



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.¹ An example of this is as follows:

X Corporation and Y Corporation were organized on January 1, 2016, and make their returns on the calendar year basis. On December 16, 2017, 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 12-31-2016	(\$35,000)	(\$5,000)
Ending 12-16-2017	(\$30,000)	XXX
Ending 12-31-2017	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 2017. In calculating the Taxable Income for 2017 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 2016 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 2017 Y Corporation is required to provide a separate schedule showing the Pennsylvania Corporate Tax Account

¹ Note that capital loss carryforwards are subject to a similar pro-rated limitation under IRC Section 381, but that previously denied interest expense under IRC Section 163(j) is not. See IRC § 381(c)(3) and IRC § 381(c)(20).



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 subsequent years.

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 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 tax period immediately prior to the change of ownership. Typically, the tax period in question will be the short tax year ending on the date of the sale. However, if no tax return is required for the short period prior to the change, the taxpayer should use apportionment from the last filed tax return before the change of ownership for purposes of this calculation.

An example of this calculation is as follows:

The stock of X Corporation, a loss corporation, is sold to Y Corporation on April 1, 2017. Prior to the sale of the stock X Corporation had the following net losses.

12-31-16	\$16,488
<u>04-01-17</u>	<u>\$55,359</u>
Total	\$71,847

On the date of the change of ownership the value of X Corporation was \$1,934,870 and the long term tax exempt rate was 2.82%. X Corporation’s Corporate Net Income Tax apportionment for January 1, 2017 to April 1, 2017 was 0.100000.

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

$$\$1,934,870 \quad \times \quad .0282 \quad \times \quad 0.100000 \quad = \quad \$5,456$$



This loss would be applied as follows:

12-31-17	\$4,095	(Limitation prorated for the number of days after ownership change)
12-31-18	\$5,456	
12-31-19	\$5,456	
12-31-20	\$5,456	
12-31-21	\$5,456	
12-31-22	\$5,456	
12-31-23	\$5,456	
12-31-24	\$5,456	
12-31-25	\$5,456	
12-31-26	\$5,456	
12-31-27	\$5,456	
12-31-28	\$5,456	
12-31-29	\$5,456	
12-31-30	\$2,280	(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.

While the above example contemplates an IRC Section 382 loss limitation that is determined on the change of ownership date and is fixed thereafter, the Department recognizes that for federal purposes built-in gains recognized during the five-year period beginning on the change date (recognition period) allow a loss corporation to increase its section 382 limitation for federal purposes in the tax year the gain is recognized. Should that situation occur for an entity filing in Pennsylvania, the taxpayer must multiply the permissible federal separate company recognized built-in gain by the CNI apportionment for the tax period immediately prior to the change of ownership, and add this amount to the previously calculated Pennsylvania loss limitation for that period. Of course, any increase to the Pennsylvania loss limitation permitted for the period in question would still be subject to the Pennsylvania net loss statutory percentage cap for the year.



Section 5. IRC Section 382 Limitation, IRC Section 163(j) Interest Expense Limitation Carryforwards, Capital Loss Carryforwards and Application of Pennsylvania Net Losses

The Tax Cuts and Jobs Act of 2017 amended Section 163(j) of the IRC to limit the deductibility of interest expense in the current tax year of certain U.S. taxpayers. These amendments apply to tax years beginning on or after January 1, 2018.

To the extent a taxpayer's current year interest expense exceeds the limitation on the federal deduction, it is carried forward for an unlimited period to potentially be taken as a deduction in future tax periods as the applicable annual interest expense limitation calculation might allow. In addition, IRC Section 382(d)(3) specifically incorporates disallowed interest under Code Section 163(j) within the term "pre-change loss". As a result, it is necessary to address the impact on the amount of net loss deductible for Pennsylvania CNI purposes in tax periods commencing after the initial period affected by the amendments to Section 163(j) contained in the Tax Cuts and Jobs Act of 2017.

As discussed above in Section 4, 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. For tax periods following the effective date of the Tax Cuts and Jobs Act of 2017, when there is a change of ownership of a loss corporation under IRC Section 382 the limitation on the use of attributes of the loss corporation applies not only to the use of net losses from years prior to the change in ownership and other attributes, but also to the use of previously disallowed interest expense deductions under IRC Section 163(j). Given that for Pennsylvania purposes the deduction of previously disallowed interest expense for a post change year, if any, occurs on the pro-forma separate company Federal Form 1120,² while the net loss deduction is taken on the Pennsylvania CNI report, additional guidance is necessary to inform taxpayers of the appropriate application of IRC Section 382 for such periods. As a general principal, before determining the available Pennsylvania net loss deduction, taxpayers must first claim deduction of any previously limited interest expenses on a pro-forma Federal Form 1120. Only after that is done and the impact to the taxpayer's separate company IRC Section 382 limitation is determined, will it be potentially permissible to take any Pennsylvania net loss deduction on the Pennsylvania Form RCT-101.

² Note that when making a determination regarding the amount of previously disallowed interest expense that can be deducted in the current year on a taxpayer's pro-forma Federal Form 1120, the taxpayer will also need to consider the permissibility for federal purposes of any pass-through interest expense limitations from partnerships in which it is a partner.



Assuming that under the applicable federal separate company principals and the guidance issued by the Department in Corporation Tax Bulletin 2019-03, a loss corporation that has undergone a change in ownership can take a federal deduction of previously disallowed interest expense in the current year, the taxpayer will first need to compare the amount of such interest under IRC Section 163(j) and the amount of any capital loss carryover to the **federal** separate company IRC Section 382 limitation. If there is excess carryover interest and /or capital loss carryforward that could be deducted, but is limited under IRC Section 382 federally, then the taxpayer will need to follow federal separate company rules in regard to the future deductibility of the IRC Section 382 limited interest carryforward amount and/or capital loss amounts.³ No pre-ownership change net losses can be claimed as a Pennsylvania net loss deduction for that year as the entire IRC 382 limit for the current year has been applied on the taxpayer's federal pro-forma federal return in taking its applicable interest expense deduction and/or capital loss deduction. The Pennsylvania net losses otherwise available for deduction for the year are not eliminated, unless the period in question is the last year of their life pursuant to 72 P.S. § 7401(3)4.(c)(2)(A), but are instead carried forward to a future year. However, the fact that the taxpayer is not permitted any Pennsylvania net loss deduction using pre-acquisition losses for the current year does not in any way impact the taxpayer's subsequent years Pennsylvania net loss limitation amounts. In other words, the Pennsylvania net loss limitations for future periods will not be increased due to a taxpayer's inability to claim a net loss deduction in this situation in the current year.

If the amount of previously disallowed interest expense under IRC Section 163(j) and/or capital loss carryforward that can be taken for federal separate company purposes in the taxpayer's current year is less than the IRC Section 382 federal separate company limit, then the remaining IRC Section 382 amount may allow for a PA net loss deduction using pre-acquisition losses to also be taken in the current year. In order to determine the potential net loss deduction for the current year the taxpayer should multiply the amount of previously disallowed interest expense under IRC Section 163(j) and/or capital loss carryover that is being deducted on its current year pro-forma Federal Form 1120 by its CNI apportionment for the period immediately prior to the change of ownership. The product of this calculation would then be deducted from the previously calculated Pennsylvania limitation of the pre-change loss available to be

³ To the extent a taxpayer is limited in the amount of IRC Section 163(j) carryforward interest that can be deducted in the current year and a portion of that carryforward amount is interest subject to a Pennsylvania addition modification pursuant to 72 P.S. § 7401(3)1.(t), a separate calculation will need to be performed in order to calculate the accurate Pennsylvania addback amount. As discussed in Corporate Tax Bulletin 2019-03, this calculation will be done on a pro-rata basis and will involve a fraction consisting of the amount of the carryforward interest deducted in the current year over the total amount of the carryforward interest at the start of the tax year, multiplied by the existing Pennsylvania specific interest addback carryforward. The resulting amount will be added back in the current year on the taxpayer's Corporate Tax Report.



used in each post change year in order to determine the amount of pre-change loss in the current year that is still available to potentially be taken in the current year as a PA net loss deduction.⁴ Any Pennsylvania net loss not eligible to be taken based on this calculation is not eliminated, unless the period in question is the last year of their life pursuant to 72 P.S. § 7401(3)4.(c)(2)(A), but similar to the previous discussion is carried forward to future years. Again, in this situation the taxpayer's existing Pennsylvania IRC 382 limitation for those future periods is not in any way impacted.

As prior to the passage of The Tax Cuts and Jobs Act of 2017, regardless of the IRC Section 382 limitation, the net loss deduction is also subject to the Pennsylvania net loss limitation found at 72 P.S. § 7401(3)4.(c). To the extent any Pennsylvania net loss eligible for deduction pursuant to the Pennsylvania IRC 382 limitation is denied solely due to either the loss limitation found at 72 P.S. § 7401(3)4.(c) or the fact that the taxpayer has a current year Pennsylvania loss, the taxpayer may carry forward such unused Pennsylvania net loss to the taxpayer's next tax period.⁵ In effect, the net loss that cannot be claimed in this situation is added to the Pennsylvania IRC 382 limitation amount for the next period in which it can be utilized, but as always the entire amount eligible for deduction as a Pennsylvania net loss cannot exceed the applicable limit under 72 P.S. § 7401(3)4.(c).

If a taxpayer is unable to claim any deduction for previously disallowed interest expense under IRC Section 163(j) or any capital loss carryover on its pro-forma Federal Form 1120 in the current year there is no impact to its Pennsylvania IRC Section 382 limitation for that year.

Section 6. 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 2017 to 2024, 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 2017 to 2024, Company Y is required to provide a separate schedule showing Pennsylvania Account ID Number of

⁴ Note that as discussed in Section 4, the current year Pennsylvania IRC Section 382 limitation may also be prorated for the number of days after ownership change.

⁵ See IRC Section 382(l)(2).



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 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.