of the loss corporation's liabilities. The 1374 NUBIG/NUBIL rule has 5 steps, but in Lossco's case only the first 3 steps apply. Under the 1374 NUBIG/NUBIL rule, as it applies to Lossco, NUBIG/NUBIL is the total of the following—

Step 1. The amount realized in the Deemed Asset Sale including the estimated value of contingent liabilities,¹ decreased by

Step 2. Any liability of the corporation that would be included in the amount realized on the Deemed Asset Sale, but only if the corporation would be allowed a deduction on payment of the liability,² decreased by

Step 3. The aggregate adjusted bases of the corporation's assets at the time of the Deemed Asset Sale.³

The 1374 NUBIG/NUBIL rule is a calculation of the *Seller's gain* on a Deemed Asset Sale. Thus, we look to the Seller's treatment as we apply the rule. With respect to Step 1, Seller's treatment on the Deemed Asset Sale, as provided by Notice 2003-65, includes taking into account the estimated value of contingent liabilities in determining the amount realized on the Deemed Asset Sale. Notice 2003-65 provides, in relevant part:

Contingent consideration (including a contingent liability) is taken into account in the initial calculation [Step 1] of NUBIG or NUBIL [unlike in a case in which an actual 338 election is made] and no further adjustments are made to reflect subsequent changes in deemed consideration.

¹ § 1.1374-3(a)(1); see also the special rule concerning contingent consideration in Notice 2003-65

² § 1.1374-3(a)(2)

³ § 1.1374-3(a)(3)

See Example 10 and accompanying text. This treatment allows NUBIG/NUBIL to be determined as of the Change Date and not be adjusted thereafter, thus avoiding having a loss corporation shift from one NUBIG/NUBIL status to another during the 5 year recognition period. Such shifting was considered inconsistent with Congressional intent and not administrable.

Step 2 requires a reduction to the Step 1 amount for liabilities included in Step 1 for which a deduction would be allowed on a payment on such liability. The effect of this rule is to include assumed liabilities that are reflected in asset basis in the NUBIG/NUBIL calculations and to not include assumed liabilities not reflected in asset basis in such calculations.

Treatment of Deferred Revenue under 1374 NUBIG/ NUBIL rule

The only issue needing resolution is Lossco's treatment of its \$b million of Deferred Revenues under the 1374 NUBIG/NUBIL rule. Lossco determined its Step 1 amount to be \$o million (the \$d million Buyer paid 3rd party creditors + the \$h million of assumed liabilities, including the \$b million of Deferred Revenues). As to the \$b million of Deferred Revenues, Lossco argues that it included them in its Step 1 amount on the theory that the Deferred Revenues oblige Lossco to provide Services to Card holders, and that obligation was "assumed" by Buyer in the Deemed Asset Sale. Lossco cites Example 10 of Notice 2003-65, for support. Example 10 of Notice 2003-65 illustrates how contingent liabilities affect NUBIG.⁴

Under Step 2, Lossco did not reduce the Step 1 amount by the Deferred Revenues of \$b million. Lossco argues the receipt of the revenues create only potential obligations, not present obligations, for Lossco to provide Services to Card holders. According to Lossco, that "potential obligation" does not rise to the level of a present obligation until

⁴ In Example 10, the FMV of the contingent liability is determined on the change date and included in the initial determination of NUBIG. When the true amount of the contingent liability becomes knowable (becomes fixed) during the recognition period, the initial NUBIG amount is not redetermined by substituting the fixed amount for the contingent amount determined on the change date.

the Card is presented to Lossco by the Cardholder to obtain the use of Lossco's assets and the Services connected with that use. Lossco argues that since the only deductible liabilities discussed in Notice 2003-65 are contingent liabilities and Lossco's Deferred Revenue obligations represent only potential liabilities as of the Change Date, those Deferred Revenue obligations do not represent deductible liabilities as of the Change Date. Elaborating on this, Lossco states:

Deferred revenue does not meet the definition of "contingent liability." Deferred revenue is a revenue item that has been collected from a customer but has not yet been recognized as income for financial statement purposes or for tax purposes. Although it does represent an obligation for which the recipient may have to perform services and incur costs in the future, the condition that creates a potential liability to pay something in the future does not occur until the holder of the Lossco card uses their card to obtain services. Furthermore, when the cardholder exercises their rights to obtain services, income will be recognized for tax purposes, offset by their expenses. This is different than a liability payment related to a contingent liability that is attributable to the pre-change period in which the condition arose where the payment is in satisfaction of the liability as opposed to an expense offsetting revenue. As such, we concluded that the deferred revenue did not constitute a contingent liability and thus, was not a deductible liability.

Taxpayer's Response to NJ021-2 Follow-Up Questions Memo.

Lossco seems to be arguing here that since it had no obligation to perform in the year it received the deferred revenue, there can be no related deductible expenses for purposes of calculating its NUBIG.

Finally, in Step 3, Lossco reduced the Step 2 amount by \$p million, the aggregate adjusted total tax basis of Lossco's assets on the Change Date, to arrive at Lossco's NUBIG of \$n million.

IRS Response

First, we note the obvious inconsistency here: If a liability is created by payment creating a Deferred Revenue obligation so that the obligation is treated as an assumed liability includable in amount realized on the Deemed Asset Sale, then how can the very same payment also represent only the creation of a "potential" liability that does not ripen into a true liability until the presentation of the Card and the scheduling of Services occurs. We conclude that it cannot be. If, for purposes of the 338 approach, payment of the Deferred Revenues for the Cards created obligations to perform Services that are sufficiently ripe to be included in amount realized then the very same obligations cannot be viewed simultaneously as insufficiently ripe to claim that they are not a deductible liability (obligations). Under the 338 approach only two results are possible—the item in question is not included in the Step 1 amount and so cannot be in the taxpayer's NUBIG calculations, or the item is included in the Step 1 amount, but will be backed out under Step 2 because a deduction would be allowed on a payment on the item. In this case, since the item clearly relates to the performance of Services, a payment on the item would clearly be deductible.

Second, a straight forward reading of Reg. § 1.1374-3(a)(2) (referred to in Notice 2003-65) clearly indicates that Lossco's obligations associated with the Deferred Revenues create deductible expenses. Because of the nature of the *payment* (here, an obligation to provide for the performance of Services) stemming from the Deferred Revenue, Lossco argues that such obligation to *pay/perform* may never be realized. Lossco states, "[T]o the extent hours are not used and the Lossco card expires, Lossco retains the revenue and does not incur any costs."

Reg. § 1.1374-3(a)(2) reads as follows:

Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section [Step 1], but only if the corporation *would be allowed* a deduction on payment of the liability.

39(Emphasis added).

It is not clear, but it appears that Lossco is interpreting this phrase as “but only if the corporation *will be allowed* a deduction for the liability“. Reg. § 1.1374-3(a)(2) uses the word “would” not “will”, however. “Would” is an auxiliary modal verb. Here it is used in the verb phrase, “would be allowed.” One function of “would” as an auxiliary modal verb is to express an imaginary future or a hypothetical situation. The 1374 NUBIG/NUBIL rule calculation in § 1.1374-3 expresses the hypothetical sale of all of a corporation’s assets and the assumption of all of the corporation’s liabilities. Any “payment” in a hypothetical sale would necessarily have to be a “hypothetical payment,” not a real payment. Thus, here the regulation drafter’s use of the word “would” in the verb phrase “would be allowed” is quite appropriate.

Thus, the relevant question to be asked here is: *if* Lossco made payment (that is, *if* Lossco performed), would Lossco be allowed a deduction for expenses incurred in performing? Thus, for purposes of calculating the amount of Lossco’s NUBIG or NUBIL, we hypothesize that Lossco does perform in order to determine if expenses related to performing would be deductible when incurred. The answer clearly is “Yes”, any payment in fulfillment of Lossco’s obligation would be a deductible expense. The condition here is – *if Lossco made payment*. If the result of that condition coming to fruition is that expenses incurred in performance would be deductible, then those expenses constitute “deductible liabilities.”

Accordingly, since Lossco included the \$b million of Deferred Revenue obligations in its 1374 NUBIG/NUBIL calculation’s amount realized [Step 1] and the \$b million of

Deferred Revenue obligations is a Step 2 deductible expense, Lossco must decrease its Step 1 amount by \$b million under Step 2 of those calculations. See Notice 2003-65; § 1.1374-3(a).

Lossco argues its profits of \$q million should be reflected in its NUBIG

Alternatively, Lossco argues that its estimated profit of \$q million, the excess of Lossco's \$b million of Deferred Revenue over its estimate of the costs to perform the Services on presentment of the Cards (\$r million), is not reflected in its NUBIG and that it should be. Lossco is arguing that there is a Seller's profit from the Card sales that should be treated as a built in item that should be included in NUBIG. We disagree for the following reasons.

First, Lossco is comparing the wrong number (*i.e.*, the estimated costs to Seller if Seller was not going to sell to Buyer and Seller was just going to perform the Services itself) with the Deferred Revenue amount (\$b million). The correct comparison is the amount of Deferred Revenue to the amount Seller would have had to pay the Buyer to perform those Services. The two numbers are not necessarily the same. For one thing, Seller no doubt would have had to pay more than just costs as Buyer would have expected to receive a normal profit for performing those same Services. Moreover, Buyer may use the amount of profit Seller was to receive as its guide as to what amount to charge Lossco to perform the Services.

Any "profit or loss" that could be attributed to Lossco would have to come from changes in circumstances effecting value from when the Cards were sold up until the Change Date. Moreover, such changes resulting in profits or loss from that period would be captured in the valuation of all of Lossco's assets and the determination of the amount of cash Buyer will pay Seller in the Deemed Asset Sale. Any excess profit or loss would have necessarily been earned or incurred in the post-Change period and as such, such excess profit would be post-change and attributable to the Buyer, not the Seller.

In addition, Lossco elected to use the deferral method of accounting under Rev. Proc. 2004-34 to defer including the \$b million in income until a later tax year after the Change Date when Lossco expected to record such revenue on its Applicable Financial Statement. See section 5.02 of Rev. Proc. 2004-34. Lossco is arguing that despite taking the position under Rev. Proc. 2004-34 that the advance payments would not be recognized into revenues until after the Change Date and therefore it was properly deferred until after the Change Date, that this income should be treated as if it were earned before the Change Date (that is, as if the related expenses of performance were incurred before the Change Date). Once again, the inconsistencies in Lossco's arguments are obvious.

Conclusions

We conclude that Lossco's Deferred Revenue obligations of approximately \$b million are not properly includible in its NUBIG/NUBIL calculations for its ownership change on Change Date. IRC Section 382(h)(6)(C) does not authorize such inclusion since such obligations stem from Deferred Revenues that Lossco earned and, therefore, were properly "attributable to" periods after the Change Date. Notice 2003-65 also does not provide authority for such inclusion. Under the 338 approach only two results are possible — an assumed liability is not included in the Step 1 amount and so it cannot be in the taxpayer's NUBIG calculations, or the assumed liability is included in the Step 1 amount but it must be backed out under Step 2 because a deduction "would be allowed" on payment of the liability. In this case, since the liability relates to the performance of Services, a payment on the liability would clearly be deductible. Finally, Lossco's profit argument does not require a different outcome as any theoretical profit or loss would likely be insignificant and already properly reflected in Lossco's NUBIG/NUBIL as an embedded component in the valuation of all of Lossco's assets on the Change Date, or properly "attributable to" periods after the Change Date and so not a built-in item of Lossco, but a post-Change item of Buyer.

Accordingly, Lossco's NUBIG, correctly calculated, will be zero or near zero. Because Lossco's NUBIG, properly calculated, will not exceed the lesser of \$10 million or 15% of the fair market value of its assets (excluding cash and cash items) immediately before the ownership change, Lossco's NUBIG is zero for purposes of section 382.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call George Johnson at (202) 317-5086 if you have any further questions.

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