



Tax Issues in Acquisitions of Loss Companies

by Karen A. Hayes

A FREEBORN & PETERS LLP CLIENT ALERT

When a corporation that has net operating losses (NOLs) undergoes a change in its stock ownership, complex rules under Section 382 of the Internal Revenue Code may apply to limit the corporation's ability to fully utilize those NOLs going forward. This article is a brief introduction to the general application of Section 382.



NOL Carryforwards and Carrybacks

In calculating its federal income tax liability, a corporation can generally offset its taxable income by its current-year losses and, subject to some limitations, unused NOLs from other tax years that were carried forward or back to that tax year. NOLs generated in tax years 2018 through 2020 may be carried back 5 years and carried forward indefinitely. If those NOLs are carried forward and used in tax years 2021 or later, they cannot offset more than 80% of the corporation's taxable income for the carryforward year. NOLs generated in tax years beginning after 2020 cannot be carried back, but may be carried forward subject to the 80% limitation.

Limitations on NOLs in Corporate Acquisitions

When a corporation is acquired in a stock acquisition, its NOLs will continue to be useable but will be subject to limitations imposed under Section 382 of the Internal Revenue Code. The purpose of Section 382 is generally to prevent taxpayers from trafficking in tax losses. The application of Section 382 can be incredibly complex, but it is important for loss corporations, their shareholders, and potential acquirors to be aware that these limitations exist.

In general, Section 382 applies to certain 50%-or-more changes in ownership of a corporation's stock. More specifically, Section 382 applies when a corporation undergoes an "ownership change." An ownership change generally occurs when the percentage of stock owned by 5-percent shareholders of a loss corporation increases by more than 50 percentage points over the lowest percentage ownership of those shareholders within a 3-year testing period. For example, the acquisition by a buyer of more than 50% of a loss corporation's stock would constitute an ownership change. Other types of stock transactions (such as stock trading, share issuances, redemptions, and recapitalizations) could also potentially trigger a Section 382 limitation. Depending on the facts, the application of the rules for determining who is a 5-percent shareholder, and what constitutes an ownership change, can be complicated.

Following an ownership change, the amount of the loss corporation's taxable income that can be offset by NOLs will be subject to an annual limitation. The limitation is equal to the value of the corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate in the month of the ownership change.

Value for this purpose is equal to the fair market value of all of the corporation's stock, with various adjustments. The long-term tax-exempt rate is a percentage published by the IRS on a monthly basis and is based on the applicable federal rate. If the annual limitation is not entirely used in a tax year, the unused portion may be carried forward to the next year.

If the loss corporation does not continue its business at all times during the 2-year period following the ownership change, the annual limitation is reduced to zero.

There are additional special rules under Section 382 that apply to built-in gains and built-in losses. These are items that have accrued economically prior to the ownership change, but that have not yet been realized or recognized for tax purposes. If a loss corporation has a net unrealized built-in gain (NUBIG), the Section 382 limitation may be increased by built-in gains that are realized following the ownership change. If the loss corporation has a net unrealized built-in loss (NUBIL), those unrealized losses that are recognized following the ownership change may be subject to the Section 382 limitation.

In addition to Section 382, potential acquirors should also be aware of the anti-abuse rules under Section 269 of the Internal Revenue Code. Section 269 may disallow the use of an acquired corporation's losses or other tax attributes if the principal purpose of the acquisition is to avoid tax by securing a tax benefit that would not otherwise be available.

Conclusion

Potential buyers of loss companies will need to consider the application of Section 382 and Section 269 in order to understand their ability to use a target company's NOLs following the acquisition. In addition, sellers who may want a buyer to attribute value to the company's NOLs should also be aware of these potential limitations. Moreover, even if a company is not anticipating being acquired, there are other types of stock transactions that could potentially trigger the application of these rules.

If you have questions, please contact Karen Hayes at khayes@freeborn.com or 312-360-6545, or another member of [Freeborn's Tax Team](#).

ABOUT THE AUTHOR



Karen A. Hayes

Partner

Chicago Office
(312) 360-6545

khayes@freeborn.com

Karen advises clients federal income tax matters. She represents corporations, partnerships and private equity funds involved in a variety of taxable and non-taxable transactions, domestic and cross-border mergers and acquisitions, divestitures, investments, reorganizations, partnerships and joint ventures. In addition, Karen has represented tax credit syndicators, banks and other institutional investors with respect to investments in affordable housing projects.



140+ Attorneys. 5 Offices.

Freeborn & Peters LLP is a full-service law firm with international capabilities and offices in Chicago, Ill.; New York, Ny; Richmond, Va.; Springfield, Ill.; and Tampa, Fla. Freeborn is always looking ahead and seeking to find better ways to serve its clients. It takes a proactive approach to ensure its clients are more informed, prepared and able to achieve greater success – not just now, but also in the future. While the firm serves clients across a very broad range of sectors, it has also pioneered an interdisciplinary approach that serves the specific needs of targeted industries.

Freeborn's major achievements in litigation are reflective of the firm's significant growth over the last several years and its established reputation as a Litigation Powerhouse®. Freeborn has one of the largest litigation departments among full-service firms of its size – currently with more than 90 litigators, which represents about two-thirds of the firm's lawyers.

Freeborn is a firm that genuinely lives up to its core values of integrity, effectiveness, teamwork, caring and commitment, and embodies them through high standards of client service and responsive action. Its lawyers build close and lasting relationships with clients and are driven to help them achieve their legal and business objectives.

For more information visit: www.freeborn.com

CHICAGO

311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

NEW YORK

230 Park Avenue
Suite 630
New York, NY 10169
(212) 218-8760
(212) 218-8761 fax

SPRINGFIELD

217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

RICHMOND

901 East Byrd Street
Suite 950
Richmond, VA 23219
(804) 644-1300
(804) 644-1354 fax

TAMPA

1 Tampa City Center
201 North Franklin Street
Suite 3550
Tampa, FL 33602
(813) 488-2920