

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 6, 1999

Index (UIL) No.: 382.08-00
CASE MIS No.: TAM-104480-99
Number: **199942003**
Release Date: 10/22/1999

CC:DOM:CORP:B3

District Director
Southwest District

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Business A =

Service =

Account =

Date B =

x = _____

y =

ISSUE:

Whether prepaid income that is properly taken into account in a tax period following an ownership change is treated as recognized built in gain, pursuant to § 382(h)(6)(A) of the Internal Revenue Code, when the income is taken into account in the post-change period.

FACTS:

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Taxpayer is an accrual method taxpayer engaged in Business A. Consistent with the industry practice in Business A, Taxpayer's customers typically pay for Taxpayer's Service in advance of the time Service is actually provided. As payments for Service are received, Taxpayer records them as a liability in its Account. No entry is made at that time to record the direct cost of providing the Service for which prepaid amounts are collected. Only when Service is actually provided are the prepayments (hereinafter, the "prepaid amounts") treated as earned income on Taxpayer's books. If Service is not provided, the prepaid amounts generally must be refunded.

Ordinarily an accrual method taxpayer that receives payments for services to be performed in the future must include the payments in gross income in the taxable year of receipt. However, under certain circumstances, Rev. Proc. 71-21, 1971-2 C.B. 549, permits accrual basis taxpayers to elect to defer reporting such payments as income until the time that the services are performed, provided that performance occurs no later than the tax period immediately following the one in which the payments are received. Rev. Proc. 71-21 states that its purpose is to reconcile tax and financial accounting treatment of such payments without permitting extended deferral in the time of including such payments in gross income for Federal income tax purposes. Taxpayer has elected, pursuant to Rev. Proc. 71-21, to defer reporting its prepaid service income until the time of performance.

On Date B (hereinafter, the "change date"), Taxpayer underwent an ownership change within the meaning of § 382(g)(1). On the change date, the balance in its Account, reflecting prepaid amounts for Service that had yet to be provided, was approximately \$x. Taxpayer properly reported the prepaid amounts as income on its federal tax return for the tax period immediately following the change date. On the change date, Taxpayer had a net unrealized built-in gain, within the meaning of § 382(h)(3), of no less than \$y.

LAW AND ANALYSIS:

Section 382 limits the rate at which a corporation may use its losses in periods following an ownership change. The statutory objective is to reduce the number of circumstances in which net operating loss carryforwards can be used as a device for transferring tax benefits. Although Congress could have disallowed the use of net operating loss carryforwards altogether following an ownership change, Congress chose instead to adopt an approach that limits the annual use of pre-change losses to an amount representing a hypothetical rate of return on the corporation's net assets on the date of the change. H.R. Rep. No. 426, 99th Cong., 1st Sess. 256, 257 (1985).

This limitation on the portion of the pre-change loss that is allowable each year is the "§ 382 limitation." Section 382(a). In general, the § 382 limitation is the value of the loss corporation multiplied by the long-term tax-exempt rate. Section 382(b)(1).

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Section 382(h)(1) provides in general that, if a loss corporation has a net unrealized built-in gain ("NUBIG") on the date of an ownership change, then the § 382 limitation for any recognition period taxable year shall be increased by the recognized built-in gain ("RBIG") for such taxable year. The increase in the § 382 limitation provided by § 382(h)(1)(A) is limited to the amount of the NUBIG reduced by RBIG for prior years ending in the recognition period. Section 382(h)(3)(A) defines NUBIG as the amount by which the fair market value of the corporation's assets immediately before an ownership change exceeds the aggregate adjusted basis of such assets at such time (subject to a threshold requirement set forth in § 382(h)(3)(B)). Section 382(h)(2)(A) defines RBIG as any gain recognized during the recognition period on the disposition of any asset to the extent the new loss corporation establishes that (i) such asset was held by the old loss corporation immediately before the change, and (ii) the gain does not exceed the excess of (I) the fair market value of such asset on the change date, over (II) the adjusted basis of the asset on such date. Section 382(h)(7) provides that the term "recognition period" means the five year period beginning on the date of the ownership change.

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 RBIG for the taxable year in which it is properly taken into account. Regulations have not yet been promulgated under § 382(h), but the fact that § 382(h) regulations have yet to be issued will not preclude the Internal Revenue Service from taking the appropriate position in this case on the issue of whether the prepaid amounts reflected in Account on the change date are items described in § 382(h)(6)(A).

Although the prepaid amounts for Service that were reflected in the Account on the change date were actually received during the pre-change period, Taxpayer has elected under Rev. Proc. 71-21 to defer reporting prepaid service income and, pursuant to its method of accounting, Taxpayer properly reported the prepaid amounts in the post-change period. Furthermore, the mere fact that Taxpayer actually received the prepaid amounts during the pre-change period does not, under these circumstances, require that such amounts be treated as items of income attributable to the pre-change period for purposes of treatment as RBIG when the income is later recognized.

CONCLUSION:

The prepaid amounts are not treated as recognized built-in gain by reason of § 382(h)(6)(A) when taken into account in the tax period following the change date.

CAVEATS:

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be

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modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the memorandum. See § 17.04 of Rev. Proc. 99-2, 1999-1 I.R.B. 73, 97 (or any successor). However, a technical advice memorandum that modifies or revokes a letter ruling or another technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in § 17.06 of Rev. Proc. 99-2, are satisfied.

No opinion is expressed about the tax treatment of the prepaid amounts for purposes of § 382 or other provisions of the Code and regulations that are not specifically covered by the above ruling.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.