Session 19 -Taxable acquisitions

- Acquire stock or assets?
- Assume that Buyer Corporation wants to acquire the business of Target Corporation
- Target's assets have appreciated and are worth more than their tax basis
- Assume the acquisition will be a taxable purchase
  - purchase price will be cash or notes rather than the buyer's stock

Why use a taxable purchase?

- seller wants cash
- buyer wants seller out of the continuing entity
- buyer wants "step-up" in tax basis of acquired assets
- seller has losses that can be used to offset taxable gain

Transaction structure

- The transaction can be structured in one of three ways
  - methods 1, 2, and 3 on page 324
- all referred to as "taxable" methods because Target's shareholders will have a taxable gain from the transaction

Transaction structures

1. Buyer purchases all of the assets from Target
   - Target liquidates and pays cash out to its shareholders
2. Buyer purchases all of the Target stock from Target shareholders
   - Target is liquidated
   - Buyer ends up with all of Target's assets
3. Buyer purchases all of the Target stock from Target shareholders
   - Target is maintained as a subsidiary of Buyer

Buyer's considerations

- Buying Target stock results in Buyer having a tax basis in the stock equal to the purchase price
  - However, Target (as a subsidiary of Buyer) keeps its old (lower) tax basis in its assets
- Therefore, Buyer gets no tax deductions (e.g., depreciation, amortization) for the excess of the purchase price paid over the basis of Target's assets
- Buying Target assets results in "step-up" in tax basis
  - higher future depreciation/amortization deductions
  - less future income tax

Limits of asset purchases

- Sometimes there are valuable intangible assets that cannot be transferred
  - examples: licenses, exclusive rights, franchises, cable tv, oil leases, cell phones, season tickets
- To obtain these assets Buyer needs to buy the stock of the corporation owning the assets
- If Target has valuable tax attributes such as NOL carryforwards these are lost if assets are purchased

Target's shareholders' considerations

- If stock is sold, there is only a single level of tax to the shareholders (lower capital gains rates usually apply)
- If assets are sold there are two levels of tax
  - Target is taxed on the (ordinary) gain from selling the assets
  - Target's shareholders are taxed on the gain from liquidating Target
    - excess of what shareholders receive on the liquidation over their basis in their stock is a gain
    - usually taxed at lower capital gains rates
- For an asset sale, Target NOLs or capital loss carryforwards, can be used to offset gain at Target's level
- If Target's shareholder is a corporation owning 80% or more of Target's stock, gain or loss on liquidation of Target is generally avoided under special rules

Section 338

- Suppose Buyer acquires Target stock
- Special tax rule (section 338) allows Buyer to elect to "step up" basis of Target's assets to equal the purchase price Buyer paid for the stock
- Should asset basis be stepped up?
  - To step up the tax basis Target has to recognize gain as though the assets had been sold
  - Tax issue: Will the present value of the future tax savings resulting from the step-up (that is, higher future depreciation and/or amortization) be more than the additional tax currently due on the additional gain?
  - Usually only optimal when Target has NOLs that can offset gain generated by step up

Section 338

- Note that under the Section 338 election the liability for the tax on the gain to Target rests with Buyer
  - Target's old shareholders have sold their stock
  - Target is now a subsidiary of Buyer
- To make the Section 338 election Buyer must purchase at least 80% of Target's stock
  - Special rule allows a basis step up to the total of the following:
    - cash paid by Buyer for stock of Target
    - liabilities of Target
    - tax liability arising from section 338 step up transaction

Allocation of purchase price among assets

- In an asset purchase, the lump-sum purchase price must be allocated among all of the assets acquired from Target
- This is extremely important as the costs of different assets are recovered over different time periods
  - Some assets can be expensed as used (e.g., supplies, inventory)
  - Some assets must be depreciated (e.g., machinery, buildings)
  - Purchased intangibles must be amortized over 15 years (e.g., goodwill)
  - The cost of some assets may not be deducted until they are sold (e.g., land)

Survival of NOLs and other tax attributes

- One of the reasons to purchase stock rather than assets is that tax attributes like NOL carryforwards may survive and be utilized by Target in the future
- To prevent people from simply purchasing net operating loss benefits ("trafficking"), the tax law puts limitations on the use of NOLs in cases where there has been a change of ownership
- This limitation applies whenever there has been a greater than 50% change in the ownership of the loss corporation
- The limitation applies to carryforwards of all tax attributes, such as tax credits, capital losses, as well as net operating losses

§382 limitation for NOL carryforwards

- Multiply the market value of Target by the long term tax exempt interest rate
- This is the amount of the NOL that may be used each year in the future
- Why this rule?
  - Congress did not want investors buying corporations with loss carryforwards, putting profitable businesses into them, and using the loss carryforwards to shield the taxable income of the profitable busi
  - Under the rules investors may only earn a "tax free" return on their investment equal to the tax exempt interest rate, in other words, what they could have earned by investing in municipal bonds
  - Any return in excess of the tax exempt rate will be subject to tax

A's Taxable Purchase of T's Stock

- T has assets with a basis of $100 (inside basis) and FMV of $200.
- A pays T shareholders $165 for their stock ($200 FMV of T assets less built in tax liability of $35 {($200-$100) x 35%}).
- T's shareholders have a basis (outside basis) in T stock = $80.

A's Taxable Purchase of T's Stock

- T Corp
  - No gain or loss on the sale of its stock
  - T's basis in its assets remain the same ($100)
  - Tax attributes generally not affected (ability to use in
  - the future may be limited)
- A Corp
  - Basis in stock purchased $165
- T's Shareholders
  - Amount realized $165
  - Basis 80
  - Gain (capital) $85

A’s Taxable Purchase of T’s Stock

- Nontax Factors:
  - An acquisition of T’s stock will protect A from T’s liabilities but will leave T’s assets subject to it’s liabilities.
  - Stock transactions may be necessary if T has licenses or other agreements that are not transferable.

A’s Taxable Purchase of T’s Assets

- T has assets with a basis of $100 (inside basis) and FMV of $200.
- A pays T $200 for the assets.
  - Why won’t A pay $165 like before?
- T’s shareholders have a basis (outside basis) in T stock = $80.

A's Taxable Purchase of T's Assets

- T Corp
  - Amount realized $200
  - Basis 100
  - Gain (capital) $100
    - Tax attributes are not affected (NOLs may be available to offset gain)
- A Corp
  - Basis in assets equal to purchase price $200
  - Stepped-up basis generates deductions (depreciation, amortization, etc.)
- T's Shareholders
  - No gain or loss unless company liquidated

A’s Taxable Purchase of T’s Assets

- Nontax Factors:
  - An acquisition of T’s assets will allow A to avoid all of T’s liabilities.
  - Must transfer title in all assets sold (may be costly)