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SUBJECT: Application of Internal Revenue Code (IRC) Sections 382 – 384 for California Tax Purposes as it Relates to Apportioning Taxpayers

QUESTIONS PRESENTED

1. For California tax purposes, whether the limitation provided for in IRC section 382(b)(1) is applied on a pre-apportionment basis or a post-apportionment basis?
2. For California tax purposes, whether the recognized built-in gains (RBIGs) and recognized built-in losses (RBILs) provided for in IRC section 382(h)(2) are determined on a pre-apportionment basis or a post-apportionment basis?
3. For California tax purposes, whether the net unrealized built-in gains (NUBIGs) and the net unrealized built-in losses (NUBILs) provided for in IRC section 382(h)(3) are determined on a pre-apportionment basis or a post-apportionment basis?
4. For California tax purposes, whether the limitation on the use of excess credits provided for in IRC section 383(a)(1), which references the limitation provided for in IRC section 382, is applied on a pre-apportionment basis or a post-apportionment basis?
5. For California tax purposes, when utilizing the examples contained in Treasury Regulation section 1.383-1(f), which illustrate the application of IRC section 383, should the California corporate franchise tax rate provided in California Revenue and Taxation Code (CRTC) sections 23151 and 23186 be substituted for the applicable federal corporate income tax rate referenced in the examples contained in Treasury Regulation section 1.383-1(f)?
6. For California tax purposes, whether the RBIGs provided for in IRC section 384(a)(2) are determined on a pre-apportionment basis or a post-apportionment basis when

considered for purposes relating to pre-acquisition losses, as also provided for in IRC section 384(a)(2)?

CONCLUSIONS

1. For California tax purposes, the limitation provided for in IRC section 382(b)(1) is applied on a pre-apportionment basis.
2. For California tax purposes, the RBIGS and RBILS provided for in IRC section 382(h)(2) are determined on a post-apportionment basis.
3. For California tax purposes, the NUBIGs and NUBILS provided for in IRC section 382(h)(3) are determined on a post-apportionment basis.
4. For California tax purposes, the limitation of the use of excess credits provided for in IRC section 383(a)(1), which references the limitation provided for in IRC section 382, is applied on a pre-apportionment basis.
5. For California tax purposes, when utilizing the examples contained in Treasury Regulation section 1.383-1(f), which illustrate the application of IRC section 383, the California corporate franchise tax rate provided in CRTC sections 23151 and 23186 should be substituted for the applicable federal corporate income tax referenced in the examples contained in Treasury Regulation section 1.383-1(f).
6. For California tax purposes, the RBIGs provided for in IRC section 384(a)(2) are determined on a post-apportionment basis when considered for purposes relating to pre-acquisition losses, as also provided for in IRC section 384(a)(2).

ANALYSIS AND DISCUSSION

CRTC section 24451 incorporates by reference Subchapter C of Chapter 1 of Subtitle A of the IRC. IRC sections 382, 383 and 384 are contained in Subchapter C. In simple terms, IRC section 382 operates when there has been a substantial change in the stock ownership by one corporation in another corporation, whereby the acquired corporation possesses net operating losses (NOLs) and/or NUBILS. The corporation with the preceding items is referred to as a "loss corporation." The NOLs, and losses associated with the NUBILS that can be utilized after the substantial change in stock ownership by the loss corporation, are limited. The limitation is set forth in IRC section 382(b)(1) and is the product of the value of the loss corporation multiplied by the long-term interest rate allowed by the federal government. Therefore, the amount of loss that can reduce income or gain for future purposes cannot exceed the limitation set forth in IRC section 382(b)(1). (See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (7th ed. 2015) ¶ 14.42[3].) IRC section 383 provides for the same limitation on the use of credits or capital loss carryovers attributable to the loss corporation. (See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (7th ed. 2015) ¶ 14.43[1].)

IRC section 384 provides for a similar, but additional, limitation on the utilization of losses in situations involving other types of corporate acquisitions and reorganizations. Generally, if a corporation that possesses NOLs and NUBILS acquires a corporation which possesses undervalued assets, any NUBIGs may not be offset by NOLs or NUBILs attributable to the acquiring loss corporation. (See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (7th ed. 2015) ¶ 14.45[2].)

As explained above, the IRC section 382 limitation is the product of the value of the loss corporation multiplied by the long-term interest rate allowed by the federal government. Neither of these components involves items such as income, deductions, gains or losses. As provided for in CRTC section 25101, apportionment relates to net income, which is comprised of items such as income, deductions, gains or losses. In fact, for California tax purposes, there is no statutory or case authority for applying apportionment provisions to items that do not directly relate to net income. Accordingly, for California tax purposes, there is no statutory or case authority to allow the IRC section 382 limitation to be applied on a post-apportionment basis. Therefore, for California tax purposes, because there is no statutory or case authority to allow the IRC section 382 limitation to be applied on a post-apportionment basis, it must necessarily be applied on a pre-apportionment basis.

Certain other jurisdictions, notably Alabama, Georgia, Pennsylvania and South Carolina, require that the IRC section 382 limitation be applied on a post-apportioned basis. Apparently when these rules were promulgated in these other jurisdictions, it was deemed that sufficient authority existed in these other jurisdictions to support the rules. However, as mentioned above, for California tax purposes, there is no statutory or case authority which would allow the IRC section 382 limitation to be applied on a post-apportioned basis. Previously, a legislative proposal, LP 06-06, was brought forth which would have enacted a provision in the CRTC to provide for such treatment. However, the Franchise Tax Board was unable to find a legislator to agree to carry the legislation.

In many instances, the loss corporation might possess under-valued and over-valued assets at the time of the ownership change. With respect to these assets, if the amount of built-in gains exceeds the amount of built-in losses, the loss corporation is considered to possess NUBIGs. If any of the under-valued assets are disposed of for a gain, the gain is allowed to increase the IRC section 382 limitation for that year. Such recognized gains are referred to as RBIGs. (See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (7th ed. 2015) ¶ 14.44[3][c].)

With respect to the over-valued assets the loss corporation might possess at the time of the ownership change, these are referred to as NUBILs. (See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (7th ed. 2015) ¶ 14.44[4][c].) If any over-valued assets are disposed of for a loss, the loss is subject to the IRC section 382 limitation. Such recognized losses are referred to as RBILs. (See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (7th ed. 2015) ¶ 14.44[3][c].) The aggregate of the RBILs allowed must not exceed the amount of NUBILs at the time of the ownership change. (IRC section 382(h)(1)(B).)

As mentioned above, pursuant to CRTC section 25101, apportionment relates to net income, which is comprised of items such as income, deductions, gains or losses. As indicated by the preceding discussions of NUBIGs, RBIGs, NUBILs and RBILs, they necessarily relate to gains and losses, including the RBIGs that are considered for purposes of applying IRC section 384. Accordingly, as such, they relate to items of income that would be subject to apportionment. Therefore, their relative post-apportionment amounts must be considered for California tax purposes. Because the NUBIGs, RBIGs, NUBILs and RBILs each relate to the time of the ownership change, the apportionment factor percentage that existed at the date of the ownership change should be applied.

IRC section 383 provides for the same limitation set forth in IRC section 382 on the use of credits or capital loss carryovers attributable to the loss corporation. Accordingly, consistent with the analysis above, the IRC section 383 limitation is also determined on a pre-apportioned basis.

Pursuant to CRTC section 24451, IRC section 383 is applicable for California tax purposes. California has not issued its own regulations pertaining to IRC section 383. Accordingly, pursuant to CRTC section 23051.5(d), Treasury Regulation section 1.383-1 is applicable for California tax purposes. Treasury Regulation section 1.383-1(f) contains examples which illustrate the application of IRC section 383. These examples incorporate the federal corporate income tax rates, which are not applicable for California tax purposes. CRTC section 23051.5(h)(7) provides that when applying an applicable Treasury Regulation, due account shall be made for "obvious differences". In this context, an "obvious difference" would be the difference between the federal corporate income tax rates and the California corporate franchise rates provided for in California Revenue and Taxation Code (CRTC) sections 23151 and 23186. Therefore, when applying the examples contained in Treasury Regulation section 1.383-1(f), the California corporate franchise rates provided for in CRTC sections 23151 and 23186 should be substituted for the federal corporate income tax rates.

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