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# Prepaid Income Not Built-in Gain Under Code Sec. 382 Rules

By Robert W. Wood • Wood & Porter • San Francisco

If you're like me, trying to put a fine point on calculating a limitation under Code Sec. 382 may seem a little bit like medieval torture. Even if that's a touch of exaggeration, there are few that would say that navigating the peaks and valleys of Code Sec. 382 and its number-crunching is a great deal of fun. Nevertheless, when an ownership change occurs, it is one of the watershed points in the life of a company. Indeed, it is especially important if you are talking about big numbers.

For that reason, M&A TAX REPORT readers should take note of the temporary and proposed regulations under Code Sec. 382 and, specifically, on their position concerning prepaid income. In a general way, we all know how Code Sec. 382 works to affect the landscape of claiming losses. If there is a more than 50-percent change in stock ownership, the amount of a loss corporation's taxable income for any post-change year that may be offset by pre-change losses is limited.

The limitation each year is equal to the product of the combined fair market value of all of the stock of the loss corporation immediately

before the ownership change, multiplied by the applicable long-term tax-exempt rate.

Significantly, though, if a loss corporation has a net unrealized built-in gain (NUBIG), the Code Sec. 382 limitation (for any tax year ending within a five-year recognition period) is actually *increased*. It is increased by the recognized built-in gain (RBIG) for the tax year, subject to the NUBIG limitation. "RBIG" is defined as any gain recognized during the five-year period on the disposition of any asset, to the extent the new loss corporation establishes that:

- the asset was held by the old loss corporation immediately before the ownership change; and
- the gain does not exceed the unrecognized built-in gain on the asset on the change date. [See Code Sec. 382(h).]

Any item of income that is properly taken into account during the five year recognition period, but that is attributable to periods *before* the change date, is treated as RBIG for

the tax year in which it is properly taken into account. [See Code Sec. 382(h)(6)(A).]

**Prepaid Income**

Prepaid income fits into this mix in a logical way. As a general rule, taxpayers must include certain payments in their income in advance of performance when they receive the income. This includes accrual method taxpayers, and again, applies without regard to whether the required performance has occurred. There are exceptions to this rule, though, including the treatment of prepaid subscription income for newspapers, magazines, etc.

Perhaps more significantly in the exception department, Rev. Proc. 2004-34, IRB 2004-22, 991, allows qualifying taxpayers to defer advance payments for services to the tax year succeeding the year of receipt, to the extent the taxpayer can establish that the advance payments are not recognized in revenues under the taxpayer’s applicable financial statement in the year of receipt. Furthermore, if the taxpayer doesn’t keep

applicable financial statements, the taxpayer can still claim this deferral if the taxpayer can show that the payment is not earned in the tax year of receipt.

Taxpayers may be tempted to take the position that prepaid income received in the period before a change in ownership (and which is included in gross income during the recognition period) is RBIG. The IRS, however, has taken the view that treating prepaid income as RBIG is inconsistent with Code Sec. 382(h). Thus, the temporary Code Sec. 382 regulations treat prepaid income as something other than recognized built-in gain.

Prepaid income is simply any amount received before the change date that is attributable to performance occurring on or after the change date. The IRS has made it clear that treating prepaid income as RBIG is contrary to the purposes of Code Sec. 382(h). [See Temporary Reg. §1.382-7T(a).] These temporary regulations apply to loss corporations that have undergone an ownership change after June 13, 2007. [See Temporary Reg. §1.382-7T(b).]

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