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Taxable and Tax-Free Acquisitions

PART 1—TAXABLE STOCK AND ASSET ACQUISITIONS

¶101 INTRODUCTION

There are many considerations that influence how a transaction is structured, including tax considerations. The most basic tax issue is whether to structure the transaction as taxable or tax-free. In general, there are four basic structures for a corporate acquisition: (1) a taxable acquisition of a target corporation's stock;[1] (2) a taxable acquisition of a target corporation's assets;[2] (3) a tax-free acquisition of the target corporation's stock; or (4) a tax-free acquisition of a target corporation's assets.[3]

While at first blush it may seem that it is always more desirable to structure a transaction as tax-free, this is not always the case. As an initial matter, the requirements for structuring a transaction as a tax-free reorganization, which are set forth in Internal Revenue Code (Code) §368, are quite strict. The strictures imposed by Code

[1] ¶101 Taxable stock acquisitions are discussed at ¶102.1, below.
[2] Taxable asset acquisitions are discussed at ¶102.2, below.
[3] Tax-free asset and stock acquisitions are discussed in Part 2, below.

§368 may not always be compatible with the business objectives of the parties to the transactions, making resort to a taxable structure more desirable. If the fair market value of a target corporation's assets is greater than the target's basis in such assets, the purchaser may wish to acquire a fair market value basis (i.e., a stepped up basis) in such assets, something that is only possible in a taxable asset acquisition or a taxable stock acquisition for which a Code §338 election is made.

¶102 TAXABLE ACQUISITIONS

In addition to the decisions to undertake a taxable or tax-free transaction, the decision whether to engage in a stock or asset deal is one of the most fundamental decisions made by a buyer and the seller—next only to whether to structure the transaction as a taxable or nontaxable transaction.[1]

¶102.1 Taxable Stock Acquisitions

From a practical standpoint, many buyers will prefer to buy a corporation's stock rather than its assets. A stock purchase often involves significantly less complexity than a direct acquisition of assets, which may involve the transfer of contracts and licenses that are not easily conveyed. In addition, a buyer may wish to insulate itself from any liabilities, including any contingent liabilities of the target corporation, by acquiring stock.

A stock acquisition can be effected through a number of different acquisition techniques. For example, a buyer can acquire the target corporation's stock through a direct purchase of stock or through a tender offer. Stock acquisitions are often effected through a reverse merger where a transitory corporation is merged into the target corporation, with the target corporation surviving. The reverse subsidiary

[1] **¶102** This chapter does not address the tax consequences and issues that may arise in the consolidated return context. For a discussion of the consolidated return tax accounting issues, see Chapter 11. For a discussion of the consolidated return rules, see Dubroff, Blanchard, Broadbent and Duvall, Federal Income Taxation of Corporations Filing Consolidated Returns (Matthew Bender 3/2006). See also Warner, Consolidated Returns Guide (CCH 2003).

Note that so-called "Midco" transactions constitute a potential trap for unwary taxpayers. In a Midco transaction, a taxpayer owns stock of a corporation and the corporation has built-in gain assets. The taxpayer desires to sell stock of a corporation and a buyer desires to purchase the assets. Pursuant to a plan, these parties conduct the transaction through an intermediary, with the taxpayer selling at least 80% of the corporation's stock to the intermediary and the buyer then purchasing at least 65%of the built-in gain assets from it. The intermediary usually receives compensation for participating in the transaction. As a result of the transaction, at least half of the taxpayer's built-in tax with respect to the target assets is offset, avoided, or otherwise not paid. The IRS has provided certain safe harbors, such that if a transaction qualifies for the safe harbor, it will not be considered a Midco transaction. See Notice 2008-111, 2008-2 C.B. 1299 (clarifying Notice 2001-16, 2001-1 C.B. 730 and superseding Notice 2008-20, 2008-1 C.B. 406). The IRS has designated Midco transactions as a "listed transaction;" as a result, taxpayers and advisors may be required to make disclosures with respect to a Midco transaction (or a substantially similar transaction) or face penalties. See Notice 2009-59, 2009-2 C.B. 170.

merger is often used instead of a direct stock purchase in situations where the target corporation's stock is too widely held to make a direct stock purchase practicable or where there may be dissenting shareholders.

EXAMPLE 1

Reverse Subsidiary Merger

To effect the acquisition of Target corporation (T) stock worth $100, Acquirer (A) forms a transitory subsidiary (Mergeco) and contributes $100 cash. Mergeco merges into T with T surviving. The historic T stock is cancelled and the T shareholders receive $100 in cash for their T stock. A's stock in Mergeco is converted into T stock by operation of law.

The formation of Mergeco and its merger into T are disregarded.[2] To the extent the $100 cash received by the T shareholders is supplied by A, the transaction is treated as if A purchased the T stock directly from the T shareholders.[3] The tax consequences to the T shareholders, A, and T are the same as if A had purchased the T stock directly.

¶102.1.1 Tax Consequences to Target Shareholders

¶102.1.1.1 Gain or Loss

The T shareholders recognize gain or loss on the sale of their target stock under Code §1001 equal to the difference between the amount realized and their adjusted basis in their T stock.

The gain or loss recognized by the target shareholders will usually be capital in nature.[4] However, the treatment of the gain as short-term or long-term capital gain depends on the length of the time the taxpayer held the stock (i.e., the "holding period"). In general, long-term capital gains are subject to more favorable tax rates—specifically, the top long-term capital gain rate for individuals is 15% on sales, exchanges, and payments received in taxable years ending on or after 5/06/2003 and not beginning after 12/31/2010.[5] In contrast, the top short-term capital gain rate is 35%. The holding period for individuals necessary to qualify for the 15% long-term capital gain rate is more than one year.

[2] See, e.g., Rev. Rul. 90-95, 1990-2 C.B. 67; Rev. Rul. 79-273, 1979-2 C.B. 125; Rev, Rul. 73-427, 1973-2 C.B. 301.

[3] See Rev. Rul. 73-427, 1973-2 C.B. 301; IRS Letter Ruling 9550013 (9/13/95); IRS Letter Ruling 9315019 (1/15/93); IRS Letter Ruling 9007037 (11/21/89).

[4] The characterization of any gain or loss recognized by the T shareholders as ordinary or capital may be affected by the application of certain special statutory provisions, including Code §306 (relating to the disposition of "Section 306 stock," as defined in Code §306(c) and Code §1244 (relating to losses on small business stock).

[5] Code §§1(h)(1)(C); 55(b)(3)(C).

EXAMPLE 2

Tax Consequences to Seller in Direct Stock Purchase

T has 100 shares of stock outstanding worth $1 each, all of which are owned by Individual A. Individual A's basis in the T stock is $60 and has been held for more than one year. On 1/1, Buyer (B) buys all of the T stock from Individual A for $100 in cash. Individual A recognizes $40 of long-term capital gain.

¶102.1.2 Installment Sale Reporting

The installment method requires gain from an eligible sale to be reported as the taxpayer receives each payment. To qualify for installment sale treatment,[6] at least one payment must be received in the taxable year after the year of payment. Thus, if the T shareholders receive S notes for their stock, they may report any gain from the sale of their T stock under the installment method set forth in Code §453[7] provided certain requirements are met, including (1) the P notes are not readily tradable and are not payable on demand;[8] and (2) the T stock was not publicly traded (i.e., not traded on an established securities market).[9] The amount of each payment that must be reported as gain is determined by multiplying the total amount of payments received during the year by the "gross profit percentage."[10] The "gross profit percentage" is the ratio of gross profit to the total contract price.[11]

EXAMPLE 3

Installment Method (Only Consideration Is a Note)

On 1/1, Individual A, a T Shareholder, sells 50 shares of T stock to P for $100, in the form of $100 P note (bearing adequate stated interest). Under the terms of the P note, P must make annual payments of $10 each on 12/1 beginning in the year of the sale. Individual A's basis in the T stock was $50.

Individual A's gain on the stock is $50. However, because the purchase price was paid with a P note, the gain is reported on the

[6] A complete discussion of the rules relating to installment reporting under Code §453 is beyond the scope of this book. For an in depth discussion of these rules, see Gertzman, Federal Tax Accounting, (2d ed. Warren, Gorham & Lamont) Chapter 5.

[7] In 1999, Congress enacted Code §453(a)(2) which disallowed installment method reporting for accrual method taxpayers, effective for transactions on or after 12/17/99. In 2000, Code §453(a)(2) was repealed by the Installment Tax Correction Act of 2000, Pub. L. No. 106-673. The repeal of Code §453(a)(2) was retroactive to its original effective date — 12/17/99.

[8] See Code §453(f).

[9] See Code §453(k)(2).

[10] See Code §453(c).

[11] Id.

installment method. Under the installment method, Individual A will report $5 of gain in the year of the sale determined as follows. The gross profit on the sales is $50 ($100 purchase price less $50 basis). The contract price is $100. The gross profit percentage is 50% ($50 gross profit divided by $100 total contract price). In Year 1, Individual A received $10, consisting of the $10 payment due under the P note on 12/1. Individual A reports 50% (or $5) of the $10 payment as gain. The remaining $5 is a nontaxable recovery of basis. Individual A will report $5 of gain in each of the next nine succeeding years when P makes the $10 payment due 12/1 under the note.

EXAMPLE 4

Installment Method (Consideration Is Cash and a Note)

Assume the same facts as above, except that Individual A receives $10 cash and a $90 P note (bearing adequate stated interest) for the T stock. Under the terms of the P note, P must make annual payments of $10 each on 12/1 beginning in the year of the sale.

In Year 1, Individual A received $20, consisting of the $10 cash and the $10 payment due under the P note on 12/1. Individual A reports $10 of gain in the year of sale (50% of $20 ($10 cash and the $10 payment under the P note)). Individual A will report $5 of gain in each of the next eight succeeding years when P makes the $10 payment due 12/1 under the note.

It is important to note that if the transaction qualifies for installment reporting, the provisions of Code §453 apply automatically. If for some reason a T shareholder in the above example does not want to report gain on the installment method,[12] an affirmative election out of the Code §453 must be made.[13]

Code §453A imposes a limit on the benefits provided by installment reporting. Specifically, Code §453A (1) triggers immediate gain recognition on any installment obligation arising out of a sale where the sales price exceeds $150,000 and the seller uses the installment obligation as a security for other indebtedness;[14] or (2) imposes annual interest charge on the portion of the seller's tax liability deferred by the installment method if the face amount of all of the installment obligations held by the seller exceed $5 million at the end of the taxable year.[15]

[12] For example, a taxpayer may wish to accelerate gain in order to use expiring loss carryovers, to be taxed at a then-favorable tax rate, or avoid the risks and uncertainties posed by changes in the tax laws.

[13] See Code §453(d). The rules electing out Code §453 are set forth in Reg. §15a.453-1(d).

[14] Code §§453A(b)(1) and (d).

[15] Code §453A(c).

¶102.1.3 The Receipt of Contingent Consideration by the Seller

¶102.1.3.1 Closed Transactions

It is not uncommon for a business acquisition, including a stock sale, to involve contingent consideration. Contingent consideration may take the form of purchase price adjustments such as earn-outs or escrows of purchase price.

In general, if a seller receives contingent consideration, gain will be reported under the installment method, unless the seller elects out.[16] If the seller elects out of the installment method, then generally, the seller must treat the fair market value of the contingent consideration as part of its amount realized.[17] In determining the fair market value of the contingent consideration, restrictions on the transferability of the right are disregarded.[18] In addition, the value of the contingent consideration cannot be less than the value of the property sold less the other consideration received.[19] This approach is referred to as the "closed transaction" approach.[20]

¶102.1.3.2 Open Transactions

It is possible that a seller could report gain on a sale on an "open transaction" approach—that is defer the recognition of gain until the contingencies associated with the consideration have been resolved.[21] Under the open transaction doctrine a taxpayer is generally entitled to recover basis first before recognizing gain. Thus, a seller has gain only after and to the extent the consideration received exceeds the seller's basis in the property transferred. The use of the "open transaction" approach, however, is limited to "only those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot be reasonably ascertained."[22]

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[16] See Reg. §15(A).453-1(c) for installment reporting rules relating to contingent consideration. Prior to the enactment of the Installment Sales Act in 1980, installment reporting was not available if any of the purchase price was contingent.

[17] Reg. §1.1001-1(g)(2).

[18] See Reg. §15A.453-1(d)(2)(iii).

[19] See Reg. §§15A.453-1(d)(2)(iii). See generally IRS TAM 200604033 (10/20/05).

[20] See IRS TAM 9853002 (9/11/98) for a discussion of the closed transaction method.

[21] Burnet v. Logan, 283 U.S. 404 (1931). Other cases applying an "open transaction" approach include Steen v. United States, 509 F.2d 1398, 1403-04 (9th Cir. 1975); United States v. Yerger, 55 F. Supp. 521, 522 (E.D. Pa. 1994); Clement v. United States, 331 F. Supp. 877, 881 (E.D.N.C. 1971); McShain v. Comm'r, 71 T.C. 998, 1003 (1979); Grudberg v. Commissioner, 34 T.C.M. (CCH) 669, 674 (1975); Dorsey v. Comm'r, 49 T.C. 606, 628 (1968); Cloward Instrument Corp. v. Commissioner, T.C Memo 1986-345; Computervision International Corp. v. Commissioner, T.C. Memo 1996-131 (1996); Rev. Rul. 58-402, 1958-2 C.B. 15; IRS Letter Ruling 200604033 (10/21/05).

[22] Reg. §15A453-1(d)(2)(iii). See also Reg. §1.1001-1(a) ("[T]he fair market value of property is a question of fact, but only in rare and extraordinary circumstances will property be considered to have no fair market value"); Reg. §1.1001-1(g)(2)(ii) ("[O]nly in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable").

The seminal case for the "open transaction" approach is *Burnet v. Logan*.[23] In *Burnet*, the taxpayer sold stock in a mining company for cash and a right to future payments based on the amount of the coal mined. The U.S. Supreme Court concluded that the promise of future money payments was wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty and, therefore, the tax should not be imposed until the taxpayer received payments in excess of basis. The Court recognized that the right to future payments had value because the transferred property had just been valued for estate tax purposes, but nevertheless held the transaction open because that value was so uncertain.

In general, under an open transaction approach, an accrual method taxpayer does not have an amount realized until all events occur which fix the right to receive the payment and the amount can be determined with reasonable accuracy. In situations where a loss is recognized, open transaction treatment may not be advantageous, because the taxpayer cannot claim a loss if contingent payments may still be received.[24]

¶102.1.3.3 Characterization of Contingent Consideration as Debt or Equity

Depending on its terms, the right to receive contingent consideration may constitute (1) debt of the acquirer;[25] or (2) an equity interest in the acquirer.[26] In addition, in the context of a stock sale, a seller's right to receive equity consideration may also constitute an equity interest in the target.[27] The determination of whether contingent consideration constitutes debt or equity is made under general principles of federal income tax law,[28] presumably by analyzing the terms of the contingent

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[23] 283 U.S. 404.

[24] See IRS Letter Ruling 8217183 (1/29/82); IRS Letter Ruling 8221081 (2/25/82).

[25] See Code §1275(a)(1) which broadly defines a "debt instrument" as a "bond, debenture, note, or certificate, or other evidence of indebtedness." See also Reg. §§1.1001-1(g)(2) and 1.1275-4, which recognize that contingent payment rights qualify as debt instruments.

[26] See, e.g., IRS TAM 9840001 (4/10/98) (the IRS found that a right to receive contingent payments constituted equity, not debt).

[27] In such a situation, the seller would either be viewed as (i) retaining an interest in the target stock and selling the rest; or (ii) receiving a new class of target stock in exchange for a portion of its historic common stock in a tax-free recapitalization under Code §368(a)(1)(E).

[28] Reg. §1.1275-1(d).

consideration under the debt/equity factors set forth in Code §385[29] and in case law.[30]

¶102.1.3.4 *Imputed Interest*

If the contingent consideration constitutes a debt obligation of the buyer and the debt obligation does not pay interest at a fair market value rate, the imputed interest rules may apply.[31] The rules relating to imputed interest are generally set forth in the provisions relating to original issue discount ("OID") (i.e., Code §§1271-1275) and Code §483. In general, under the imputed interest rules, amounts that might otherwise have qualified as principal are, instead, treated as interest. From a seller's standpoint, the imputed interest rules, thus, have the effect of recharacterizing amounts that might otherwise constitute capital gain as ordinary income. The imputed interest rules are complex and beyond the scope of this chapter.[32]

[29] Code §385 sets forth certain factors that may be taken into account in determining whether a particular instrument should be characterized as debt or equity. As indicated in the legislative history to Code §385, however, these factors are not intended to be exclusive or necessarily probative of a particular factual situation. The factors set forth in Code §385 include: (1) whether there is a written unconditional promise to pay on demand, or on a specified date, a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

[30] The courts have enunciated many factors (often including the Code §385 factors) in making the determination of whether an instrument should be characterized as debt or equity. As a general matter, no particular weight is assigned to each factor, and no single factor is controlling. See John Kelly Co. v. Commissioner, 326 U.S. 521 (1943). See also Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980); Anchor National Life v. Commissioner, 93 T.C. 382, 400 (1989). "The various factors . . . are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968). Courts have enunciated a host of factors including (1) whether the shareholder/creditor enjoys the rights and remedies of a creditor; (2) whether the intercompany debt had a fixed final maturity date and whether the maturity date extended far into the future; (3) whether the intercompany debt provided the holder with any right to participate in corporate management or any right to vote on matters normally reserved to shareholders; (4) whether the holder has an unsecured claim in respect of intercompany obligation to make payments on the intercompany debt that is not subordinated to any other debt, and in the event of a liquidation or bankruptcy, the intercompany debt generally would take precedence over equity holders, and would rank *pari passu* with general creditors; (5) whether the obligations to make principal and interest payments on the intercompany debt are unconditional and, in the event of default, the holder has the right to accelerate maturity, to demand payment of amounts due, and to sue for payment thereof; (6) whether the obligations to make principal and interest payments on the intercompany debt are contingent upon, or otherwise linked to, earnings, revenues, or other financial criteria of the debtor or a related party; (7) whether the parties intended to create a debtor/creditor relationship; and (viii) whether the intent to create a debtor/creditor relationship was realistic in an economic sense (based on adequacy of capitalization of the debtor and the commercial reasonableness of the terms of the debt).

[31] Note that the imputed interest rules would apply to any debt instrument issued by the buyer, whether contingent or not, if it did not bear interest at fair market rates.

[32] For a detailed discussion of the imputed interest rules, see Garlock, Federal Income Taxation of Debt Instruments (CCH 2005), Chapter 3.

¶102.1.3.5 *Contingent Consideration Examples*

EXAMPLE 5

Closed Transaction Approach

On 1/1, Year 1, A owns 100 shares of T stock with a basis of $60. A sells the 100 T shares to P for $100 and a right to receive contingent payments of between $0 to $200 in two years if certain contingencies are met (i.e., T meets certain earnings targets within specified time). The contingent consideration has a reasonably ascertainable value of $50. A elects out of installment reporting. All of the contingencies are satisfied and A receives $200 on 1/1, Year 3.

A recognizes capital gain in the amount of $90 on 1/1, Year 1 ($100 cash payment plus $50 value of the contingent consideration less $60 stock basis). A takes a $50 basis in the contingent consideration. When A receives the $200 payment on 1/1, Year 3, A recognizes $150 of income ($200 less $50 basis in the contingent consideration). A portion of the $150 will be treated as imputed interest,[33] and the remainder will be capital gain.

EXAMPLE 6

Open Transaction Approach

Same facts as Example 5, except that the contingent consideration does not have a readily ascertainable fair market value. A recognizes capital gain in the amount of $40 on 1/1, Year 1 ($100 cash payment less $60 stock basis). When A receives the $200 payment on 1/1, Year 3, A will have $200 in income. A portion of the $200 will be treated as imputed interest, and the remainder will be capital gain.

[33] See generally Reg. §1.1275-4(c) for rules relating to the imputation of interest on contingent consideration.

6

Final Capitalization Regulations

¶601 OVERVIEW OF THE FINAL REGULATIONS

The most significant development in the area of capitalization since the Supreme Court's *INDOPCO*[1] decision is the issuance of the Reg. §1.263(a)-4 and 5 "the Final Regulations." The process was initiated by the issuance of the Advance Notice of Proposed Rulemaking (the "Advance Notice")[2] and the proposed regulations. In addition, following the issuance of the final regulations, the Internal Revenue Service (IRS) issued several notices regarding the capitalization regulations.

On 12/19/02, the IRS released proposed regulations under Internal Revenue Code (Code) §263(a) (the "proposed regulations") providing rules for the capitalization of intangibles, which made some fundamental changes in this area.[3] Most importantly, the proposed regulations essentially turned the "significant future benefits" test of *INDOPCO* on its head. This test had provided the primary basis for both the IRS and courts to require capitalization of intangibles.

On 12/31/03,[4] the IRS published the final regulations. The final regulations retain many of the same rules as the proposed regulations; however, there were also a number of significant changes, particularly in the area of transaction costs. The final regulations provide two sets of rules. Reg. §1.263(a)-4 states the first set of rules, which deal with amounts paid to acquire or create intangibles. Reg. §1.263(a)-5 provides the second set of rules, which address the treatment of amounts paid or incurred to facilitate an acquisition or a trade or business, a change in capital structure, and certain other specifically identified transactions.

¶602 AMOUNTS PAID OR INCURRED TO ACQUIRE OR CREATE INTANGIBLES

In general, under Reg. §1.263(a)-4, except as otherwise provided, a taxpayer is required to capitalize (1) amounts paid to acquire certain intangibles specifically identified in the final regulations ("acquired intangibles"); (2) amounts paid to create intangibles that are specifically identified in the final regulation ("created intangibles"); (3) an amount paid or incurred to create or enhance a separate and distinct intangible asset; (4) an amount paid to create or enhance a future benefit identified in future published guidance; and (5) an amount paid to facilitate the

[1] ¶601 503 U.S. 79 (1992).

[2] Announcement 2002-9, 2002-1 C.B. 536. The Advance Notice was the first indication that Treasury and IRS were rethinking many of the well-established positions regarding the application of *INDOPCO* to intangibles. Importantly, the framework set forth in the Advance Notice indicated that the Treasury and IRS were reconsidering the application of the "significant future benefits" test of *INDOPCO*. The Advance Notice separated expenditures into three categories: (1) amounts paid to acquire intangible property, (2) amounts paid to create or enhance certain intangible rights or benefits, and (3) transaction costs. With respect to amounts paid to acquire intangible property, the proposal stated that capitalization will be required for amounts paid to acquire financial interests (i.e., amounts paid to purchase, originate, or otherwise acquire a security, option, any other financial interest described in Code §197(e)(1), or any evidence of indebtedness) and amounts paid to acquire intangible property from another person. This rule would not apply, however, to certain related transaction costs, such as employee compensation, fixed overhead, and costs below a specified *de minimis* amount (see below).

With respect to amounts paid to create or enhance certain intangible rights or benefits, the Advance Notice Stated that Treasury and IRS expected to propose a "12-month rule." Under the 12-month rule, it was expected that capitalization would not be required for certain enumerated expenditures unless that expenditure created or enhanced intangible rights or benefits for the taxpayer that extend beyond the earlier of (1) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (2) the end of the taxable year following the taxable year in which the expenditure is incurred.

(Footnote Continued)

With respect to transaction costs, Treasury and IRS proposed to require capitalization of certain transaction costs that facilitate a taxpayer's acquisition, creation or enhancement of intangible assets. This general rule requiring capitalization of transaction costs also would apply to costs that facilitate the taxpayer's acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of Code §1060(c) or a transaction involving the acquisition of capital (such as stock issuance, borrowing, or recapitalization).

The Advance Notice stated that the general rule requiring capitalization of transaction costs would *not* require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead, or costs that do not exceed a specified *de minimis* amount (i.e., $5,000), even if such costs are incurred in connection with the acquisition or enhancement of intangible property.

The Advance Notice provided several examples of how the general rule requiring capitalization of transaction costs would be applied. According to the Advance Notice, the general rule would require a corporate taxpayer to capitalize legal fees in excess of the threshold dollar amount (i.e., $5,000) paid to outside counsel to facilitate an acquisition of all the taxpayer's outstanding stock by an acquirer.

[3] 67 Fed. Reg. 77702.

[4] T.D. 9107.

acquisition or creation of an intangible asset described in (1)-(4) above. Importantly, if an intangible does not fall into one of the categories identified above, presumably it is not required to be capitalized.[1]

The regime adopted in the final regulations has relegated the "significant future benefit" test of *INDOPCO*, which served as the broad general principal capitalization rule for intangibles, to a position of less prominence. Under the final regulations, the "significant future test" survives only to the extent that the final regulations or subsequent guidance specifically identifies a future benefit as requiring capitalization.[2] This is a radically different approach from that taken by the IRS and some courts after *INDOPCO*, in which capitalization of a future benefit appeared to be the general rule. That is, a future benefit had to be capitalized unless it was shown not to be significant because, for example, it was speculative or minimal.

The final regulations also provide certain operating rules for the capitalization of intangible assets including: (1) a 12-month rule; and (2) a 15-year safe-harbor amortization period.[3]

The provisions of Reg. §1.263(a)-4 are generally effective for amounts paid or incurred on or after 12/31/03 Pursuant to Rev. Proc. 2004-23, a taxpayer must obtain an automatic consent to change to an accounting method consistent with the rules set forth in the final regulations. However, the rules regarding the effective date are deceptively simple and raise a number of complex issues, which are discussed below.

¶602.1 *Rules for Acquired Intangibles*

The final regulations require capitalization of amounts paid to another party to acquire one of the following categories of intangibles in a purchase or similar transaction:[4] (1) an ownership interest in a corporation, trust, estate, limited liability company, or other entity;[5] (2) a debt instrument, deposit, stripped coupon (including a servicing right for federal income tax purposes such as a stripped coupon), regular interest in a real estate mortgage investment conduit (REMIC) or financial asset-securitization investment trusts (FASIT), or any other intangible treated as debt for

[1] **¶602** See e.g., IRS Letter Ruling 200828011 (4/15/08), where the IRS held that payments made by the taxpayer to terminate a power purchase agreement and certain other related agreements were not required to be capitalized because the terminated agreements were not among the agreements identified in Reg. 1.263(a)-4(d)(7) (relating to payments to terminate certain agreements) and were not among any of the other intangibles identified in Reg. §1.263(a)-4.

[2] But see, IRS Letter Ruling 200709003, in holding that an advance payment for postage made by X prior to the end of its fiscal Year 1 and reasonably to be used by X in the $3^1/_1$ months following the date of payment falls is deductible by X in its Year 1 fiscal year under §§1.263(a)-4(f)(1) (relating to the the 12-month rule discussed below) and 1.461-1(a)(2)(i) (relating to the "all events test" discussed in ¶202) and 1.461-4(d)(6)(ii) (relating to the recurring item exception to the economic performance rules discussed in ¶203.3.1.1), the IRS reiterated the significant future benefits test as a basis for capitalization. It stated that an "amount paid or incurred is not allowed as a current deduction if it provides significant future benefits that extend substantially beyond the close of the taxable year", citing *Indopco*.

[3] See Reg. §1.167(2)-3(b).

[4] Reg. §1.263(a)-4(c)(1) (2003).

[5] Reg. §1.263(a)-4(c)(1)(i).

federal income tax purposes;[6] (3) a financial instrument;[7] (4) an endowment contract, annuity or insurance contract;[8] (5) non-functional currency;[9] (6) a lease;[10] (7) a patent or copyright;[11] (8) a franchise, trademark, or trade name (as defined in Reg. §1.197-2(b));[12] (9) an assembled work force in place (as defined in Reg. §1.197-2(b)(3));[13] (10) goodwill (as defined in Reg. §1.197-2(b)(1)) or going concern value (as defined in Reg. §1.197-2(b)(2));[14] (11) a customer list;[15] (12) a servicing right (for example, a mortgage servicing right that is not treated for federal income tax purposes as a stripped coupon);[16] (13) a customer-based intangible (as defined in Reg. §1.197-2(b)(6)) or supplier-based intangible (as defined in Reg. §1.197-2(b)(7));[17] (14) computer software;[18] and (15) an agreement providing either party the right to use, possess or sell an intangible described in the above categories of intangibles.[19]

In the case of financial instruments it is important to note that they are defined only by way of example. Specifically, the final regulations identify the following types of interests as "financial interests": (1) notional principle contracts;[20] (2) a foreign currency contract;[21] (3) a futures contract;[22] (4) a forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property);[23] (5) an option (including an agreement under which the taxpayer has the right to provide or to acquire property or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property);[24] and (6) any other financial derivative.[25] Thus, a financial instrument that is not specifically listed could nevertheless be subject to the rules of the final regulations. There is no guidance either in the final regulations or in the proposed regulations as to what characteristic might cause an intangible to be treated as a financial instrument.

[6] Reg. §1.263(a)-4(c)(1)(ii).
[7] Reg. §1.263(a)-4(c)(1)(iii).
[8] Reg. §1.263(a)-4(c)(1)(iv).
[9] Reg. §1.263(a)-4(c)(1)(v).
[10] Reg. §1.263(a)-4(c)(1)(vi).
[11] Reg. §1.263(a)-4(c)(1)(vii).
[12] Reg. §1.263(a)-4(c)(1)(viii).
[13] Reg. §1.263(a)-4(c)(1)(ix).
[14] Reg. §1.263(a)-4(c)(1)(x).
[15] Reg. §1.263(a)-4(c)(1)(xi).
[16] Reg. §1.263(a)-4(c)(1)(xii).
[17] Reg. §1.263(a)-4(c)(1)(xiii).
[18] Reg. §1.263(a)-4(c)(1)(xiv).
[19] Reg. §1.263(a)-4(c)(1)(xv).
[20] Reg. §1.263(a)-4(c)(1)(iii)(A).
[21] Reg. §1.263(a)-4(c)(1)(iii)(B).
[22] Reg. §1.263(a)-4(c)(1)(iii)(C).
[23] Reg. §1.263(a)-4(c)(1)(iii)(D).
[24] Reg. §1.263(a)-4(c)(1)(iii)(E).
[25] Reg. §1.263(a)-4(c)(1)(iii)(F).

churning rule applies to the transferee only to the extent that its basis in the goodwill or going concern value exceeds the gain recognized by the transferor with respect to those intangibles.[30] The gain recognition election is made by attaching an election statement to its original or amended income tax return for the taxable year in which the disposition occurs,[31] and by providing written notification to the person acquiring the section 197 intangible.[32]

¶906 GENERAL ANTI-ABUSE RULE

Regulations provide that the Commissioner will interpret and apply the rules as necessary and appropriate to prevent avoidance of the purposes of section 197. If one of the principal purposes of a transaction is to achieve a tax result that is inconsistent with the purposes of section 197, the Commissioner will recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 197, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.[1]

(Footnote Continued)

not taken into account, S would have no tax liability for the year. Thus, the amount of tax (other than the tax imposed under the gain recognition exception) imposed on the gain is also $4,500. The gain on the disposition multiplied by the highest marginal tax rate is $17,500 ($50,000 × .35). Accordingly, S's tax liability for the year is $4,500 plus an additional tax under the gain recognition election of $13,000 ($17,500 - $4,500). B has a basis of $75,000 in the intangible. As a result of the gain recognition election by S, B may amortize $50,000 of its basis under section 197. However, the remaining basis does not qualify for the gain recognition exception and may not be amortized by B.

[30] Reg. §1.197-2(h)(9)(ii). The scope of the gain recognition election is limited only to the extent the acquiring taxpayer's basis in the section 197(f)(9) intangible exceeds the gain recognized by the transferor. Curiously, the language of this regulation appears to call off the anti-churning rules under -2(h) in their entirety—including the user-does-not-change prong under -2(h)(2)(ii). It does not seem that this result was intended, however, since the gain recognition exception is available only in cases where the anti-churning rule would not apply but for the related person threshold under -2(h)(6)(i)(A) being reduced from more-than-50-percent to more-than-20-percent. See Reg. §1.197-2(h)(9)(i)(A).

[31] Reg. §1.197-2(h)(9)(iii). In IRS Letter Ruling 200724009 (6/15/07), the IRS National Office granted an extension of time to make the gain recognition election, based upon information that established that the taxpayer reasonably relied on a qualified tax professional who failed to make, or advise the taxpayer to make, the election.

[32] Reg. §1.197-2(h)(9)(vi).

[1] **¶906** Reg. §1.197-2(j). None of the 31 examples in Reg. §1.197-2(k) illustrates the application of the anti-abuse rule.

10

Limitation on Loss Carrybacks—Corporate Equity Reduction Transactions

¶1001 OVERVIEW OF CARRYBACK LIMITATION ON CORPORATE EQUITY REDUCTION TRANSACTIONS

In computing taxable income for any taxable year, Code §172(a) allows as a deduction the aggregate of the net operating loss ("NOL") carryovers and NOL carrybacks to such taxable year,[1] with the carryover period generally including the twenty taxable years following the taxable year of the NOL, and the carryback period generally including the two taxable years preceding the taxable year of the NOL.[2] The entire amount of the NOL for any taxable year is carried to the earliest of the taxable years to which such loss may be carried (although the NOL carried to a taxable year cannot reduce the taxable income of such taxable year below $0),[3] and the portion of

[1] **¶1001** Code §172(a); Reg. §1.172-1(a).

[2] Code §172(b)(1)(A). The Court in United States v. Foster Lumber Co., 429 U.S. 32, at 42-43 (1976) described the rationale behind the Code §172 deduction:

> [There are] several policy considerations behind the decision to allow averaging of income over a number of years. Ameliorating the timing consequences of the annual accounting period makes it possible for shareholders in companies with fluctuating as opposed to stable incomes to receive more nearly equal tax treatment. Without loss offsets, a firm experiencing losses in some periods would not be able to deduct all the expenses of earning income. The consequence would be a tax on capital, borne by shareholders who would pay higher taxes on net income than owners of businesses with stable income. Congress also sought through allowance of loss carryovers to stimulate enterprise and investment, particularly in new businesses or risky ventures where early losses can be carried forward to future more prosperous years.

[3] Code §172(b)(2); Reg. §1.172-4(b)(1). Code §172(b)(2), in its entirety, reads "[t]he entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed (A) with the modifications specified in

the NOL which is carried to each of the other taxable years is the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.[4]

The term "NOL" generally means, for a given taxable year, the excess of the deductions allowed over the taxpayer's gross income.[5] Thus, calculation of an NOL generally includes deductions for interest paid or accrued pursuant to Code §163(a). However, Code §172(b)(1)(E) provides that, in the case of certain corporate equity reduction transactions, or "CERTs," deductions that are derived from interest on indebtedness directly or indirectly funding such transactions and that contribute to a net operating loss ("NOL") taint the NOL such that it is limited as a carryback.

Code §172(b)(1)(E) and its related rules, often referenced herein as the "CERT provisions," were created to prevent certain types of transaction from abusing the fisc. These rules are quite complex, and the absence of regulations and dearth of administrative guidance makes dealing with the CERT provisions challenging.

¶1001.1 *Executive Summary*

Readers will quickly observe from the detailed discussion below that the intricacies associated with the application of the CERT rules are legion. For those desiring a high level-understanding of the rules, the following summarizes their key aspects.

The CERT rules are relevant where a corporation has a net operating loss carryback. In such a case, if the corporation either acquired or was acquired by another corporation, or if the corporation made an unusually large distribution and/or redemption during the taxable year, an analysis generally must be made to determine the extent to which the net operating loss is precluded under the CERT rules from being carried back (it may still be carried forward, though).

The computation of the amount of net operating loss that may not be carried back is made under the so-called "avoided cost method," which effectively determines the amount of interest that the corporation could have avoided had it paid down debt rather than participated in the stock acquisition or made the large distribution(s). The computation may be quite difficult: the CERT rules are derived from the UNICAP regulations which, not surprisingly, were not drafted to address CERT matters and thus a significant degree of translation is required. A highly simplified method for making the computation is to multiply the cost of participating

(Footnote Continued)

subsection (d) other than paragraphs (1), (4), and (5) thereof, and (B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter, and the taxable income so computed shall not be considered to be less than zero").

[4] Code §172(b)(2); Reg. §1.172-4(a)(3).

[5] Code §172(c); Reg. §1.172-2(a). Cf. Reg. §1.172-1(a) (stating that the NOL is the basis for the computation of the NOL carryovers and NOL carrybacks and ultimately for the net operating loss deduction itself). The deductions allowed are found in Chapter 1 of Subtitle A of the Code, which currently includes Code §§ 1 through 1400U-3.

in the stock acquisition (or distribution(s)) by the taxpayer's average cost of borrowing.

EXAMPLE 1

Basic CERT Limitation Computation

Corporation P, which has been in a taxpaying posture for prior years, borrows $100 at the start of Year 3 in order to pay a dividend. P also has outstanding a separate $100 debt to an unrelated party. During Year 3, in which P conducts no activity, P incurs $15 of total interest payments and generates a corresponding $15 interest deduction, which gives rise to a net operating loss. Because P has paid taxes in prior years, P ordinarily could carry back its $15 loss to a prior year, providing P with a tax refund. However, if P's leveraged distribution is a CERT, the portion of the $15 NOL that could have been avoided had P instead forgone the distribution (and thus not required the $100 borrowing) cannot be carried back. P has outstanding in Year 3 $200 of total debt and deducted $15 of interest, giving P an effective cost of borrowing of 7.5%. Thus, had P not undertaken the CERT, it could have avoided incurring $7.50 (7.5% of $100) of interest, which is the portion of P's NOL that cannot be carried back.

While the author does not suggest relying on this simplified method for making definitive computations, it often can be helpful in at least identifying the potential scope of a CERT limitation. The author suggests that, afterwards, the taxpayer retain the napkin on which this computation was made so that he or she may wipe away the tears likely to ensue while going through a full-blown CERT computation.

¶1001.2 *Background*

Many transactions are structured as "leveraged buyouts" or "leveraged restructurings." In these transactions, the funding is sourced, directly or indirectly, in indebtedness, which in turn gives rise to an unusual form of secondary financing: federal income tax refunds. Essentially, where either the purchaser or the target (or, in the case of a restructuring, the restructured party) has been a taxpayer in prior years, the large interest deductions resulting from the transaction could give rise to a net operating loss eligible for carryback, thus generating a refund.

EXAMPLE 2

Basic Leveraged Transaction

Corporation P borrows $100 at a 10% annual interest rate in order to buy all the stock of T, a corporation that has been in a taxpaying posture for prior years. Following the purchase, P pushes the debt into T. T incurs a $10 interest payment and generates a corresponding $10 interest deduction which gives rise to a net operating loss. Because T has paid taxes in

prior years, T may carry back its loss to a prior year, providing T with a tax refund.

As the leveraged transaction craze took hold in the 1980s,[6] Congress became concerned with how such transactions affected the fisc, and expressed its view of leveraged transactions as abusive in the following way:

> [T]he ability of corporations to carry back NOLs that are created by certain debt-financed transactions is contrary to the purpose of the NOL carryback rule. Specifically, the purpose of the rule is to allow corporations to smooth out the swings in taxable income that can result from business cycle fluctuations and unexpected financial reverses. [When] a corporation is involved in certain debt-financed transactions, the underlying nature of the corporation is substantially altered. In addition . . . , the interest expense associated with such transactions does not have a sufficient nexus with the prior period operations to justify a carryback of NOLs attributable to such expense. Therefore . . . , it is inappropriate to permit a corporation to carry back an NOL generated by such a transaction to a year prior to the year in which such transaction occurred.[7]

With the abuse identified, Congress next had to consider how to identify the transactions giving rise to the abuse such that administrable rules could be implemented. Essentially, Congress thought that the most problematic types of transactions were those resulting in a reduction of corporate equity, or, stated another way, generally those that replaced outstanding equity with outstanding debt.[8]

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[6] Cf. ABC Beverage Corp. v. Commissioner, T.C. Memo 2006-195 ("1986 was the heyday of the leveraged buyout (LBO) era, in which investors were scouring the country for high cashflow industries").

[7] H.R. Rep. No. 247, 101st Cong., 1st Sess. 1250 (1989). See also H.R. Rep. No. 881, 101st Cong., 2d Sess. (1990) ("Corporations generally are allowed to carry back NOLs in order to smooth out the swings in taxable income that can result when business cycles overlap taxable yearends or from unexpected financial reverses. Present law limits the ability of an acquired corporation to carry back the interest expense component of an NOL arising after a CERT because the leveraging involved in the CERT substantially alters the nature of the corporation and is not related to a natural business cycle or an unexpected financial reversal."); IRS TAM 200432014 (4/6/04) (stating that "[i]n enacting these provisions, Congress expressed concern that the interest expense associated with certain debt-financed transactions did not have sufficient nexus with prior period operations to justify the carryback of NOLs attributable to such expense," and that, accordingly the CERT rules identify a portion of the NOL (the "corporate equity reduction interest loss," or "CERIL") as effectively tainted, and prohibit the carryback of the CERIL to taxable years preceding the CERT).

[8] See, e.g., IRS TAM 9743001 (6/4/97) ("Congress enacted the CERT rules as part of the Revenue Reconciliation Act of 1989 to discourage the increase of corporate indebtedness generated by certain transactions such as leveraged buyouts and recapitalizations, and other transactions in which corporate equity is replaced with debt."); H.R. Rep. No. 247, 101st Cong., 1st Sess., 1252 (1989) (authorizing regulations that would exempt transactions from application of the CERT rules where corporate equity has not been replaced by debt).

EXAMPLE 3

Acquisition Resulting in Corporate Equity Reduction

P's outstanding stock is worth $100, and unrelated S's outstanding stock is worth $50. P borrows $50 from Bank and uses the proceeds to purchase all the S stock. Prior to the transaction, the aggregate corporate equity between P and S was $150 ($100 plus $50). After the transaction, the aggregate corporate equity is $100 (i.e., P's net worth, which is P's $100 pre-transaction net worth and remains $100 after the borrowing due to the $50 loan proceeds offset by the $50 loan obligation, and then still remains $100 as the $50 loan proceeds are swapped for the S stock worth $50 while P retains the $50 loan obligation, and finally the S shareholders no longer owning any corporate equity)[9] Thus, $50 of corporate equity has been replaced with $50 of debt to Bank.

EXAMPLE 4

Distribution Resulting in Corporate Equity Reduction

P's outstanding stock is worth $100. P borrows $50 from Bank and uses the proceeds to pay a dividend to its shareholders. Prior to the transaction, the corporate equity of P was $100. After the transaction, the aggregate corporate equity is $50 (i.e., P's net worth, which is P's $100 pre-transaction net worth and remains $100 after the borrowing due to the $50 loan proceeds offset by the $50 loan obligation, then decreased by the extraction of $50 from P while P retains the $50 loan obligation). Thus, $50 of corporate equity has been replaced with $50 of debt to Bank.[10]

In the Revenue Reconciliation Act of 1989,[11] Congress addressed the leveraging problem through enacting the CERT provisions, which limit the deductibility of NOL carrybacks generated by interest deductions on debt issued in leveraged buyouts or restructurings. By restricting carrybacks, the CERT provisions eliminate the tax

[9] S's outstanding stock value is already reflected in P's stock value and thus is not counted again.

[10] Cf. IRS TAM 9743001 (6/4/97) (P, which owned Oldco, formed Newco and contributed all the Oldco stock thereto in exchange for all the Newco stock and Newco notes. Thereafter, Oldco liquidated into Newco (thus, Newco resembled Oldco except that it now had outstanding debt to its shareholder). The Service treated the transaction as a reorganization under Code §368(a)(1)(F) with a separate Code §301 distribution of the Newco notes under Reg. §1.301-1(l). The Service went on to observe that, prior to the transaction, Oldco was financed with equity and no debt, and as a result of the transaction Newco replaced its equity with debt, and that the substantial NOLs generated in large part by the deduction of interest payments attributable to the Newco notes were unrelated to its natural business cycle or an unexpected financial reversal).

[11] Pub. L. No. 101-239 (12/19/89).

refund financing, thus reducing the immediate tax benefit of highly leveraged transactions.[12]

¶1001.3 *General Operating Provisions*

In general, if there is a *corporate equity reduction transaction* ("CERT"), and an *applicable corporation* has a *corporate equity reduction interest loss* ("CERIL") for any *loss limitation year*, then the CERIL is an NOL carryback and carryover to the taxable years described in Code §172(b)(1)(A), except that such loss may not be carried back to a taxable year preceding the taxable year in which such transaction occurs.[13] For this purpose, a CERT is (i) a major stock acquisition; or (ii) an excess distribution.[14] Both of these terms, as well as the term "CERIL," are discussed in greater detail below.

An "applicable corporation" is (1) a C corporation which acquires stock in a major stock acquisition;[15] (2) a C corporation the stock of which is acquired in a major

[12] Cf. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1250 (1989) ("The ability of C corporations to obtain refunds of taxes paid in prior years by carrying back NOLs is limited in cases where the losses are created by interest deductions allocable to certain corporate equity-reducing transactions.")

[13] Code §172(b)(1)(E)(i) (also providing that, for Code §172(b)(1)(E) to apply, the loss limitation year must end after August 2, 1989). As will be discussed below, members of a consolidated group are treated under Code §172(h)(4)(C) as a single corporation, and thus the NOL considered is the consolidated NOL (or "CNOL"). IRS ILM 200305019 (12/13/02) (providing that to the extent that the allocable interest deductions increased the group's CNOL, a portion of the CNOL is a CERT-tainted loss, and such loss may not be carried back to years prior to the CERT).

Presumably, this NOL limitation applies also for purposes of computing the alternative minimum tax. Briefly, Code §55(a) imposes an additional tax equal to the excess (if any) of the tentative minimum tax for the taxable year over the regular tax for the taxable year. In the case of a corporation, the "tentative minimum tax" for the taxable year is derived in part from the alternative minimum taxable income ("AMTI") for the taxable year. Code §55(b)(1)(B). Code §56(a)(4) provides that, in determining the amount of the AMTI for any taxable year, the alternative tax NOL ("ATNOL") deduction is allowed in lieu of the NOL deduction allowed under Code §172. Code §56(d)(1) provides that, for purposes of Code §56(a)(4), the term "ATNOL" means the NOL deduction *allowable* for the taxable year under Code §172; thus, one would expect the Code §172(b)(1)(E) limitation to shape what is "allowable" for the ATNOL computation. Cf. H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986) ("in light of the parallel nature of the regular tax and minimum tax systems, any limitations applying for regular tax purposes to the use by a consolidated group of NOLs or current year losses . . . apply for minimum tax purposes as well").

There is no CERT limitation with respect to capital loss carrybacks under Code §1212(a), which makes sense given the orientation of the rules toward the inappropriate carryback of interest deductions only. Cf. Rev. Proc. 2003-34, 2003-1 C.B. 856, Sec. 5.03(3) (in specifying limitations on both NOLs and capital losses in the case of a short period arising from a change in accounting period, Service cites Code §172(b)(1)(E) only with respect to NOLs).

[14] Code §172(h)(3)(A). See also Code §172(b)(1)(E)(iv) (cross-referencing Code §172(h) for definitions of terms used in Code §172(b)(1)(E)). Putting CERT terminology into non-tax parlance, a major stock acquisition basically is a leveraged buyout, and an excess distribution basically is a leveraged restructuring transaction, such as a recapitalization or stock buy-back.

[15] A "C corporation" is, with respect to any taxable year, a corporation which is not an S corporation for such year. Code §1361(a)(2). An "S corporation" is, with respect to any taxable year, a small business corporation for which an election under Code §1362(a) is in effect for such year. Code §1361(a)(1). Because Code §172(b)(1)(E)(iii)(I) refers to "stock" being acquired by a "C corporation" or the acquisition of stock of a "C corporation" by another corporation, it appears that an S corporation can be an "applicable corporation" if it's acquired by a C corporation or if it acquires a C

stock acquisition; or (3) a C corporation making distributions with respect to, or redeeming, its stock in connection with an excess distribution.[16] In other words, an applicable corporation can be either the acquirer or the target in the major stock acquisition, as well as a corporation making an excess distribution. In addition, an applicable corporation includes a C corporation which is a successor of a corporation described in Code §172(b)(1)(E)(iii)(I) or (II).[17] Unfortunately, the term "successor" is not defined. Presumably, distributees or transferees in Code §381(a) transactions could be successors, but it is far from clear whether other sorts of transactions may give rise to successor.[18]

Finally, the term "loss limitation year" means, with respect to any CERT, the taxable year in which such transaction occurs and each of the 2 succeeding taxable years.[19] Presumably, short taxable years are regarded as full taxable years for this

(Footnote Continued)

corporation. Also, note that an organization exempt from federal income tax under Code §501(a) can be a "C corporation" and so, theoretically, the CERT rules could apply to a organization attempting to carry back an unrelated business loss to offset unrelated business income; however, query whether such an organization's equity is viewed as "stock" for CERT purposes given that exempt organizations are not "owned" in the same manner as regular C corporations (e.g., state law may prohibit the payment of dividends) and so perhaps Congress' concern with a reduction in corporate equity simply isn't' present under these circumstances. Cf. Rev. Rul. 58-566, 1958-2 C.B. 355.

[16] Code §§172(b)(1)(E)(iii)(I) and (iii)(II). Note that the term "in connection with" is not defined for CERT purposes, and the Service has yet to issue any illuminating guidance with respect thereto. As discussed below, Code §172(h)(4)(C) treats a consolidated group as a single entity for CERT purposes; unsurprisingly, this concept extends to the definition of "applicable corporation." See ILM 200305019 (stating that the "single entity treatment [of Code §172(h)(4)(C)] would cause [an] entire group to qualify as an 'applicable corporation'").

[17] Code §172(b)(1)(E)(iii)(III).

[18] For example, Reg. §1.1502-13(j)(2)(i) provides that, for purposes of the intercompany transaction rules, a corporation may be a successor to another corporation in situations other than Code §381(a) transactions. Also, under Reg. §1.1502-80(g), two or more corporations may succeed to Code §381(c) attributes in the case of certain liquidating transfers.

Regulatory authority for an explanation of successors is given. See Code §172(h)(5)(A) (providing that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of Code §172(h), including regulations for applying Code §172(h) to successor corporations).

[19] Code §172(b)(1)(E)(ii). See also H.R. Rep. No. 247, 101st Cong., 1st Sess., 1251 (1989) ("If the corporation has an NOL in any of the 2 taxable years succeeding the taxable year in which the CERT occurred, a portion of the corporation's NOL carryback may still be limited"). This definition as currently drafted may appear excessive in that NOLs only can be carried back two taxable years. Thus, if a CERT occurs in Year 2, and the loss limitation years are Years 2, 3, and 4, a Year 4 NOL cannot be carried back to Year 1 (or earlier); therefore, it would not seem that the goal of precluding NOLs back to pre-CERT years could be contravened. Presumably, this definition is merely a vestige of pre-1997 law, under which Code §172 provided a 3-year carryback period.

Interestingly, under former Code §172(b)(1)(H), taxpayers with NOLs in taxable years ending in 2001 or 2002 could carry back such losses up to 5 years. This rule interacted strangely with the CERT limitation. For example, if a CERT occurs in Year 3, Year 6 is not a "loss limitation year" as it is not one of the two years succeeding the CERT. Thus, if the interest deduction in Year 6 generates a NOL (which is not a CERIL since Year 6 is not a loss limitation year), this NOL may be carried back to Year 1 or Year 2, years that would otherwise be ineligible for carryback treatment. Cf. IRS ILM 200622045 (2/2/06) ("a CERIL can never be carried back to a taxable year preceding the taxable year of the CERT"). Congress, aware of this incongruity from the 2001 and 2002 taxable years, revised its approach when enacting in February of 2009 new Code §172(b)(1)(H) (dealing with an extended carryback period for certain NOLs generated by "eligible small businesses" in 2008). See Code

purpose given that the statute does not refer to "calendar years" or to 12-month periods.[20]

EXAMPLE 5

Basic Application of the CERT Provisions

P, a calendar year C corporation, is capitalized with $200 million of equity. P has paid an average annual dividend to its shareholders of $0.5 million for each of the past 3 years. On 1/1/90, P borrows $50 million at a 10% annual interest rate and distributes all the proceeds to its shareholders. Due to the interest deduction of $5 million, P incurs an NOL in 1990 of $4 million. Assume that P has had no other indebtedness and that, absent the $5 million interest deduction, P would not have incurred an NOL in 1990.

As will be explained in further detail below, P was involved in a CERT in 1990 because it made an "excess distribution" to its shareholders. Therefore, P is an "applicable corporation" given its C corporation status and its participation in an excess distribution. Also, each of 1990, 1991,

(Footnote Continued)

§172(b)(1)(H)(i)(II). Later, in November of 2009, Congress extended similar benefits to other taxpayers and continued this revised approach. See Code §172(b)(1)(H)(i)(II) (providing that, in the case of an applicable net operating loss with respect to which the taxpayer has elected the application of Code §172(b)(1)(H) (i.e., the extended carryback), Code §172(b)(1)(E)(ii) shall be applied by substituting the whole number which is one less than the whole number substituted under Code §172(b)(1)(H)(i)(I) for "2."

[20] Cf. Code §7701(a)(23) (providing that, when used in the Code, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed and that "taxable year" means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations, the period for which such return is made); Code §441(b) (similar); Reg. §1.172-4(a)(2) (a fractional part of a year that is a taxable year under Code §§ 441(b) and 7701(a)(23) is a preceding or succeeding taxable year for the purpose of determining under Code §172 the first, second, etc. preceding or succeeding taxable year); Reg. §1.381(c)(1)-1(e)(3) (treating short years arising in the context of Code §381 transactions as a taxable year for purposes of NOL carryforwards); Roodner Est. v. Comm'r, 64 T.C. 680 (1975), acq, 1976 AOD 204 (1976) and Gen. Coun. Mem. 36543 (Jan. 5, 1976)) (treating a short taxable year as the taxpayer's "entire taxable year"); Dawson v. Comm'r, 59 T.C. 264 (1972) (strictly interpreting Code §7701(a)(23)); 1992 FSA Lexis 233 (August 28, 1992) (in addressing whether a full year's worth of Code §1253 amortization is deducted in a short taxable year, Service noted that Code §1253(d)(2)(A) refers to "taxable year" and that, as combined with Code §7701(a)(23), "a full section 1253(d)(2) amortization deduction is permitted for each short taxable year for which a return was made"); FSA 200011002 (October 26, 1999) (citing Reg. §1.172-4(a)(2) and Valley Paperback Manufacturers, Inc. v. Comm'r, T.C. Memo 1975-311 in stating that, "[f]or purposes of [NOLs], a fractional part of a year that is a taxable year under . . . §§ 441(b) and 7701(a)(23) is treated as a taxable year"); TAM 7821004 (February 2, 1978) (treating short taxable years as full years for NOL carryback purposes). Moreover, it is notable that in Code §172(h)(2)(F) Congress provided a transition rule under which taxpayers were allowed to measure interest on an "annualized basis," thereby indicating that Congress had considered the need for annualization in the CERT context and enacted such a rule exclusively for transition cases.