AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

SOUTH CAROLINA ISSUES GUIDANCE ON THE APPLICATION OF THE IRC § 382 LIMITATION

SUMMARY

On July 6, 2016, the South Carolina Department of Revenue issued Revenue Ruling No. 16-7 (“Rev. Rul. No. 16-7”), in which the Department discusses the application of IRC § 382 as it relates to a multi-state South Carolina taxpayer. The revenue ruling addresses the apportionment of the federal IRC § 382 limitation (“382 Limitation”), the adjustment to the South Carolina 382 Limitation for a recognized built-in gain (“RBIG”), and the adjustment to the South Carolina pre-ownership net operating losses (“NOL”) for a recognized built-in loss (“RBIL”). Rev. Rul. No. 16-7 applies to all periods open under the statute.

DETAILS

Background[1]

South Carolina, a separate company reporting state, allows a deduction for a post-apportioned NOL, applies a 20 year carryforward period, and adopts IRC § 382. However, until the issuance of Rev. Rul. No. 16-7, South Carolina has not provided guidance regarding the application of IRC § 382 to a multi-state South Carolina taxpayer, including the apportionment of the federal 382 Limitation, the determination of net unrealized built-in gains (“NUBIG”), RBIGs, net unrealized built-in losses (“NUBIL”), and RBILs for South Carolina income tax purposes.

Very generally, following an “ownership change,” as that term is defined for federal income tax purposes, IRC § 382 applies an annual limitation to a loss corporation’s use of an NOL carryforward attributed to a pre-ownership change

[1] For a detailed discussion regarding IRC § 382, including the terms contained herein, see Rev. Rul. No. 16-7.

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NOL. The amount of the annual limitation is the product of the loss corporation's value at the time of the ownership change, and the published federal long-term tax-exempt rate, where the loss corporation's value is based on the fair market value ("FMV") of its stock.

The federal 382 Limitation may be increased for a NUBIG recognized (i.e., an RBIG) by the loss corporation during the 5 year period following the ownership change, provided that a threshold is met, and the aggregate increases do not exceed the loss corporation's NUBIG at the time of the ownership change. A NUBIL recognized (i.e., an RBIL) during the 5 year recognition period may be added to the pre-ownership change NOLs, provided that a threshold is met, and the aggregate RBILs do not exceed the loss corporation's NUBIL.

A NUBIG arises when the fair market value of the loss corporation's assets (other than cash and certain cash equivalents) at the time of the ownership change exceeds their adjusted bases. A NUBIL arises when the adjusted bases of the assets at the time of the ownership change exceeds their fair market value.

South Carolina 382 Limitation

Since South Carolina typically requires separate company reporting, the South Carolina 382 Limitation of a multi-state corporation is the product of the federal 382 Limitation of the loss corporation as calculated on a separate company basis, and the loss corporation's South Carolina apportionment percentage for the year in which the ownership change occurs.[2] South Carolina NUBIGs, RBIGs, NUBILs, and RBILs are also calculated on a separate company basis.

South Carolina Net Unrealized Built-In Gains and Recognized Built-In Gains

Federal NUBIG threshold – For federal income tax purposes, a loss corporation meets the NUBIG threshold where its NUBIG exceeds either one of the following: (1) $10 million; or (2) 15 percent of the FMV of the loss corporation's assets (other than cash and certain cash equivalents) on the date of the ownership change.

South Carolina NUBIG threshold if federal threshold is met – South Carolina deems the NUBIG threshold met if met for federal income tax purposes. In that case, South Carolina provides the following two methods for purposes of calculating the South Carolina NUBIG:

1. *Simplified Method* – The product of the federal NUBIG, and the South Carolina apportionment percentage for the year in which the ownership change occurs; or

2. *Detailed Method* – The federal NUBIG attributed to real property of the loss corporation located in South Carolina, plus the product of the federal NUBIG attributed to the loss corporation's other assets and the South Carolina apportionment percentage for the year in which the ownership change occurs, where the bases of the assets are adjusted for any federal-state depreciation differences.

South Carolina NUBIG threshold if federal threshold is not met – If the federal NUBIG threshold has *not* been met, a loss corporation must determine whether or not it meets the South Carolina NUBIG threshold. A loss corporation meets the South Carolina NUBIG threshold if its South Carolina NUBIG exceeds either of the following: (1) the product of $10 million, and the loss corporation's South Carolina apportionment percentage for the year in which the ownership change occurs; or (2) the product of 15 percent of the FMV of the loss corporation's assets (other than cash and certain cash equivalents), and the South Carolina apportionment percentage for the year in which the ownership change occurs.

South Carolina RBIG – If the loss corporation meets the South Carolina NUBIG threshold requirement, then it may increase its South Carolina 382 Limitation by a South Carolina RBIG arising during the 5 year recognition period to the extent the aggregate increase in the South Carolina 382 Limitation does not exceed the South Carolina NUBIG. The South Carolina RBIG is calculated using an approach similar to the one described under the Detailed Method above, regardless of whether the loss corporation opted to use the Simplified or the Detailed Method to calculate its South Carolina NUBIG.

[2] Rev. Rul. No. 16-7 advises that if a South Carolina nexus consolidated return is elected, aspects of the South Carolina 382 Limitation are calculated on a separate company basis in that case as well, because a South Carolina nexus consolidated return is a "post-apportionment-style" consolidated return.

South Carolina Net Unrealized Built-In Losses and Recognized Built-In Losses

Federal NUBIL threshold – For federal income tax purposes, a loss corporation meets the NUBIL threshold where its NUBIL exceeds either of the following: (1) $10 million; or (2) 15 percent of the FMV of the loss corporation's assets (other than cash and certain cash equivalents) on the date of the ownership change.

South Carolina NUBIL threshold if federal threshold is met – If the federal NUBIL threshold is met, a loss corporation must determine its South Carolina NUBIL threshold, which is the lesser of either of the following: (1) the product of $10 million, and the South Carolina apportionment percentage for the year in which the ownership change occurs; or (2) the product of 15 percent of the FMV of the loss corporation's assets (other than cash and certain cash equivalents), and the South Carolina apportionment percentage for the year in which the ownership change occurs.

If the South Carolina NUBIL of a loss corporation, calculated in a manner similar to the South Carolina NUBIG, does not exceed the applicable threshold amount, then none of the loss corporation's South Carolina RBILs are subject to the South Carolina 382 Limitation. Alternatively, if the South Carolina NUBIL exceeds the applicable NUBIL threshold, then an RBIL arising during the 5 year recognition period is subject to the South Carolina 382 Limitation.

South Carolina RBIL – The South Carolina RBIL is calculated using an approach similar to the one described under Detailed Method above.

BDO INSIGHTS

- South Carolina is among the minority of states that have provided detailed guidance related to the application of IRC § 382. South Carolina taxpayers that have undergone an ownership change should refer to Rev. Rul. No. 16-7 for purposes of calculating their South Carolina 382 limitation or, given the significant complexities associated with this topic, consult with their tax advisor.