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Fr. Doc. E7-11444

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-144540-06]

RIN 1545-BG03

Built-in Gains and Losses Under Section 382(h)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rule making by cross-reference to temporary regulations.

SUMMARY: In the Rules and Regulations section of this issue of the Federal Register, the IRS is issuing temporary regulations that apply to corporations that have undergone ownership changes within the meaning of section 382. These regulations provide guidance on the treatment of prepaid income under the built-in gain provisions of section 382(h). The text of the temporary regulations published in this issue of the Federal Register serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 12, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-144540-06), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-144540-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC; or sent electronically, via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-144540-06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Keith Stanley, (202) 622-7750; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst, at (202) 622-2949 (TDD Telephone) (not toll free numbers) and his e-mail address is Richard.A.Hurst@irs.counsel.treas.gov.

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in the Rules and Regulations section of this issue of the Federal Register amend the Income Tax Regulations (26 CFR part 1) relating to section 382 of the Code. The text of the

temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. These regulations only apply in the rare circumstance in which a qualifying loss corporation that uses a particular accounting method undergoes an ownership change. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Nevertheless, the IRS and Treasury Department request comments from small entities that believe they might be adversely affected by these regulations. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and (8) copies) or electronic comments that are submitted timely to the IRS. Please see the "Comments" section of the temporary regulation on this subject for a description of specific issues on which comments are requested. The IRS and Treasury Department also request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Sean McKeever, Office of Associate Chief Counsel (Corporate).

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.382-7 is also issued under 26 U.S.C. 382(m). * * *

Par. 2. Section 1.382-7 is added to read as follows:

§1.382-7 Built-in gains and losses.

[The text of this proposed section is the same as the text of §1.382-7T(a) through (b)(1) published elsewhere in this issue of the Federal Register].

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

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Fr. Doc. E7-11438

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9330]

RIN 1545-BG66

Built-in Gains and Losses Under Section 382(h)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that apply to corporations that have undergone ownership changes within the meaning of section 382. These regulations provide guidance regarding the treatment of prepaid income under the built-in gain provisions of section 382(h). The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register.

DATES: Effective Date: These regulations are effective on June 14, 2007.

Applicability Date: For dates of applicability, see §1.382-7T(b).

FOR FURTHER INFORMATION CONTACT: Keith Stanley at (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 382

Section 382 limits, after a more than 50 percent change in stock ownership (ownership change), the amount of a loss corporation's taxable income for any post-change year that may be offset by pre-change losses. The amount of the limitation each year is equal to the product of the fair market value of all the stock of the loss corporation immediately before the ownership change multiplied by the applicable long-term tax-exempt rate (section 382 limitation).

Section 382(h)(1)(A) provides that if the loss corporation has a net unrealized built-in gain (NUBIG), the section 382 limitation for any taxable year ending within a 5-year recognition period is increased by the recognized built-in gain (RBIG) for the taxable year, subject to the NUBIG limitation. Section 382(h)(2)(A) defines RBIG as any

gain recognized during the 5-year recognition period on the disposition of any asset to the extent the loss corporation establishes that (i) It held the asset on the change date and (ii) such gain does not exceed the asset's built-in gain on the change date. Section 382(h)(6)(A) also treats as RBIG any item of income "properly taken into account during the recognition period" if the item is "attributable to periods before the change date."

In Notice 2003-65 (2003-2 CB 747), the IRS provided interim guidance regarding the identification of built-in gains and losses under section 382(h). The Notice provides, among other things, that a loss corporation may use the 338 approach in determining the amount of its RBIG or recognized built-in loss (RBIL) for purposes of section 382(h). The 338 approach identifies items of RBIG and RBIL generally 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 of the outstanding stock of the loss corporation on the change date.

Prepaid Income

Generally, a taxpayer, including an accrual method taxpayer that receives payments in advance of performance, must include the payments in gross income in the taxable year of receipt without regard to whether the required performance has occurred. In *Schlude v. Commissioner*, 372 U.S. 128 (1963), the Supreme Court held that advance payments for dance lessons were includable in gross income when received because the payments were nonrefundable and the services were provided on demand of the student. In *American Automobile Association v. United States*, 367 U.S. 687 (1961), the Supreme Court held that membership dues entitling members to emergency road assistance and trip-planning services were includable in gross income when received, even though the taxpayer's method reflected income in accordance with generally accepted accounting principles (which generally operate to defer income recognition until the item is economically earned).

However, courts have allowed the deferral of prepaid income in limited circumstances. In *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968), the court held that amounts received on advance ticket sales relating to major league baseball games to be played on fixed dates in the next year could be deferred to that year. In *Tampa Bay Devil Rays, Ltd. v. Commissioner*, T.C. Memo 2002-248, the Tax Court held that deposits received by a new baseball franchise (Devil Rays) in 1995 and 1996 on advance season tickets for major league baseball games to be played by the Devil Rays in its first season in 1998 could be deferred until 1998, even though the deferral period was greater than a year. The Tax Court emphasized that the games were to be played on a fixed and definite schedule in 1998 and that deferral more clearly matched the deposits with the related expenses that were incurred and deducted in 1998.

Congress, the IRS, and Treasury Department have allowed deferral of prepaid income in certain circumstances. For example, section 455 allows taxpayers that have prepaid subscription income for newspapers, magazines, and other periodicals to elect to defer such income to the taxable years during which the liability to furnish or deliver the newspaper, magazine, or periodical exists. Section 1.451-5(b)(1)(ii) allows advance payments for the sale of goods to be

deferred to the year the payments are included in gross receipts under the taxpayer's method of accounting for tax purposes (such as when the goods are shipped or delivered), unless the income is recorded earlier for purposes of the taxpayer's financial statements. For goods that must be inventoried the permitted deferral is further limited by §1.451-5(c)(1) to the second year following the year substantial advance payments, as defined in §1.451-5(c)(3), are received.

Revenue Procedure 71-21 (1971-2 CB 549), which was modified and superseded by Rev. Proc. 2004-34 (2004-1 CB 991), allowed accrual method taxpayers that received a payment in one taxable year for services to be performed before the end of the next succeeding taxable year to defer income inclusion until the services were performed (but no later than the end of the succeeding taxable year). The stated purpose of the Revenue Procedure was to reconcile the tax accounting treatment of such payments with the financial accounting conventions consistently used by accrual method taxpayers in the treatment of such payments. Rev. Proc. 2004-34 allows a qualifying taxpayer to defer advance payments for services (and for certain non-services and combinations of services and non-services) to the taxable year succeeding the taxable year of receipt to the extent the taxpayer establishes that the advance payments are not recognized in revenues in the taxpayer's applicable financial statement in the taxable year of receipt; or, if the taxpayer does not have an applicable financial statement, the payment is not earned in the taxable year of receipt.

The common purpose of the prepaid income deferral provisions described above is to better match the taxpayer's income with the expenses incurred to earn that income and, as a result, to more clearly reflect the taxpayer's income both in the year of receipt and in the year of performance.

Certain taxpayers are taking the position that prepaid income received in the period before the change date (pre-change period) but included in gross income in the recognition period is RBIG. As further explained below, the IRS and Treasury Department believe that prepaid income is attributable to the period on or after the change date (post-change period) rather than the pre-change period. Thus, treating prepaid income as RBIG is inconsistent with the purposes of section 382(h).

Explanation of Provisions

This temporary regulation provides that 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 the temporary regulation applies 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 (or any successor revenue procedure).

The IRS and Treasury Department believe that the section 382 legislative history, through the examples set forth therein, supports the position that prepaid income should not be treated as RBIG for section 382 purposes. The House and Senate Committee Reports that accompanied the enactment of section 382(h)(6)(A) both state that items of income attributable to the pre-change period include accounts receivable of a cash basis taxpayer that arose before the

change date and are collected after that date, the gain on completion of a long-term contract performed by a taxpayer using the completed contract method of accounting that is attributable to the pre-change period, and the recognition of income attributable to the pre-change period pursuant to section 481 adjustments, as when the loss corporation is required to change to the accrual method. See H. Rep. No. 100-795, 46 (1988); S. Rep. No. 100-445, 48 (1988).

The IRS and Treasury Department believe that prepaid income is distinguishable from the income items described in the committee report examples. In each of the committee report examples, the item of income is attributable to the pre-change period because that is the period in which performance occurred and expenses were incurred to earn the income. By contrast, prepaid income is attributable to the post-change period because that is the period in which performance occurred and expenses were incurred to earn the income. Therefore, because prepaid income is attributable to the post-change period rather than the pre-change period, the IRS and Treasury Department have determined that such prepaid income should not be treated as RBIG under section 382(h).

The 338 approach described in Notice 2003-65 hereinafter will be applied consistently with this temporary regulation.

Comments

The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register. Please see the "Comments and Requests for a Public Hearing" section of the notice of proposed rulemaking for the procedures to follow in submitting comments on the proposed regulations on this subject.

In preparing comments on the proposed regulations, please consider the following. In Notice 2003-65, comments were requested regarding the different approaches, including the 338 approach, set forth for determining RBIG and RBIL under section 382(h). The IRS and Treasury Department believe the 338 approach, in most cases, will properly identify whether or not an item of income or deduction is treated as RBIG or RBIL. However, the IRS and Treasury Department are concerned that taking items of income and deduction into account separately may cause the 338 approach, in some cases, to not properly identify whether or not an item of income or deduction is treated as RBIG or RBIL. The purpose of section 382(h)(6) is to treat items of income or deduction in similar fashion to gain and loss under section 382(h)(2). However, under general tax principles, there is a fundamental difference between the treatment of items of income or deduction and items of gain or loss. On the one hand, under section 382(h)(2), which incorporates the principles of section 1001, gain or loss on the disposition of an asset is taken into account net of the taxpayer's basis, or investment, in the assets. In contrast, under section 382(h)(6), an item of income is generally a gross amount that is not netted and therefore not necessarily matched with the item of deduction incurred to earn the item of income.

Therefore, the IRS and Treasury Department request comments on the proposed regulations about identifying cases where taking into account items of income and deduction separately may cause the 338 approach to not properly identify whether or not an item of income or

deduction is treated as RBIG or RBIL, and how the 338 approach might be adapted so that in such cases it properly identifies whether or not an item of income or deduction is treated as RBIG or RBIL.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12666. Therefore, a regulatory assessment is not required. These temporary regulations address situations in which taxpayers inappropriately attempt to treat deferred prepaid income as net unrealized built-in gain for purposes of increasing the amount of post-ownership change income that may be offset by pre-ownership change losses. For this reason, it has been determined pursuant to 5 U.S.C. 553(b)(B) that prior notice and public procedure are impracticable and contrary to the public interest. For the same reason, it has been determined pursuant to 5 U.S.C. 553(d)(3) that good cause exists to make these temporary regulations effective upon the date of publication. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of the proposed rulemaking published in the Proposed Rules section in this issue of the Federal Register. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Sean McKeever, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Availability of IRS Documents

IRS revenue rulings, procedures, and notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.382-7T also issued under 26 U.S.C. 382(m). * * *

Par. 2. Section 1.382-7T is added to read as follows:

§1.382-7T Built-in gains and losses (temporary).

(a) Treatment of prepaid income. For purposes of section 382(h), 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 CB 991) (or any successor revenue procedure) (see §601.601(d)(2) of this chapter).

(b) Effective/applicability date. (1) This section applies to loss corporations that have undergone an ownership change on or after June 14, 2007.

(2) The applicability of this section expires on or before June 14, 2010.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Eric Solomon,

Assistant Secretary of the Treasury.

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