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LEWIS M. HOROWITZ, B.A., Columbia University (1981); J.D., Georgetown University (1985); member of the Oregon State Bar since 1993; principal, Lane Powell Spears Lubersky LLP, Portland.

NICHOLAS P. NGUYEN, B.A., Princeton University (1991); M.A., Harvard University (1993); J.D., University of Washington (1996); member of the Oregon State Bar since 1996; associate, Lane Powell Spears Lubersky LLP, Portland.

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I. INTRODUCTION

A. (§53.1) In General

Regardless of the type of business, tax outcome is always a major consideration in structuring a business acquisition or disposition. This chapter discusses some of the federal income tax considerations that a buyer and a seller should address in structuring the purchase and sale of a business.

The tax objectives of the seller and the buyer may not be the same. The seller generally wants to minimize any tax liability from the disposition. The buyer generally wants to maximize deductions and tax attributes from the purchase to derive more tax benefits in the future. The conflicting objectives and the complexity of applicable tax law often make tax planning neither easy nor simple. However, even a little tax planning can often help minimize any adverse consequences and add substantial value for the client.

One basic rule to keep in mind is the importance of tax planning very early in the process of offer and negotiation. The tax structure of a transaction has a direct bearing on the purchase price and other essential economic variables of the deal. Without a clear understanding of the tax issues and the tax consequences of different alternative structures, the parties cannot intelligently negotiate the key terms of the deal. When the parties attempt tax planning after reaching an agreement, it is often too late to repair the damage.

In this chapter, all section citations are to the Internal Revenue Code (IRC) of 1986, as amended, and the Treasury regulations promulgated thereunder, unless otherwise specified. The business being sold or acquired is the seller or target corporation, and the entity in control of the acquired business after the transaction is the buyer or acquiring corporation. Unless otherwise stated, both buyer and seller are C corporations.

B. (§53.2) Alternatives

The structure of an acquisition, including the forms of the transaction and the types of consideration, depends on myriad considerations, such as business contingencies, tax planning, labor, financing, securities, antitrust, and franchise. The relative importance of these considerations evolves with time. For example, financial accounting used to impose substantial constraints on the form of a transaction. Whether an acquisition was treated as a pooling of interests or as a purchase for accounting purposes could be a key determinant because the
accounting treatment directly affected the balance sheet and reporting of future earnings. In part because of the effect of financial accounting on corporate acquisitions and the difficulty of comparing financial results between different entities, the Financial Accounting Standards Board (FASB) in Statement 141 required all business combinations of for-profit entities after June 30, 2001, be accounted for by the purchase method. In light of that significant change, financial accounting is less of a factor in structuring a transaction.

An acquisition can be accomplished by a “tax-free” (i.e., tax-deferred) reorganization or by a taxable sale. In either case, the acquisition could be in the form of a stock purchase, an asset purchase, a merger under local law, or any combination of the foregoing. State law characterizations may differ from tax characterizations. For example, a stock sale in form may be deemed an asset sale for tax purposes. Similarly, many states now allow mergers between and among different types of business entities, such as corporations and limited liability companies (LLC). These state law mergers are generally taxable transactions, although the Internal Revenue Service (IRS) has issued proposed regulations to recognize, under certain conditions, a merger of a target corporation into an LLC wholly owned by the acquiring corporation as a valid tax-deferred merger for corporate tax purposes. Prop Treas Reg §1.368-2(b)(1).

The acquisition could be a combination of steps, which may or may not happen simultaneously, such as a stock purchase followed by a liquidation, or a stock purchase in connection with a partial redemption of the selling shareholders.

In some circumstances, the parties can also consider the following:

1. A joint venture structure between the buyer and the seller;
2. An employee stock ownership plan (ESOP) rollover under IRC §1042 (followed perhaps by an S election for the entity);
3. A like-kind exchange under IRC §1031; or
4. An involuntary conversion under IRC §1033.

The forms of consideration can also vary widely. The consideration could be in cash paid at closing or over time, either fixed or contingent based on economic performance, notes, stock, bonds, convertible instruments, warrants, or options. The form of consideration may dictate the type of acquisition. For example, in a reverse triangular merger under IRC §368(a)(1)(A) and (a)(2)(E), the selling shareholders need to exchange at least 80% of the stock of the target corporation (in vote and
value) for voting stock in the parent of the acquiring corporation. See 2 ADVISING OREGON BUSINESSES ch 38 (Oregon CLE 2001) for further discussion of reverse triangular mergers.

C. (§53.3) Scope of Chapter—Taxable Sale

An initial tax consideration is whether the transaction can and should be structured, in whole or in part, as a nontaxable reorganization rather than as a taxable sale. For purposes of this chapter, assume that the buyer and the seller have determined that the transaction should be structured as a taxable sale. For a discussion of nontaxable reorganizations, see 2 ADVISING OREGON BUSINESSES chs 37–41 (Oregon CLE 2001).

Furthermore, assume that the business being sold is operated as a C corporation and is not part of an affiliated group of corporations filing a consolidated tax return. Much of the discussion could also apply to the sale of an S corporation (some significant differences will be pointed out as appropriate).

Some of this discussion also may apply to partnerships and LLCs. However, there are many substantial differences. In addition, because many partnership tax provisions are unique, a separate analysis is often required.

For discussion of ESOP rollovers, see chapters 45–46, supra. For like-kind exchanges under IRC §1031, see 1 ADVISING OREGON BUSINESSES, supra, ch 5.

II. ASSET SALE VERSUS STOCK SALE

A. (§53.4) In General

In general, a buyer can acquire a target business by using two principal methods. A buyer may acquire the target corporation by purchasing stock from the selling shareholders. Alternatively, the buyer may acquire the relevant business assets directly from the target corporation itself.

The tax consequences between these choices are significant and are discussed in greater detail in §§53.5–53.12, infra. However, nontax considerations may outweigh tax considerations. For example, if the buyer purchases the target stock, then the buyer also indirectly acquires all of the target corporation’s hidden liabilities (including contingent liabilities). If the buyer purchases the target assets, then the buyer may, depending on local law, be able to limit the liabilities it assumes.
On the other hand, an asset acquisition can be more cumbersome or costly. A transfer of legal ownership of assets may be impracticable for licenses, leases, contracts, and other assets that require a third party’s consent for an effective transfer. State and local transfer taxes (particularly with respect to transfers of real property) also may be expensive in an asset acquisition.

Normally, the key tax consideration in a taxable transaction is whether the sale should be structured as a sale of assets by the target corporation or as a sale of corporate stock by the shareholders. The two choices have significantly different federal income tax consequences. See §§53.5–53.11, infra.

In certain circumstances, an election to characterize a formal stock sale as an asset sale for federal income tax purposes provides additional planning flexibility. See IRC §338. This election does not operate in reverse. If there is in fact an asset sale, it generally is not possible to treat the transfer as a stock sale for tax purposes.

B. (§53.5) Tax at Corporate Level

In a stock sale, the target corporation does not dispose of any assets or otherwise engage in any taxable transaction. Accordingly, the target corporation recognizes neither gain nor loss as a result of the acquisition, and its tax basis and other tax attributes generally remain unchanged.

If, on the other hand, the buyer purchases the target assets, the target corporation must recognize any gain or loss realized on that sale for federal income tax purposes. An asset sale often generates business income subject to apportionment and tax at the state and local levels, and may also be subject to excise taxes.

Following an asset sale, the target corporation often liquidates and makes a liquidating distribution of the after-tax proceeds of the sale to its shareholders. This liquidating distribution is taxable to the shareholders.

Thus, the proceeds of the corporation’s asset sale may be taxed twice: first on receipt by the corporation and, second, on receipt by the shareholders of the liquidating distribution.

NOTE: There may be tax reasons for proceeding promptly with a liquidation after a corporation sells substantially all of its assets, such as avoiding the personal holding company tax rules (see IRC §541).
If the seller is an S corporation, the sting of double taxation might be significantly reduced. In that case, corporate income is passed through to the shareholders, which increases their basis in their stock of the corporation, thereby minimizing or neutralizing the amount of taxable gain that the shareholders realize on the liquidating distribution. Nonetheless, for S corporations, meaningful differences may arise between a stock sale and an asset sale. For example, if the S corporation sells target stock in a stock sale, the shareholders can generally expect to recognize capital gain. In an asset sale, the character of gain depends on the assets. Furthermore, if the target S corporation was a C corporation any time during the 10-year period before the asset, a corporate tax may be imposed on certain built-in gains. See IRC §1374.

Hence, a stock sale generally yields better after-tax return to the selling shareholders: for the same price, the selling shareholders would have more after-tax income from a stock sale compared with an asset sale. Most sophisticated buyers, however, would take this disparity into account and pay less for a stock purchase compared with an asset purchase.

C. (§53.6) Basis Step-up for Acquired Assets

In an asset sale, the acquiring corporation takes each asset with a tax basis equal to cost. Thus, the acquiring corporation realizes tax benefits through increased depreciation deductions attributable to the basis step-up.

As discussed in §53.5, supra, in a stock sale the selling shareholders can avoid tax at the corporate level. The buyer, however, acquires a corporation that continues to hold its assets with the same tax attributes, with no basis step-up (or “step-down” when the assets are sold at a loss). Therefore, in a stock sale the target corporation often incurs greater future taxes than the buyer would incur in an asset transaction (assuming built-in gain inherent in assets of the target corporation). This effect can take the form of either (1) smaller depreciation deductions than otherwise would be the case had there been a basis step-up or (2) a larger realized gain on any subsequent disposition of the assets.

Thus, if the corporate-level tax were the sole consideration, the seller generally would prefer a stock sale for the same price. The buyer, on the other hand, would just as clearly prefer an asset sale. This divergence of interest normally can be accounted for by a purchase
price adjustment (an upward adjustment in an asset sale and a downward adjustment in a stock sale).

**Practice Tip:** The foregoing analysis assumes that the target corporation will have a net gain when its assets are sold. If there is an expected net loss rather than a net gain, the target corporation would recognize loss on the sale and the buyer has basis step-down. If the target corporation cannot effectively use that loss, structuring the transaction as a stock sale rather than as an asset sale could be advantageous for both the buyer and the seller. Therefore, it is critical to examine the tax basis of assets and stock when choosing the form of the transaction.

D. (**§53.7**) Depreciation Recapture

In structuring a transaction, the parties should consider the effects of depreciation recapture. When a company depreciates a capital asset, it takes a deduction against ordinary income. Some of the gain realized is treated as ordinary income with respect to personal property. IRC §§1245, 1250. The amount recharacterized as ordinary income generally is the amount of depreciation deductions previously taken with respect to the assets. For real property improvements, recapture generally applies only to the extent of what is claimed above the straight-line method of depreciation, that is, “accelerated” depreciation. Because corporate capital gains and ordinary income are currently taxed at the same rate, depreciation recapture is generally not a significant consideration. However, this tax rate could pose a tax problem for a selling corporation if it has a capital loss from another transaction, because corporate capital losses are generally deductible only against capital gains. IRC §1211(a). Conversion of potential capital gain to ordinary income through recapture could adversely affect the ability to deduct the unrelated capital loss.

This issue generally is more significant if the seller is an S corporation. For an S corporation, any capital gain or ordinary income would pass through to the shareholders with the same character, and because the ordinary and capital tax rates are significantly different for individuals, there may be substantial differences in tax consequences for the shareholder.

E. (**§53.8**) Continuation or Termination of Tax Attributes

Generally, in a stock sale the corporation’s tax attributes are not affected. Thus, the tax bases of corporate assets, earnings and profits, accounting methods, and taxable year will not change. One exception is
net operating losses, which are severely limited if there is an “ownership change.” IRC §382. See §53.17, infra.

In an asset sale, the target tax attributes will not follow the assets. Thus, if the seller has favorable tax attributes, both the buyer and the seller may prefer a stock deal over an asset deal.

F. (§53.9) Installment Reporting for Deferred Payments

Installment payments of the purchase price are discussed in detail in §53.24, infra. In general, the gain can be recognized over time. Note that in an asset sale, income with respect to certain assets is not eligible for installment-method reporting under IRC §453. This category includes income with respect to inventory, receivables, stock traded on an established securities market, dealer property, and recapture items. See IRC §453. Thus, if the sale includes any of these assets, only a portion of any gain could be deferred under IRC §453. In contrast, in a sale of nonpublicly traded stock, the seller may defer gain under the installment method. IRC §453. See §53.24, infra, for further discussion of installment reporting for deferred payments.

G. (§53.10) FIRPTA Considerations

The Foreign Investors Real Property Tax Act (FIRPTA) provides that when a nonresident alien person or a foreign corporation disposes of a U.S. real property interest, the gain or loss is treated as income or loss effectively connected with a U.S. trade or business. IRC §897. If this characterization applies to a sale or an exchange, the net gain is subject to the regular U.S. income tax rates that apply to ordinary income. For a nonresident alien person, however, the net gain is generally subject to a minimum tax rate of 26%. See IRC §§55(b)(1), 897(a)(2).

If FIRPTA applies to the transaction, the tax consequences of an asset sale may differ from those of a stock sale. In addition to the FIRPTA tax imposed on the nonresident seller, the buyer must deduct and withhold 10% of the sale price on the purchase of a United States real property interest from a foreign person. IRC §1445.

A United States real property interest is generally defined as (1) an interest in United States real property or (2) an interest in a corporation in which more than 50% of the value consists of United States real estate. If the sale is an asset sale, only the portion of the sale price attributable to United States real estate is subject to FIRPTA withholding. If the sale is a stock sale, and the United States real
property constitutes more than 50% of the value of corporate assets, then
the entire sale price is subject to FIRPTA withholding.

H. (§53.11) Special Tax Treatment for Certain Stock Sales

Certain exclusions and deferrals are available only in a stock sale. For example, individual taxpayers may defer gain from the sale of qualified small business stock held for more than six months to the extent that the proceeds are reinvested in other qualified small business stock. See IRC §1045. For qualified small business stock held for more than five years, half of the gain is tax-free. See IRC §1202.

The term qualified small business stock generally refers to stock acquired by direct issue after August 10, 1993, from a domestic C corporation whose aggregate gross assets at all times are $50 million or less. For definitions and other applicable requirements, see IRC §1202.

Oregon income tax can be deferred on the sale of certain “small business securities” acquired between 1986 and 1990 if the sale proceeds are reinvested in other “small business securities” within six months. See ORS 316.871–316.872 for definitions and other applicable requirements.

I. (§53.12) Summary

In summary, when structuring the purchase and sale of a business, the buyer and the seller should consider, among other things, tax at corporate level; basis step-up for acquired assets; depreciation recapture; the continuation or termination of tax attributes of the target corporation; installment reporting for deferred payments; the applicability of FIRPTA; and special tax treatment for certain stock sales.

III. ASSET SALE

A. (§53.13) In General

For purposes of §§53.14–53.15, infra, assume that the buyer will purchase the target assets.

B. (§53.14) Allocation of Purchase Price

Although an asset sale of an ongoing business often has a single aggregate price, for tax purposes it is necessary to account separately for each asset. The seller uses the allocation to compute gains or losses on the disposition of each asset. The buyer uses the allocation to establish tax bases in the acquired assets.
Sales of real estate and equipment generally produce capital gain or loss, while sales of inventory and receivables produce ordinary income and loss. Some business assets, such as equipment and buildings, are depreciable; others, such as land, are not. The sale of depreciable assets at a gain generally triggers depreciation recapture under IRC §1245 or §1250. See §53.7, supra. Gain on the sale of some assets, such as inventory, is not eligible for deferral under the installment sale method.

In general, a seller wants a higher percentage of the purchase price allocated to capital items, particularly if the selling corporation is an S corporation. Amounts allocated to inventory, covenants not to compete, and recapture income generate ordinary income or loss, whereas amounts allocated to goodwill and nonrecapture assets generate capital gains or losses. In addition, the seller might also be concerned about the availability of installment reporting under IRC §453, which generally is not available on the sale of inventory, receivables, or recapture items.

On the other hand, a buyer generally wants a higher percentage of the purchase price allocated to short-term depreciable assets. In many cases, the value inherent in a business being sold is not limited to “hard” assets like fixtures and equipment, but is attributable to intangible factors like customer loyalties and methods of doing business. Amortization of intangibles is governed by IRC §197, which generally requires that intangibles be amortized over 15 years. Section 197 intangibles generally include goodwill, going-concern value, workforce in place, business books and records, patents, copyrights, formulas, designs, know-how, customer-based intangibles, supplier-based intangibles, licenses granted by the government, covenants not to compete, franchises, trademarks, and trade names.

Ideally, a buyer and a seller will establish the allocation of the purchase price as part of the sale agreement and agree to report the transaction to the IRS in a manner consistent with the agreed-on allocation. The allocation in a written agreement generally binds the buyer and the seller for federal income tax purposes. IRC §1060(a); Treas Reg §1.1060-1(c)(4); C.I.R. v. Danielson, 378 F2d 771, 777–778 (3d Cir 1967).

Putting the allocation in writing also helps to prevent controversies that can arise if the buyer and the seller adopt inconsistent positions in their tax returns and can significantly increase the chance that the allocation will be respected by the IRS or the court, especially when the parties have adverse interests or have a good business reason to support the allocation.
In an “applicable asset acquisition,” the parties must report a purchase price allocation in the manner provided by the regulations, usually on IRS Form 8594. An applicable asset acquisition is the acquisition of assets that constitute a trade or business and the bases of which are determined wholly by the consideration paid. IRC §1060. See §53.32, infra, for reporting requirements under IRC §1060.

C. (§53.15) Direct Payments to Shareholders

In an asset sale, the buyer can make different types of direct payments to the selling shareholders. Because those direct payments are not subject to the corporate-level tax inherent in a corporate asset sale, they may present a significant tax-planning opportunity.

For example, the buyer may hire one or more of the selling shareholders pursuant to an employment or consulting arrangement. The buyer generally can deduct these consulting payments, which constitute ordinary income to the selling shareholders.

Alternatively, one or more of the selling shareholders may enter into a covenant not to compete with the buyer. Although the parties have relatively more latitude in drafting a covenant not to compete as part of a sale of a business compared to the employment context, care must be taken to ensure that the covenant is enforceable under local law by appropriate limits on duration and geography.

For the buyer, a 15-year amortization applies to covenants not to compete entered into in connection with acquiring a trade or business, regardless of the term of the covenant. IRC §197. For the shareholders of the selling corporation, noncompete payments generally are not self-employment income and therefore are not subject to self-employment tax.

PRACTICE TIP: Because noncompete payments are not self-employment income, selling shareholders may prefer covenants not to compete over consulting agreements. On the other hand, the buyer may prefer consulting agreements over covenants not to compete. Although noncompete payments must be amortized over 15 years regardless of their terms, consulting payments generally are deductible when paid or accrued.

The IRS generally scrutinizes short-term employment or consulting agreements to determine whether they are really in the nature of noncompete covenants or a disguised sale price, and advisers should not allow clients to characterize payments in a manner not supported by the facts. See, e.g., Treas Reg §1.197-2(b)(9). Similarly, the IRS may
scrutinize a covenant not to compete if, for example, the selling shareholder represents little competitive threat to the buyer. The payment may be recharacterized as a disguised sale price.

**PRACTICE TIP:** If the seller is an S corporation, direct payments to the shareholders might not always be preferable. For example, shareholders of a selling S corporation might prefer a higher sales price for corporate goodwill rather than direct payments for a covenant not to compete. Payments for purchased goodwill from an S corporation would pass through to the shareholders and be taxed at capital gains rates. The passed-through gain increases the shareholders’ “outside” tax basis in corporate stock, and therefore prevents a second level of tax on the liquidating distribution. On the other hand, payments to the selling shareholders for a covenant not to compete would be taxed at ordinary income rates. Given the still considerable disparity between the top marginal tax rates for capital gain and for ordinary income, a selling S shareholder might prefer larger goodwill payments.

In some special circumstances, a buyer can pay key shareholders of the selling corporation directly for business goodwill to the extent that goodwill belongs to the shareholders rather than to the corporation. *See Martin Ice Cream Co. v. Commissioner,* 110 TC 189 (1998); *William Norwalk,* 76 TCM (CCH) 208 (1998). A direct payment could qualify for capital gain treatment by the selling shareholders. This tax-planning opportunity might be available if the shareholders are also key employees, if the customer goodwill largely depends on the relationship with and service by the employees, and if there is no covenant not to compete or similar contractual safeguard to secure the goodwill at the corporate level. This analysis is fact-intensive and the specific circumstances of each case must be weighed carefully in light of applicable case law.

**IV. STOCK SALE**

**A. (§53.16) In General**

Although in some respects a stock purchase and sale is more straightforward than an asset purchase and sale, there are significant tax differences.

Stock is generally treated as a capital asset in the seller’s hands unless the seller is a “dealer” in the stock that he or she is selling. IRC §1221. A nondealer’s gain or loss on a stock sale is capital gain or loss,
except when provided otherwise by statute, such as the ordinary income exceptions under IRC §304 (redemptions by related parties), IRC §306 (sale or exchange of stock received as dividend), or IRC §341 (sale or exchange of stock in collapsible corporation).

In general, a stock sale has no effect on the target corporation. In other words, a stock sale generally does not give rise to corporate-level gain or loss and has no effect on corporate tax attributes, except when the stock sale is treated as a deemed asset sale under a special election.

**Practice Tip:** A seller might consider coordinating charitable objectives with the stock sale. For example, a seller who donates some of his or her appreciated stock to a charity before a sale would have no gain with respect to the donated stock and also would receive a charitable deduction for the fair market value of the donated property (assuming that the built-in gain is long-term capital gain at the time of donation). However, proper planning is critical to avoid having the transaction recharacterized as a stock sale followed by a charitable contribution of the sale proceeds. See *Ferguson v. C.I.R.*, 174 F3d 997 (9th Cir 1999).

A seller also might create a charitable trust that is funded with the appreciated stock and then let the trust sell the stock. This arrangement can produce many of the same tax benefits of an installment sale while achieving possible estate tax benefits, ordinary income tax deductions, and charitable objectives. A suitable combination of charitable donation and stock sale could be structured to yield larger after-tax cash flow than would be available from a straight stock sale. Again, proper planning is critical to avoid having the transaction recharacterized as a stock sale followed by donation to the charitable trust, and to avoid any unrelated business taxable income that could undermine all the tax benefits.

**B. (§53.17) Net Operating Losses and Related Issues**

In some cases, a target corporation may have a substantial amount of net operating losses (NOLs). In an asset sale, the NOLs remain with the corporate seller, who may use the NOLs to offset gain on the sale of assets, or to offset income from a new line of business. In a stock sale (unless there is a deemed asset sale), the NOLs remain with the target corporation.

The corporation’s ability to take advantage of the NOLS may be limited by IRC §382: if ownership changes with respect to a corporation with an NOL carryover or an NOL for the taxable year of the ownership
change, the amount of prechange NOLs that may offset postchange income in any one year is an amount equal to the value of the corporation when the ownership changed, multiplied by the long-term tax-exempt rate as defined in IRC §382(f).

An *ownership change* occurs if, as a result of stock transfers and corporate restructuring or reorganization, the percentage of stock owned collectively by one or more 5% shareholders has increased by more than 50 percentage points during a three-year period. IRC §382(g).

**EXAMPLE 1:** A owns 40 shares of Beaver Corporation stock and B owns 60 shares. Beaver Corporation has a large amount of NOL carryover. C acquires 30 shares of Beaver stock from A and 30 shares from B within a three-year period. An *ownership change* has occurred because C increased its stock ownership from nothing to 60%, an increase of 60 percentage points in the testing period. IRC §382 limits the amount of prechange NOL that Beaver Corporation can use after the ownership change.

If the income in any postchange year is less than the annual IRC §382 limitation for that year, the unused IRC §382 limitation can be carried over and added to the regular amount of IRC §382 limitation for the next year.

In addition to the NOL limitation of IRC §382, other limitations could be relevant. Limitations apply to certain unused tax credits if ownership changes. IRC §383. Restrictions also apply to the use of preacquisition losses as an offset against built-in gains of an acquired corporation that are recognized within five years of the acquisition. IRC §384.

Furthermore, the IRS may disallow or limit deductions and other tax benefits when tax avoidance is the principal purpose for the direct or indirect (1) acquisition of control of a corporation or (2) transfer of assets from one corporation to another. IRC §269. The word *control* for this purpose means ownership of 50% of the stock, by vote or value. A transaction that escapes the application of IRC §382 might still be subject to §269. For example,

§382 requires an ownership change of *more* than 50 percentage points of stock value in order to constitute a triggering event. Section 269(a)(1), by contrast, only requires a 50 percent change of control measured by vote or value. Thus, 50–50 joint ventures are not caught by §382 but could result in a §269(a)(1) control acquisition.

**BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶14.44[7][a] (7th ed 2000).**
The determination of tax avoidance purpose is highly factual. For a discussion of some judicial (but commonsense) criteria concerning the standard for tax avoidance purpose under IRC §269, see BITTKER & EUSTICE, supra, ¶14.41[4].

C. IRC §338  
1. (§53.18) Regular §338 Election  
In what is referred to as a “regular §338 election” (in contrast with the special election under IRC §338(h)(10)), a corporate taxpayer who has purchased 80% of the stock of a target corporation may elect to treat the purchase as an acquisition by the target corporation of its own assets. IRC §§338, 1504(a)(2). If a §338 election is made, for federal income tax purposes, the target corporation is treated as though it had sold all of its assets, subject to its liabilities, to a newly formed corporation and thereafter immediately liquidated and distributed its assets to the buyer, its new shareholder. See IRC §338(h)(9). This generally results in the target corporation’s recognizing gain on the deemed asset sale.

   **EXAMPLE:** Duck Corporation acquires all the stock of Big Green Corporation for $200,000 cash. Big Green Corporation has two assets: land having a fair market value of $50,000 and an adjusted basis of $20,000, and a building having a fair market value of $150,000 and an adjusted basis of $40,000. Duck Corporation makes a regular §338 election. Big Green Corporation is deemed to have sold its assets for $200,000, and recognizes a $140,000 gain. The “new” Big Green Corporation is treated as a new company for tax purposes. It has a $50,000 basis in its land and a $150,000 basis in its building.

   Although the new target corporation will have a basis step-up in its assets after the transaction, because of the second level of tax a §338 election generally makes sense only when the target corporation has significant losses that would offset any corporate-level gains. For example, if the target corporation has significant loss carryovers that are about to expire (or that could not be effectively used after an acquisition because of the rules of IRC §382, discussed in §53.17, supra), a regular §338 election could provide the benefits of basis step-up to the buyer without significant cost.

2. (§53.19) §338(h)(10) Election  
A special election allows a sale of stock in a member of an affiliated group to be treated for tax purposes as an asset sale from the
“old” target to the “new” target, followed by a liquidation of the “old” target into the selling group. IRC §338(h)(10). See Treas Reg §1.338(h)(10)-1. The deemed sale happens when the target is still a member of the selling affiliated group (unlike the regular §338 election, see §53.18, supra, in which the deemed asset sale is deemed to occur after the sale of the target stock). The selling group recognizes only one level of tax because the deemed liquidation is tax-free under IRC §332, and the selling group thereby inherits the target corporation’s tax attributes under IRC §381(a). The acquiring corporation acquires a “new” target corporation with a basis step-up in its assets. A §338(h)(10) election must be made jointly by the acquiring corporation and the selling group.

3. (§53.20) §338(h)(10) Election by S Corporation Shareholders

Although IRC §338(h)(10) refers only to selling consolidated groups, the relevant Treasury regulations also allow S corporation shareholders to make a §338(h)(10) election. See Treas Reg §1.338(h)(10)-1(c)(1).

The deemed asset sale presents the same potential tax problems as a direct sale of assets. See §§53.14–53.15, supra. If the target is a former C corporation, a corporate tax may be imposed on certain built-in gain. See IRC §1374. Also, adverse state or local tax consequences may occur: the deemed asset sale may be subject to excise taxes and could generate business income subject to apportionment and tax at the state and local levels.

Installment reporting is available for the deemed asset sale under a §338(h)(10) election. See Treas Reg §1.338(h)(10)-1(d)(8). In a deemed asset sale, the S corporation, and indirectly the shareholders of the S corporation, cannot use installment reporting with respect to its inventory and must recognize any depreciation recapture immediately in the year of sale.

A distribution of installment notes on complete liquidation generally is not taxable to the S corporation shareholders or the S corporation (except with respect to tax imposed by Subchapter S). See IRC §§453(h), 453B(h); Treas Reg §1.453-11. In effect, the shareholders are treated as having sold their stock directly to the buyer for the installment notes and other consideration received on the liquidation. In addition, given the pass-through character of an S corporation, there will be no corporate-level tax other than the taxes
imposed by Subchapter S on built-in gain from Subchapter C history or excessive passive-investment income. Nevertheless, in a deemed asset sale under §338(h)(10), the S shareholders could report relatively more gain in the first year. See IRC §§453(h), 453B(h); Treas Reg §1.453-11.

The acceleration of gain reported by the S corporation shareholders in a §338(h)(10) election is illustrated in the following example.

**Example:** A owns all the stock of an S corporation, which has a basis of $20 and a fair market value of $100. The corporation is not subject to any tax imposed by Subchapter S, and has an aggregate basis of $20 in its assets. Suppose the stock is sold under a §338(h)(10) election for $25 cash and a $75 note. The transaction would be treated for tax purposes as if the corporation has sold all its assets and then distributed the proceeds in complete liquidation. Assume that all the assets are eligible for installment reporting, and that there is no depreciation recapture. The aggregate selling price or contract price on the deemed asset sale is $100, with a gross profit or gain of $80. The gross profit ratio is therefore 80%. Accordingly, 80% of the $25 cash payment, or $20, is reportable as gain in the year of sale. The remaining $5 is recovery of basis.

The $20 recognized gain would flow through to A and increase A’s basis from $20 to $40. On the deemed liquidation, A would receive $25 cash and a $75 note in exchange for A’s stock, and the corporation would recognize no gain or loss with respect to the distribution. For A, the aggregate selling price or contract price received on the deemed liquidation is $100, with a gross profit or gain of $60. Shareholder-level gross profit ratio is therefore 60%. Accordingly, 60% of the $25 cash payment, or $15, is reportable as gain in the year of sale. The remaining $10 is recovery of basis. Thus, A is taxed on $20 + $15 = $35 on the transaction, despite the fact that A receives only $25 in cash.

On the other hand, had A sold the stock for the same consideration without a §338(h)(10) election, A would have realized a gain of $80, only $20 of which would be taxed immediately under the installment method. Indeed, the aggregate selling price or contract price is $100 and the gross profit or gain is $80. The gross profit ratio is therefore 80%. Accordingly, 80% of the $25 cash payment, or $20, is reportable as gain in the year of sale. The remaining $5 is recovery of basis.
Thus, although the total amount of gain is the same in either case, A would report more gain at the time of sale with a §338(h)(10) election.

D. (§53.21) IRC §1244 Stock

A taxpayer may treat losses on the sale of stock in certain relatively small corporations as an ordinary loss rather than as a capital loss. IRC §1244. The loss is allowed as a deduction against a taxpayer’s adjusted gross income. Section 1244 stock generally is stock of a domestic corporation owned by an individual, issued for money or property, when the corporation has capitalization of less than $1 million. The deductible ordinary loss is subject to an annual limitation of $50,000 ($100,000 on joint returns).

E. (§53.22) Bootstrap Acquisitions

A bootstrap acquisition is a stock acquisition that is partially financed by the target assets. Leveraged buyout, in which the buyer finances the acquisition with debt that is supported largely by projected cash flow or earning power of the target corporation, is a special type of bootstrap acquisition.

Bootstrap acquisitions can take a number of forms, including any combination of a stock purchase with a redemption by the target corporation of a portion of its stock or with a dividend distribution by the target corporation (either to the selling shareholders before the acquisition or to the buyer after the acquisition).

EXAMPLE: Duck Corporation has net assets of $500, of which $100 consists of cash or liquid assets with a $100 basis. S is Duck’s sole shareholder. B wishes to acquire all of S’s stock in Duck Corporation. B and S might structure the transaction as follows:

(1) B purchases 80% of the stock of Duck Corporation from S for $400 and, either immediately before or after the purchase but as part of the same transaction, Duck Corporation redeems 20% of its stock held by S for $100; or

(2) Duck Corporation declares and pays a dividend of $100 to S, then B acquires all of the stock of the (now smaller) Duck Corporation for $400; or

(3) B acquires all the stock of Duck Corporation for $500, then Duck Corporation distributes $100 to B as a dividend.
In each of the three alternatives in the example, the parties reach essentially the same economic result. However, the tax results may be substantially different.

The redemption approach, if structured properly, generally results in capital gain treatment for the selling shareholders and a lower initial basis in the target stock for the buyer. The preacquisition dividend, assuming that the form of the transaction is respected, results in part dividend treatment and part capital gain treatment to the selling shareholders, and a lower initial basis in the target stock for the buyer. However, an important consideration is whether the preacquisition or presale dividend would be respected as a separate transaction for tax purposes. See, e.g., Uniroyal Inc., 65 TCM (CCH) 2690 (1993); Litton Industries, Inc. v. Commissioner, 89 TC 1086 (1987); compare Waterman Steamship Corporation v. C.I.R., 430 F2d 1185 (5th Cir 1970), overruled on other grounds, Utley v. C.I.R., 906 F2d 1033, 1036 n 7 (5th Cir 1990). The postacquisition dividend generally results in higher capital gain treatment to the selling shareholders, a higher initial basis in the target stock for the buyer, and dividend treatment to the buyer on the cash distribution. Whether dividend treatment to the buyer generates taxable income depends on whether the buyer is an individual or a corporation.

A redemption results in capital gain treatment for the redeeming shareholder only if it meets one of the conditions set forth in IRC §302(b). If the parties are unrelated, a redemption often qualifies for capital gain treatment as a complete termination of shareholder interest, or as a substantially disproportionate redemption. See IRC §302(b)(2)–(3). If one or more steps are properly integrated, a bootstrapping redemption also will qualify. In Zenz v. Quinlivan, 213 F2d 914 (6th Cir 1954), a corporation’s sole shareholder disposed of all of her shares in the corporation in two steps. First, she sold some of her shares to an unrelated buyer. The corporation then redeemed her remaining shares. The court considered both the buyer’s acquisition and the seller’s redemption, and also determined that the selling shareholder had completely terminated her interest in the target corporation. As a result, she was entitled to capital gain treatment with respect to the redemption. See Rev Rul 75-447, 1975-2 CB 113.

When planning a bootstrap alternative, consider, among other things, the needs of the parties. For example, a corporate shareholder generally prefers dividend treatment over capital gain because the shareholder will receive a deduction for dividends received or can exclude the distribution from gross income. See IRC §243; Treas Reg
§1.1502-13(f)(2). If the target corporation has no earnings and profits, individual selling shareholders may prefer to structure the distribution as a return of capital rather than as a purchase.

Certain expenses may not be deductible in a redemption: deductions by a corporation for amounts paid to repurchase stock, premiums paid for stock, and professional or transaction fees incurred in the redemption. IRC §162(k).

V. SOME COMMON ISSUES IN A TAXABLE ACQUISITION

A. (§53.23) Characterization

In general, a taxpayer may freely structure a transaction to achieve the desired tax results in accordance with the letter of the law. However, it is important to appreciate that, under the judicial principle of substance over form, the IRS and the courts may recast the form of a transaction for tax purposes. In other words, the IRS or the courts may recharacterize a transaction as though it had been accomplished by the use of a different, and generally more direct, form. A variant of substance over form is the step-transaction doctrine, which allows the IRS or the courts to view formally separate actions as a single integrated transaction for tax purposes.

An analysis of substance over form requires thorough knowledge of statutory and regulatory tax provisions, as well as analogous court decisions, and often contradictory distinctions that courts have made in similar situations. The courts have not made this analysis easy. For example, courts have announced at least three different judicial tests for determining whether two or more formally separate actions will be integrated and treated as a single transaction. These include the “binding commitment” test, which applies the step-transaction doctrine if, when the first action occurs, there is a legally binding obligation to carry out the subsequent action; the “mutual interdependence” test, which applies if “the legal relations created by one transaction would have been fruitless without a completion of the series”; and the “end result” test, which applies if the different actions were part of a plan and were all intended from the outset to achieve a common end result. See, e.g., McDonald’s Restaurants of Illinois v. C.I.R., 688 F2d 520, 524–525 (7th Cir 1982), rev’g 76 TC 972 (1981).

The theme of substance over form can be particularly knotty in the corporate acquisition context because often a variety of forms achieve substantially similar economic consequences. Because of the uncertainty
and risk of recharacterization, a cautious planner may prefer to stick with well-established structures. If this caution is not practicable, the planner must be sensitive to the myriad ways in which a transaction may be recharacterized. If any recharacterization would result in unacceptable tax consequences, discuss the risk of recharacterization with the client.

As with many tax problems, the other side of risk and uncertainty is opportunity. Creative tax planning often allows a taxpayer to take advantage of the substance-over-form doctrine to achieve favorable tax positions within the constraints that nontax considerations impose on the form of a transaction.

B. (§53.24) Deferred Payments

In a transaction with deferred payments received after the year of sale, a seller generally can report gain from the sale under the installment method. The installment method permits the deferral of gain recognition ratably over the payment period. For example, if the purchase price for a sale is to be paid in 10 equal annual installments, the gain under the installment method would be recognized ratably in 10 equal installments. In an installment sale, the installment method of reporting automatically applies unless the seller elects out of the installment method with respect to the sale.

The installment method is available to both cash-basis and accrual-basis taxpayers.

Note: For a brief period of time, accrual-basis taxpayers were unable to use the installment method. See former IRC §453(a)(2) (added in the 1999 Tax Relief Extension Act). However, Congress subsequently repealed IRC §453(a)(2), effective retroactively to its inception. See Installment Tax Correction Act of 2000, Pub L No 106-573. Consequently, the installment method of reporting is available to accrual method taxpayers as if former IRC §453(a)(12) had never been enacted.

However, certain limitations apply to the taxpayer’s ability to report transactions on the installment method. For example, a taxpayer may not report gain from sales of stock or securities traded on an established securities market, inventory, receivables, dealer property, and recapture items. IRC §453(b)(2), (k)(2). Limitations also apply if the sale price exceeds $150,000 and the total outstanding installment obligations held by the seller at year end exceed $5 million. See IRC §453A. Special rules apply to installment sale transactions between related parties. IRC §453(e), (g). Last, if a seller later sells an installment
obligation, the sale triggers immediate recognition of the deferred gain. IRC §453B.

Under the installment method, payments that the seller receives each year must be separated for tax purposes into interest, return of capital, and gain. Interest is taxed as ordinary income. If interest is unstated, it is imputed under IRC §1274 or §483 and the purchase price is adjusted downward for tax purposes. The seller generally reports a fixed fraction of each installment payment as gain, in proportion to the “gross profit ratio” that total gain bears to aggregate selling price. As discussed above, gain attributable to inventory, receivables, or recapture income may not be deferred and must be recognized in the year of sale.

PRACTICE TIP: By increasing the interest rate on the installment note and making a corresponding reduction in the purchase price, the buyer can increase the amount of ordinary deductions. Lawyers should take care to ensure that the characterization reflects the actual facts, recognizing that a range of values may well be supportable.

An installment sale often involves contingent payments. For example, a seller of a business may require a cash payment at the time of sale plus annual “earnout” payments that will vary in amount depending on the business profitability. In such a case, because the parties cannot determine the aggregate selling price (and consequently the gross profit ratio) at the time of sale, the standard installment sale reporting method cannot be used. Instead, the seller must report the gain using the basis-allocation methods prescribed by Treas Reg §15A.453-1(c).

The contingent payment rules of Treas Reg §15A.453-1(c) distinguish between sales for which there is a maximum selling price, sales for which there is no maximum selling price but the payment period is determinable, and sales for which there is neither a maximum selling price nor a definite payment period. For example, if the sale has no stated maximum selling price but has a fixed payment period, basis generally is allocated to the taxable years in the payment period in equal annual amounts. See Treas Reg §15A.453-1(c)(3).

A taxpayer also may elect to use an alternative method of basis recovery if he or she can prove that the normal basis-recovery rule would substantially and inappropriately defer recovery of basis. Treas Reg §15A.453-1(c)(7). In particular, the taxpayer must prove that (1) the alternative method is a reasonable method of basis recovery and (2) the taxpayer is likely to recover basis at a rate twice as fast as the rate at
which basis would have been recovered under the otherwise applicable normal basis-recovery rule. The taxpayer must secure a private letter ruling from the IRS before using an alternative method of recovery. Treas Reg §15A.453-1(c)(7)(ii).

Practice Tip: A seller who anticipates receiving most of the estimated selling price in the year of sale should consider applying for a ruling that would authorize an accelerated basis-recovery schedule based on estimated payments, particularly if the payment in the year of sale is likely to be more than twice the size of the estimated mean annual payment. For example, suppose a contingent payment sale has a fixed five-year payment period and no maximum selling price. Under the applicable standard method of recovery, one-fifth, or 20%, of the basis would be allocated to each payment. Assume that based on recent and current operating history of the business, the payment received in the year of sale is likely to be the largest single payment and to represent 50% of the total selling price. Under the circumstances, the seller may propose allocating 50% of the basis to the year of sale, with the other 50% allocated uniformly over the remaining four years. The maximum rate of 50% under the proposed method is more than twice as high as the maximum rate of 20% under the standard method.

Practice Tip: As another way to accelerate basis recovery in an asset sale, the parties could attempt to allocate more of the first-year payment to high-basis assets. If such an allocation is well-documented and supported by good business reasons, and if the amounts are reasonable and consistent with IRC §1060, there is a good chance that the IRS will respect the allocation. For example, the parties could allocate most of the first-year payment to the operating assets, while designating the earnout payments as payments for goodwill and other intangible assets, which usually have low tax basis.

If a seller sells property in an installment sale with a below-market interest rate, the imputed interest rules of IRC §1274 or §483 generally apply to recharacterize a portion of the sale price in a deferred payment sale as interest if the interest rate charged in the sale is less than the so-called applicable federal rate.

Example: Duck Corporation wishes to sell a machine for $300,000, payable at the end of 10 years with no interest. If the applicable federal rate is 9% compounded semiannually and no exceptions to the imputed interest rates apply, the imputed interest
rules would recharacterize the transaction as a sale of the machine for $124,500 payable at the end of 10 years, together with interest thereon at 9%, compounded semiannually. The tax consequence is that the seller has imputed interest income of $175,500 under IRC §1274 and the buyer has interest expense of $175,500 and an adjusted basis in the machine of $124,500.

The imputed interest rules do not apply if the buyer pays a market rate of interest. IRC §1274 applies to debt instruments given in consideration of the sale or exchange of property. Exceptions to its application include, among others, (1) the sale of a principal residence, (2) sales involving total payments of less than $250,000, (3) debt instruments having a maturity less than six months, and (4) sales of farms for less than $1 million. IRC §483 covers some of the situations that are exempt from IRC §1274.

C. (§53.25) Disposition of Unwanted Assets

In some cases, the buyer may not want to purchase all of the target assets.

One approach for dealing with this problem is via a tax-free spin-off. The target corporation may transfer the unwanted assets to a new corporation and then distribute the stock of the new corporation to the shareholders as a dividend in partial redemption of its target stock. If the requirements of IRC §355 are satisfied, this may be a tax-free transaction.

Alternatively, the target corporation may distribute the unwanted assets to its shareholders as a dividend or in partial redemption of its stock. (Some types of assets are more readily distributable than others.) From the perspective of the selling shareholders, receipt of noncash distributions is generally treated like receipt of cash from the target corporation. Assuming that the assets are treated as a distribution from the target corporation, a distribution in the context of a stock acquisition is generally treated as a redemption. A distribution in the context of an asset acquisition is generally treated either as a liquidating distribution or as a redemption or a dividend, depending on whether or not the target corporation is liquidated as part of the transaction, and, if it is not liquidated, on whether or not shares are repurchased by the target corporation.

For the target corporation, the distribution is treated as a sale to the shareholder and triggers corporate-level tax on any appreciation in the distributed asset. IRC §311(b). The target corporation will not, however,
be permitted to recognize a loss on distribution if its basis in the
distributed property exceeds the fair market value of that property. See
IRC §311(a)(2).

If the target corporation owns assets that have an unrealized loss
and that the buyer of target stock does not wish to acquire, some tax
planning opportunities arise. One technique for recognizing that loss is
for the target corporation to simply sell the assets to an unrelated third
party.

D. (§53.26) Treatment of Transaction Costs
A business acquisition often involves significant transaction costs,
including both “outside” costs, such as investment banking, legal and
accounting fees, and associated in-house costs. A common issue is
whether those transaction costs may be deducted or must be capitalized.
A deduction is allowed for “ordinary and necessary expenses” of
carrying on a trade or business. IRC §162(a). On the other hand,
deductions are generally disallowed for capital expenditures, that is, costs
related to creating, acquiring, or improving an asset. IRC §263(a). A
capitalized cost generally is added to the asset’s basis and recovered
through depreciation or amortization deductions or on disposition of
the asset.

An acquirer that purchases a target corporation’s stock or assets
generally must capitalize its acquisition costs, and add them to the basis
of the stock or assets acquired. See Woodward v. Commissioner, 397 US
572, 90 S Ct 1302, 25 L Ed2d 577 (1970); United States v. Hilton
Hotels, 397 US 580, 90 S Ct 1307, 25 L Ed2d 585 (1970). However, a
distinction must be drawn between costs incurred to acquire a capital
asset (capitalized) and costs incurred to satisfy preexisting liabilities
assumed in the acquisition (might be deductible). See, e.g., Rev Rul 73-

In contrast, the tax treatment of transaction costs for the target is
generally more complicated because a target corporation does not acquire
anything and, in a stock acquisition, does not even engage in any
transaction at all for tax purposes. The treatment of transaction costs for
the target in a taxable stock purchase was the subject of the leading
Supreme Court case on the question of capitalization versus deduction.
In INDOPCO, Inc. v. Commissioner, 503 US 79, 112 S Ct 1039, 117
L Ed2d 226 (1992), the taxpayer target corporation claimed deductions
for its transaction costs, arguing that those costs should not be
capitalized because it did not acquire any assets in the transaction and
the transaction costs therefore did not result in creating a separate asset to the basis of which the costs could be added. The target corporation also maintained that because its directors were required by their state law fiduciary duties to consider and act in the best interests of shareholders in connection with the initially unsolicited offer, its expenses were incurred incident to the fiduciary obligation rather than to the acquisition itself. The IRS relied on a line of authorities holding that expenses incurred by a corporation in connection with any changes to its own capital structure are nondeductible capital expenditures.

The Supreme Court held that the costs must be capitalized because they produced a benefit to the corporation that would extend beyond one year, even though the expenditures did not result in creating a “separate and distinct asset.” The Court found that both the anticipated operational benefits and administrative savings from the acquisition would result in a sufficient long-term benefit to require capitalization. INDOPCO, Inc., supra, 503 US at 88–90.

However, not every long-term benefit requires capitalization under the INDOPCO case. Although a necessary condition for capitalization is that there is a benefit extending beyond the current year, the presence of a long-term benefit is not sufficient by itself to require capitalization. In Wells Fargo & Co. and Subsidiaries v. C.I.R., 224 F3d 874 (8th Cir 2000), an Iowa state bank merged into and became a wholly owned subsidiary of Norwest, a bank holding company that later acquired the Wells Fargo group and assumed the Wells Fargo name. On audit of the Norwest (now Wells Fargo) consolidated return, the IRS denied a deduction for the portion of the bank’s corporate officers’ salaries attributable to the services that the officers performed in the merger transaction; the IRS argued those costs must be capitalized. In a thorough analysis of Supreme Court precedents, the court explained that an expenditure incurred in connection with a significant long-term benefit is deductible if the expenditure is not directly related to the transaction that provides the long-term benefit. Therefore, “the ultimate question is whether the expense is directly related to the transaction which provides the long term benefit.” Wells Fargo, supra, 224 F3d at 886. In other words, assuming that the expense in issue is otherwise deductible, it must be capitalized if directly related to the transaction, but it may be deducted if it is indirectly related.

See PNC Bancorp, Inc. v. C.I.R., 212 F3d 822 (3d Cir 2000) (in-house salaries for bank officers and employees charged with responsibility for generating and originating loans were deductible
because that was the ordinary business of bank and its officers and employees, regardless of duration of loans).

The *Wells Fargo* and *PNC Bancorp* decisions undermine Rev Rul 73-580, 1973-2 CB 86, in which the IRS had concluded that in-house salaries attributable to services performed in connection with a corporate merger and acquisition must be capitalized because they are indistinguishable from outside fees and costs.

**Practice Tip:** Because the tax treatment of service fees may differ depending on the service, and particularly in light of the *Wells Fargo* decision, establish a record of fee allocation early in the transaction to facilitate deductions. For example, some legal and accounting services in an acquisition may arguably relate more to ordinary business operations, such as preparing and reviewing financial records, reviewing and structuring pension plans and other compensation arrangements, and giving general advice to shareholders on corporate operations and fiduciary duty. A good record of fee allocations could allow the taxpayer more flexibility in claiming deductions and more room for compromise on an audit.

If one party to an acquisition pays fees that are properly attributable to another party, the fees are deemed paid by or on behalf of—and will therefore be deductible or capitalizable by—that other party. The characterization of the deemed transfer of funds from the party who actually paid the bill to the party for whom services were rendered (e.g., a loan, dividend, contribution to capital, additional consideration, or compensation) depends on the form of the transaction as well as on the relationship between the parties.

The IRS and Treasury Department expect to issue proposed regulations to clarify the treatment of expenditures associated with acquiring, creating, or enhancing intangible assets or benefits. *See* IRS Announcement 2002-9, 2002-7 IRB 536, *as corrected by* IRS Announcements 2002-30, 2002-11 IRB 632, *and* 2002-35, 2002-12 IRB 667. The IRS Chief Counsel Office has announced that it will no longer litigate certain transaction-cost issues pending the outcome of the proposed regulations. Chief Counsel Notice CC-2002-021 (Mar 15, 2002). Similarly, the IRS division commissioners for large- and mid-sized business and for small business and self-employed taxpayers have instructed their employees not to pursue on audit the transaction cost issues that the IRS Chief Counsel Office has declined to litigate.
E. (§53.27) Some Compensation Issues

An excess parachute payment is a payment or series of payments (1) in the nature of compensation, (2) paid to a disqualified individual (generally an officer, shareholder, or highly compensated person), (3) contingent on a change in the ownership or effective control of the business, and (4) whose present value equals or exceeds three times the base amount of the disqualified individual. IRC §280G(b). Any excess parachute payment is not deductible. IRC §280G(a). A 20% excise tax is imposed on receipt of an excess parachute payment. IRC §4999. An exception applies to payments by S corporations and nonpublicly traded corporations whose shareholders approve the payments. IRC §280G(b)(5).

If the target has outstanding employee stock options, an important consideration in an acquisition is how to deal with these options. The available alternatives may depend on the terms of the options and on the extent of discretion by the target corporation. In general, assuming that the options are already vested and not subject to termination, the buyer and the target corporation may deal with the options by cash-out (canceling the options in exchange for a cash payment equal to the option spread), substitution (replacing the options with comparable stock options in the acquiring corporation or its parent), or a combination of the two, such as giving employees an election to either cash out or substitute options.

In addition to, and probably more important than, tax considerations, the parties must take into account employee benefits and contractual and corporate laws in deciding what to do with outstanding employee stock options.

Whether the options are statutory (qualified) stock options under IRC §421 et seq. or nonqualified stock options subject to IRC §83, a cash-out is generally taxable as ordinary compensation income to the employees under IRC §83(a), and the target corporation employer is entitled to a corresponding compensation deduction under IRC §83(h). See Bagley v. Commissioner, 85 TC 663 (1985), aff’d, 806 F2d 169 (8th Cir 1986). A substitution of one nonqualified stock option for another, even with substantially different terms, is generally treated as a nonevent for tax purposes, with no taxable consequences for either the employee or the target corporation employer. See Treas Reg §1.83-7. (This treatment will not be true if the options are traded on an established market.)
In contrast, substituting a statutory option for another must be reviewed to see if it qualifies as a modification of the option. If a modification, the substitution will be treated as a grant of a new option, which must be tested against the statutory option requirements at the time of the substitution. See IRC §424(h)(1).

If the employees are allowed to choose between a cash-out and substitution, the parties should also consider applying the constructive receipt doctrine. See, e.g., Rev Rul 80-300, 1980-2 CB 165, as amplified by Rev Rul 82-121, 1982-1 CB 79.

F. (§53.28) Related-Party Sales

The term related parties includes family members, a corporation and its controlling shareholder, two corporations that are members of the same controlled group, and other similar related parties. See IRC §267(b).

If a buyer and a seller are related parties, certain tax provisions may affect their tax treatment of the transaction. Any loss from the sale of property between related parties is disallowed. IRC §267(a).

The installment method of reporting cannot be used on the sale of depreciable property (depreciable in the hands of the transferee) between related parties and the purchaser is not entitled to a basis step-up until the seller includes the proceeds in income. See IRC §453(f)(7), (g)(1). If a taxpayer makes an installment sale to a related party and the related party subsequently disposes of the installment sale property, that disposition is treated as a disposition of the installment obligation, triggering immediate gain recognition. IRC §453(e).

Any gain on the sale of depreciable property (depreciable in the hands of the transferee) between related parties is taxed as ordinary income. IRC §1239(a).

G. (§53.29) Cash Mergers

A cash merger is a method that an acquiring corporation can use to acquire 100% control of a target corporation without having to negotiate a separate deal with each shareholder of the target corporation. A forward cash merger is a merger of the target corporation into the acquiring corporation or its subsidiary (forward subsidiary cash merger), with the acquiring corporation or its subsidiary being the surviving corporation and the target shareholders receiving cash for their stock. A reverse subsidiary cash merger is a merger of a subsidiary of
the acquiring corporation into the target corporation, with the target corporation surviving as a subsidiary of the acquiring corporation and the target shareholders receiving cash for their stock.


H. (§53.30) Tax Representations in a Stock Purchase

The parties to a stock purchase often negotiate specific contractual provisions relating to the allocation of risks related to the target’s historic tax liabilities, as well as those arising out of the transaction itself. This allocation is generally done through the target’s tax representations or the target’s selling shareholders, concerning the target’s tax history and condition. In addition to the representations, the parties also may have (1) indemnity provisions, whereby the seller may agree to indemnify the buyer for certain undisclosed or contingent liabilities, and (2) provisions governing the calculation and allocation of tax liability during the period between the execution of the contract and the closing of the acquisition, as well as, in some cases, tax liability arising out of the acquisition itself.

The tax representations serve to assure and protect the buyer against unexpected liabilities by disclosing all the material facts about the target business’s tax history and condition. A breach of the tax presentations could give the buyer a ground to void the transaction, or to assert a claim against the seller, either under a common-law theory of breach of contract or under a specific contractual indemnity provision. As with most other provisions, the tax representations are often subject to a “materiality” condition or an agreed-on “deductible” so that indemnification is required only if the aggregate amount of damages exceeds a specified level.

For the buyer, the tax representations should cover as broad a range of applicable taxes as possible, including all federal, state, local, foreign, and other taxes of all sorts, especially income and sales, as well as charges, fees, and similar items, however designated. The definition should also encompass any interest, penalties, and additions to tax.
The buyer should generally request representations to the effect that all tax returns have been filed on a timely basis and are accurate, that all taxes required to be paid have in fact been paid on a timely basis, and that the target’s balance sheet reflects an accurate reserve for any taxes for which payment is not yet required. In addition, buyers often request representations and indemnifications concerning any taxable years that are still open to assessment and collection; any taxable years currently under audit; and issues raised in previous or current tax audits that potentially relate to years not yet audited.

For a discussion of tax representation and indemnity provisions in acquisition agreements, see Robert Rothman, *The Least Fun Part of the Job or a Tax Lawyer’s Guide to Acquisition Agreements*, 55 TAX LAW 711 (Spring 2002).

VI. (§53.31) REPORTING REQUIREMENTS

Several income tax reporting and withholding requirements may apply to an acquisition transaction. See §§53.32–53.34, infra.

A. (§53.32) IRC §1060 and Applicable Asset Acquisitions

If the transaction is an “applicable asset acquisition” as provided in IRC §1060, the buyer and the seller must allocate the purchase price according to the regulations, and the parties must report the allocation and certain other information on Form 8594. Form 8594 is filed with the buyer’s and the seller’s regular income tax return for the taxable year that includes the purchase.

For applicable asset acquisitions completed on or after March 15, 2001, the assets are divided into seven classes for allocation purposes. See Treas Reg §§1.1060-1, 1.338-6, 1.338-7. If the seller and the buyer enter into a noncompete covenant, the covenant is treated as an asset transferred as part of the trade or business. Treas Reg §1.1060-1(b)(7). Class I assets are cash and demand deposits (like accounts in banks, saving and loan associations, and other depository institutions). Class II assets are certificates of deposit, foreign currency, and actively traded personal property, such as U.S. government securities and publicly traded stock. Class III assets are assets that are marked to market at least annually for federal income tax purposes and certain types of debt instruments (including accounts receivable). Class IV assets are inventory. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets. Class VI assets are IRC §197 intangibles, except those
in the nature of goodwill or going-concern value. Class VII assets are goodwill or going-concern value.

Information must be reported in the manner required by the IRS when a 10% owner of an entity transfers an interest in the entity and in connection with the transfer that owner (or a related person) enters into an employment contract, a covenant not to compete, a royalty or lease agreement, or a similar agreement with the buyer. IRC §1060(e). This reporting requirement applies to asset acquisitions, whether or not subject to the other reporting requirements under IRC §1060, as well as to stock purchases, whether or not there is a deemed asset sale election under IRC §338 (see §53.18, supra).

B. (§53.33) FIRPTA Reporting

If FIRPTA applies to a transaction, the buyer has an obligation to withhold 10% of the purchase price or otherwise report the transaction as provided in IRC §1445 and related regulations. See §53.10, supra, for a more detailed discussion of FIRPTA. The buyer may be liable for failing to withhold. Treas Reg §1.1445-1(e)(1). Assuming the transferred interest may be a United States real property interest, there are several ways the buyer can protect itself. For example, the buyer can (1) obtain an affidavit from the seller that provides the seller’s taxpayer identification number and stating that the seller is not a foreign person, or (2) if the interest is an interest in a nonpublicly traded domestic corporation, obtain an affidavit from the domestic corporation that the domestic corporation is not, and has not been in the past five years, a United States real property holding corporation. IRC §1445(b)(2), (b)(3)(A). The affidavit is not adequate to discharge the withholding obligation if the buyer has actual knowledge or receives notice that the affidavit is false. IRC §1445(b)(7); Treas Reg §1.1445-2(c)(3)(ii). FIRPTA withholding is not required on the sale of publicly traded stock. IRC §1445(b)(6).

Although many standard nonforeign certificates are available for this purpose, the buyer should always review these forms carefully to make sure that they contain the information required by the IRS regulations. In addition, the buyer should consider the effect of state law on, and any record keeping requirement related to, the certificate. For example, a nonforeign certificate must be kept for five years. Treas Reg §1.1445-2(b)(3).
C. (§53.34) Other Reporting or Withholding Requirements

A corporation must report to the IRS its plan of liquidation within 30 days of adopting the plan. IRC §6043(a). The corporation reports this information on Form 966.

Aside from FIRPTA reporting discussed in §53.33, supra, the buyer should be sensitive to other withholding or reporting requirements with respect to payments made in the transaction. Information reporting might apply to consulting or similar payments. Tax withholding under IRC §§1441–1442 might apply to payments to nonresident aliens and foreign corporations for interest, dividends, rent, salaries, premiums, or other fixed or determinable annual or periodic gains, profits, and income, including noncompete payments. See Rev Rul 74-108, 1974-1 CB 248. On failure to withhold as required, the buyer may become liable for the tax due.

If any person gains control (ownership of at least 50% of the stock in vote or value) of a corporation in a transaction or series of transactions, that corporation must make an information return as required by regulations. IRC §6043(c). The IRS has at one time proposed, then withdrawn, regulations under IRC §6043(c). The stated reason for the withdrawal was the undue burden of the reporting requirement. However, the IRS also stated that it might issue new reporting requirements under IRS §6043(c) in the future.