

Purchasers of Stock Must Be Aware of New IRS Regulations

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If you plan to acquire a business by purchasing the stock of a corporation, you need to be aware of two sets of new guidance recently issued by the IRS, both of which may affect the tax attributes of the target after the acquisition.

Seller's Tax Loss on Disposing of Target May Now Impair Target's Tax Attributes

The first set consists of final consolidated return regulations applicable to transactions after September 17, 2008 and is relevant only if you purchase the stock of a subsidiary that is included in a consolidated federal income tax return with the selling parent company. The regulations apply when the parties *do not* elect under Internal Revenue Code (hereafter "IRC" or "Code") Section 338(h)(10) to treat the transaction as an asset sale.

If the seller realizes a loss on the sale of the subsidiary stock, then the subsidiary, now owned by the buyer, must reduce valuable tax attributes. Capital and net operating loss ("NOL") carryovers are eliminated first, up to the extent of the loss on sale realized by the seller. If the loss exceeds the amount of such carryovers, then the income tax basis of the subsidiary's assets is reduced. This will reduce your depreciation or amortization deductions and increase your tax gain if you sell any of the assets.

A seller may make two different elections to cause a different result. It can elect not to deduct its loss, in which case the subsidiary keeps its losses and basis; or, the seller can elect to re-attribute the subsidiary's NOL back up to the seller, which reduces the seller's basis in its stock and reduces or eliminates the loss on sale. Any amount of NOL that is re-attributed to the seller is not available to the subsidiary to offset income it earns during your period of ownership. To avoid unpleasant surprises, it is important for the buyer to negotiate with the seller over the treatment of the seller's prospective loss, or at least protect itself through representations and warranties in the agreement.

Proposed Regulations Would Allow More Stock Purchasers to Step Up the Basis of Target Assets

More transactions may be affected by the second set of regulations which is proposed regulations issued on August 25, 2008 under IRC Section 336(e). These regulations would expand the circumstances in which a stock purchase can be treated as an asset purchase for federal income tax purposes, thereby allowing the purchaser to obtain a cost basis in the assets of the target without directly acquiring those assets. The regulations will be effective when published as final regulations.

Generally, when a purchaser acquires the stock of a corporation ("Target"), the purchaser takes a "carried over" basis in Target's assets equal to Target's tax basis in those assets. By

contrast, when a purchaser acquires Target's assets, the purchaser takes a cost basis, generally equal to the value of the acquired assets. A cost basis is generally preferable to a carried over basis if the Target's assets are appreciated, since a cost basis will result in larger depreciation and/or amortization deductions.

The tax law has for many years provided two elections (under Code Sections 338(g) and 338(h)(10)) that allow a purchaser of at least 80 percent of the stock of Target over a 12-month period to treat the stock purchase as an asset purchase for federal tax purposes, and thereby obtain a cost basis in the assets without formally acquiring the assets. Both of these elections, however, are generally available only where the purchaser is a C corporation.

Unlike the other Section 338 elections, these new regulations under Section 336(e) do not require the purchaser to be a corporation (although both Seller and Target must be domestic C corporations). Another important difference between the Section 336(e) election and either the Section 338(g) election or the Section 338(h)(10) election is that the Seller makes the Section 336(e) election unilaterally. Such a unilateral election by Seller could have a negative impact on a purchaser that desires to use Target's prior NOLs to offset future income or to use the built in loss in certain assets to offset other gains. If the acquisition is treated as a stock sale, these NOLs (and any such built-in losses) would generally remain available to Target post-closing (subject to certain limitations). Where the Seller makes a Section 336(e) election to treat the transaction as an asset sale, however, Target would have its prior tax attributes (including the NOLs and such built-in losses) wiped out.

A prospective purchaser should take into account Seller's ability to unilaterally elect to eliminate Target's tax attributes by means of a Section 336(e) election when negotiating the purchase transaction with Seller. While the regulations are not effective until they are finalized, nobody knows when that will be. If you are negotiating now to purchase the stock of a corporation from a seller that is a C corporation, the possibility that this election will become available before your transaction closes should be taken into account. Overall, when finalized, the Proposed Regulations will provide greater flexibility to parties to transactions involving the sale of corporate subsidiaries.