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New Rules for Purchase Price Allocations in Taxable "M&A" Transactions

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A business can be acquired by the purchase of its assets. It can also be acquired, except in the case of an acquisition of a business previously conducted as a sole proprietorship, by the purchase of the ownership interests in the entity conducting the business (for example, the purchase of stock of a corporation that conducts a business). These different modes of acquisition can have very different tax consequences to both the seller and the purchaser.[1]

For example, in the case of a purchase and sale of assets, the seller is required to allocate the consideration received among the assets sold. To the extent that some of those assets—such as inventory or other property held for sale to customers in the ordinary course of trade or business—are not "capital assets," the seller may recognize ordinary income, taxable at significantly higher rates than those applicable to "capital gains." Similarly, the seller may realize gain on the sale of some assets and loss on the sale of others. On the other hand, the purchaser's tax basis in the assets acquired will reflect the purchase price paid.

By contrast, in the case of a sale of stock, the seller will ordinarily treat the transaction as a single sale, on which there is a single gain (or loss), which is characterized as capital gain (or loss). The purchase does not generally change the basis of the assets of the acquired corporation (the "target"). Instead, the assets retain their historic tax basis, even though the buyer may have paid a significantly higher amount for the stock of the acquired corporation. There are, of course, circumstances in which the applicability of special rules could change these results. For example, the "collapsible corporation" provisions of the Internal Revenue Code (the "Code"), where applicable, do raise a risk that the seller's gain on a stock sale will be treated as ordinary income.[2] However, with one major exception discussed in the next paragraph, the basic tax framework that governs stock acquisitions results in no change to the basis of the assets of the target.

In the case of a "qualified stock purchase" of at least 80% of the stock of a target by an acquiring corporation,[3] an election is sometimes available under section 338(h)(10) of the Code to treat the transaction *as though* the stock of the target had not been sold. Rather, the transaction is treated as though the target had sold its assets to a "new" corporation controlled by the acquiring corporation, for a price determined by reference to the amount paid for the target's stock in the qualified stock purchase, and the target had then been liquidated.[4]

Section 338(h)(10) applies only when the target is a domestic corporation. If there has been a qualified stock purchase of an S corporation, a section 338(h)(10) election will generally be available.[5] The availability of a section 338(h)(10) election in the case of a qualified stock purchase of stock in a C corporation, however, turns on the identity of the seller(s). If the qualified stock purchase is made from a single domestic corporation, or from a group of corporations filing consolidated returns of which the target is a member, a section 338(h)(10) election can be made; otherwise, it cannot. A section 338(h)(10) election requires the concurrence of the buyer and the seller(s). If the target is an S corporation and there are any shareholders who are not selling their stock, but are continuing as minority shareholders of the target, those continuing shareholders must concur in the election as well.

Acquisitions that take the *form* of asset purchases, regardless of the identity of the target or the seller(s), and stock acquisitions that are subject to section 338(h)(10) are likely to have similar tax consequences. Someone—either the seller of the assets or the target—will be subject to tax on the gain inherent in the assets. Conversely, the buyer—either the actual buyer, in the case of an asset purchase, or the target itself (now deemed to be a "new" corporation), in the case of a section 338(h)(10) transaction—will take a basis in the target's assets measured by the amount paid by the acquiror.

How, precisely, is that basis to be measured and how is it to be allocated among the assets acquired? Clarifying and refining the answers to those questions is one of the main subjects of proposed Regulations published in the *Federal Register* this past August 10. These Regulations are proposed to be effective for qualified stock purchases or asset acquisitions occurring on or after the date that final Regulations are published. However, since the proposed rules are in some ways more favorable to taxpayers than the existing ones, taxpayers and their representatives may be expected to contend that the IRS should make the new rules, when finalized, applicable retroactively, on an elective basis.

Existing Regulations under Code section 338(b)(5), which govern section 338(h)(10) elections, have provided, since their promulgation in January 1986,[6] that basis in such a transaction is to be allocated among the assets of the target based on a "residual" method. First, basis is allocated to cash, demand deposits, and similar accounts ("class I assets"), up to the amount of their fair market value. Then, any remaining basis is allocated to certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency ("class II assets"), again in an amount up to their fair market value. Third, any remaining basis is allocated to all other assets ("class III assets") of the target other than class I assets, class II assets, and section 197 intangibles,[7] again in an amount up to their fair market value. If the basis available for allocation to class III assets is less than the aggregate fair market value of all of the target's class III assets, the available basis is allocated among the class III assets in proportion to their fair market values. Fourth, any remaining basis is allocated to section 197 intangibles, other than those in the nature of goodwill and going concern value, in an amount up to their fair market value. Finally, any "residual" basis (whence the name of this basis allocation method) is allocated to assets in the nature of goodwill and going concern value, regardless of their fair market value.

In the case of taxable acquisitions of assets constituting a business, section 1060 the Code (added in 1986) provides that the "consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts allocated to assets under section 338(b)(5)," that is, under the class-by-class residual method described above. As legislative history of this provision states, "Congress intended to endorse the use of the residual method and generally to apply the same method regard-

less of whether the transfer took the form of a stock transfer or an asset transfer. It did not intend to preclude the Treasury Department from making changes to the final regulations, not inconsistent with the statutory purpose."[8]

The recently proposed revision of the section 338 Regulations stems from two motives. First, as stated in the Notice of Proposed Rulemaking issued by the Service on August 10:

> The regulations under section 338 have developed, in large part, through a series of small changes and additions according to the priorities of taxpayers' and the government's needs and in response to statutory amendments to section 338 and other relevant Code sections.... As a result of the ad hoc manner in which the regulations under sections 338 and 1060 have been amended, the current regulations are difficult to follow. Thus the IRS and Treasury determined that a review of the regulations was appropriate.

Accordingly, the new proposed Regulations would work a complete reordering and reorganization of the Regulations, a change of importance to tax practitioners, but of little interest to a broader audience concerned only with substantive tax results. More significantly, however, the Service identified some major respects in which the current Regulations "have proven problematic" and proposes to change the existing Regulations in substantive ways to deal with the perceived problems.

Contingent Payments for Stock. In the case of a transaction structured as a purchase of assets (such as one subject to section 1060) in which the purchaser is to make one or more contingent payments to the seller, the tax law creates an intentional discontinuity between the treatment of the seller and the treatment of the purchaser. Except in "rare and extraordinary circumstances," the seller is required to take the current fair market value of the promised future contingent payments into account in computing its gain on the sale.[9] By contrast, the purchaser is not permitted to include the contingent payments in its basis for the assets acquired until the amount of the payments becomes fixed.

The existing section 338(h)(10) Regulations, however, are more beneficial to the taxpayer. They allow the "old" target, in computing its gain on the deemed sale of its assets, to defer taking the contingent payments into account until they are fixed, although it may still subtract its entire basis in its assets in computing that gain. The proposed Regulations would conform the treatment of section 338(h)(10) transactions to the treatment of asset purchases and require that the value of contingent payments be taken into account in computing the gain on the deemed sale of the assets.

A similar issue arises under the current Regulations with respect to liabilities of the target that are "contingent" at the time of the acquisition. The current Regulations provide that such liabilities will increase the target's basis in its assets when they become "fixed and determinable." However, under general principles of tax law applicable outside of the section 338 context, it is sometimes the case that contingent liabilities assumed in connection with an asset acquisition cannot be taken into account in determining the basis of the acquired assets until sometime *after* they have become fixed and determinable. The proposed Regulations would provide that general principles of tax law, rather than the "fixed and determinable" standard, apply for this purpose in section 338(h)(10) transactions.

Installment Method. The application of the installment method for reporting gain on the deemed sale of assets, in the case of a section 338(h)(10) transaction in which the consideration paid for the stock of the

target corporation included evidences of indebtedness of the purchaser, is not clear under the existing Regulations. The proposed Regulations would make clear that the installment method could apply, subject, however, to all of the limitations that would apply if the target corporation had actually sold its assets in exchange for an installment obligation of the purchaser and then liquidated.

Classes of Assets for Basis Allocation Purposes. As described above, basis in asset acquisition and section 338(h)(10) transactions is allocated pursuant to the "residual" method. Currently, there are only five classes taken into account under the Regulations; all assets, other than cash, demand deposits, and similar accounts (class I), certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency (class II), and section 197 intangibles (classes IV and V), are lumped together in class III. Within class III, basis is allocated proportionately to the fair market value of the assets acquired, with no distinction drawn between assets that turn over quickly, such as accounts receivable and inventory, and those that are longer lived. Taxpayers have sometimes engaged in elaborate planning transactions to avoid the effect of this basis allocation rule, the effect of which could be to require recognition of income on the collection of purchased accounts receivable (or on the resale of purchased inventory at an amount equal to its value on the date of purchase).

The proposed Regulations would retain the class-by-class residual method of basis allocation, but would break class III into three new classes, numbered III, IV, and V, thereby renumbering existing classes IV and V as classes VI and VII. New Class III would include accounts receivable, mortgages, and credit card receivables which arise in the ordinary course of business. New Class IV would include inventory and property held primarily for sale to customers in the ordinary course of business. New Class V would include all assets formerly included in old Class III and not included in new Classes III and IV.[10] These rules would make it less likely that a purchaser would be required to recognize gain shortly after a purchase as a result of the basis allocation rules.

Extent of Changes

The foregoing are the proposed changes likely to be of broadest interest. However, the proposed Regulations run to 187 typewritten pages and there are a host of other changes and "clarifications" proposed as well, some substantive, some technical, and some purely linguistic or organizational. Moreover, the Service has asked for public comment not only on the proposed Regulations themselves, but on a variety of issues that it chose not to address in the present proposal. Accordingly, the proposed Regulations will merit much study and comment, both now and after they have been finalized.

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[1] This article focuses specifically on taxable asset acquisitions, regardless of whether or not the business was previously conducted in corporate form, and on taxable stock acquisitions. In many cases, the acquisition of a business previously conducted in corporate form is structured as a wholly or partially tax-free "reorganization." The rules governing reorganizations are very complicated and differ in many material respects from those governing fully taxable transactions. These rules and the rules governing acquisitions of businesses conducted in partnership form by means of an acquisition of some or all of the interests in the partnership are beyond the scope of this article.

[2] The collapsible corporation rules are among the most complicated in the Code and are replete with definitions, presumptions, exceptions, and exceptions to the exceptions. It is a blessing to tax practitioners that, as a practical matter, they seem to have become something of a dead letter since the enactment of the Tax Reform Act of 1986; however, they remain in the Code as a threat (at least a theoretical threat) to capital gain treatment in many corporate transactions.

[3] A detailed discussion of the requirements for a "qualified stock purchase" is beyond the scope of this article. Very generally, those requirements are that a corporation acquire at least 80% of the total voting power of the stock of the target and

stock having a value equal to at least 80% of the total value of the stock of the target (not including certain preferred stock) in taxable transactions, from unrelated parties, during a "12-month acquisition period." See Code sections 338(d)(3), (h)(1), (3), 1504(a)(2), (4).

[4] The asset basis of the "new" corporation is generally equal to the sum of the purchasing corporation's basis in the stock of the target plus the liabilities of the "old" target deemed to have been "assumed" in the transaction. Appropriate adjustments are made for situations in which less than 100% of the stock of the target is acquired in the qualified stock purchase.

[5] The Code does not appear to authorize the making of a section 338(h)(10) election in the case of the acquisition of stock of an S corporation. Nevertheless, the Treasury Regulations have, since 1994, provided that a section 338(h)(10) election is available in such a transaction. T.D. 8515, 1994-1 C.B. 89.

[6] T.D. 8072, 1986-1 C.B. 111.

[7] Section 197 intangibles include goodwill, going concern value, franchises, trademarks, trade names, "market share," and a variety of other intangible assets.

[8] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 359 (1987).

[9] If the seller reports the transaction on the installment method, it will not have to take the contingent payments into account until they are received. There is a cost to this beneficial treatment, however. If the seller does *not* use the installment method, it can apply all of its basis in the assets sold against the amount realized in order to compute the amount taxable in the year of sale. By contrast, if the seller *does* use the installment method, it must apportion some of its basis to the contingent payments to be received in the future, so that the amount of gain reported on receipt of the fixed payments (if any) is increased.

[10] Another change made by the proposed Regulations would widen the scope of "marketable securities" includible in class II, thereby further shrinking the pool of assets included in this "catchall" class.

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