

CORPORATION TAX BULLETIN 2008-03

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Net Loss Deduction Limitations under Internal Revenue Code Section 381 and Section 382

Section 1. Introduction

The purpose of this bulletin is to provide guidance on the application of IRC Section 381 and IRC Section 382 in the calculation of the PA Corporate Net Income Tax.

Section 401(3)4(g) of the Tax Reform Code of 1971, relating to Net Loss Deductions, reads as follows:

In the case of a change in ownership by purchase, liquidation, acquisition of stock or reorganization of a corporation in the manner described in section 381 or 382 of the Internal Revenue Code of 1954, as amended, the limitations provided in the Internal Revenue Code with respect to net operating losses shall apply for the purpose of computing the portion of a net loss carryover recognized under paragraph (3)4(c) of this section. When any acquiring corporation or a transferor corporation participated in the filing of consolidated returns to the Federal Government, the entitlement of the acquiring corporation to the Pennsylvania net loss carryover of the acquiring corporation or the transferor corporation will be determined as if separate returns to the Federal Government had been filed prior to the change in ownership by purchase, liquidation, acquisition of stock or reorganization.

72 P.S. § 7401(3)4(g)

Section 2. Merger Survivor Corporation Net Loss Deduction Limited by IRC Section 381

Under Internal Revenue Code ("IRC") Section 381 (26 USCS § 381) the amount of Net Loss Deduction generated by the company merging out of existence that may be used by the survivor in the year of the merger is limited to the income of the surviving corporation prorated for the number of days between the date of the merger and the end of the tax year. An example of this is as follows:

X Corporation and Y Corporation were organized on January 1, 2006, and make their returns on the calendar year basis. On December 16, 2007, X Corporation transferred all its assets to Y Corporation in a statutory merger to which IRC

Section 381 applies. The net loss and taxable income (computed without the net loss deduction) of the two corporations are as follows:

Operation of IRC Section 381 Limitation on Net Loss Deduction		
Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
Ending 12-31-2006	(\$35,000)	(\$5,000)
Ending 12-16-2007	(\$30,000)	xxx
Ending 12-31-2007	xxx	\$36,500

The total net loss carryover of X Corporation is \$65,000. However, only \$1,500 of such aggregate amount ($\$36,500 \times 15/365$) may be used in computing the Net Loss Deduction of Y Corporation for 2007. In calculating the Taxable Income for 2007 Y Corporation would be allowed a Net Loss Deduction of \$6,500 which is made up of the net loss carryforward generated by Y Corporation in 2006 plus \$1,500 of net loss carryforward from X Corporation.

Section 3. Preparation of the Pennsylvania Corporate Tax Report for Merger Survivor Corporation

When filing the Pennsylvania Corporate Tax Report for 2007 Y Corporation is required to provide a separate schedule showing the Pennsylvania Corporate Tax Account number of X Corporation, the calculation of the Net Loss Deduction allowed for that year, and an explanation of the transaction. A copy of this schedule should also be included in the PA Corporate Tax Report for 2008.

Section 4. Change of Ownership of Loss Corporation – Net Loss Deduction Limited by IRC Section 382

When there is a change of ownership of a loss corporation, including a merger, the limitations on the Net Loss Deduction under Internal Revenue Code (“IRC”) Section 382 (26 USCS § 382) may also apply. The determination as to whether IRC Section 382 applies to the Net Loss Deduction available to be used is based on the application of this section and applicable Treasury Regulations in effect at the time of the change of ownership on a separate company basis. Under IRC Section 382, when there is a change of ownership of a loss corporation the net losses from years prior to the change in ownership available to be used in years following the change of ownership are limited

to the value of the loss corporation on the date of the change of ownership times the long term tax exempt rate*. In the case of a short period the limitation is prorated. In calculating this limitation for Pennsylvania Corporate Net Income (CNI) Tax purposes the portion of the value of the loss corporation attributable to Pennsylvania is the value of the corporation times the CNI apportionment for the period immediately prior to the change of ownership. An example of this calculation is as follows:

The stock of X Corporation, a loss corporation, is sold to Y Corporation on April 1, 2007. Prior to the sale of the stock X Corporation had the following net losses.

12-31-06	\$16,488
04-01-07	\$55,359
Total	\$71,847

On the date of the change of ownership the value of X Corporation was \$193,487 and the long term tax exempt rate was 4.92%. X Corporation's Corporate Net Income Tax apportionment for January 1, 2007 to April 1, 2007 was 0.100000.

The limitation of the pre-change loss available to be used in each post change year would be as follows:

$$\$1,934,870 \quad \times \quad .0492 \quad \times \quad 0.100000 \quad = \quad \$9,520$$

This loss would be applied as follows:

12-31-07	\$7,146	(Limitation prorated for the number of days after ownership change)
12-31-08	\$9,520	
12-31-09	\$9,520	
12-31-10	\$9,520	
12-31-11	\$9,520	
12-31-12	\$9,520	
12-31-13	\$9,520	
12-31-14	\$7,581	(remaining net loss to be used)

* The long-term tax-exempt rate is the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change occurs. These rates are published by the Internal Revenue Service and can be found on their website at www.irs.gov.

Section 5. Preparation of the Pennsylvania Corporate Tax Report – Net Loss Deduction Limited by IRC Section 382

A. If the transaction is a sale of stock (Company X continues operation)

When preparing the Pennsylvania Corporate Tax Reports for 2007 to 2014, Company X is required to provide a separate schedule showing the calculation of the Net Loss

Deduction allowed for each and an explanation of the transaction which resulted in the limitation.

B. If the transaction is a merger (Company X ceases to exist)

When preparing the Pennsylvania Corporate Tax Reports for 2007 to 2014, Company Y is required to provide a separate schedule showing Pennsylvania Account ID Number of Company X, the calculation of the Net Loss Deduction allowed for each year and an explanation of the transaction which resulted in the limitation.

In both cases, if the taxpayer is unable to use the full amount of the limitation in a tax year the unused amount would be available for use in subsequent years. Also, if the Pennsylvania net losses expire prior to it being available for use under IRC Section 382 the taxpayer loses the benefit of the unused net losses.