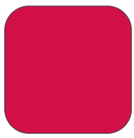

CONSIDERATIONS IN THE ACQUISITION OF A TAX LOSS CONSTRUCTION COMPANY

This discussion summarizes the factors that acquirers and their advisers should consider when structuring an M&A transaction that involves a target corporation with net operating loss and similar tax attributes.

ROBERT F. REILLY

Merger and acquisition (M&A) activity continues at a brisk pace in many segments of the construction industry. This trend in construction industry M&A activity has continued despite general concerns about COVID-19 as a national health issue and despite the impact of the pandemic on the national economy.

The typical reasons for a construction industry M&A transaction remain the same, regardless of the health and economic effects of the COVID-19 pandemic. Some of the reasons for considering a construction industry M&A transaction include:

1. the economies of scale and size;
2. the elimination of a competitor (due to the consolidation) resulting in geographic concentration;
3. the combination of industry segment participants into a multispecialty company;
4. the ability to buy (acquire) functions and capabilities at a lower cost than that of making (internally developing) functions and capabilities; and
5. the availability of otherwise successful target companies that do not have other management/ownership succession options available to them.

Any combination of these factors could lead to (1) the identification of acquisition target companies; (2) the negotiation and consummation of a successful M&A transaction; and (3) the creation of an integrated combined entity that is experiencing post-merger synergies, economies of scale, and other entity value enhancements.

During this pandemic, some companies in some industry segments have been quite successful. They have experienced increased revenue, increased profitability, and increased taxable income. Such companies are often attractive M&A target companies. During this same period, other companies have experienced operational issues, decreased revenue, negative profitability, and tax-related net operating losses. In addition to their other attributes, the tax attributes (including their net operating loss, or NOL, carryforwards) of these companies may also make them attractive M&A target companies. In fact, the tax attributes

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of the loss companies may increase the attractiveness of — and enhance the acquisition value of — such companies to acquisitive profitable companies.

Acquirers and their tax and other professional advisers should be careful when pricing and structuring the acquisition of target corporations with NOLs and certain other income tax attributes. The income tax attributes of a target company are a consideration in any M&A transaction, as these attributes are a component of the value of any target company. However, the acquisition of income tax benefits should not be the only (or even the primary) value driver in (or for the purpose of) the M&A transaction.

The IRS may disallow the acquirer's use of the target company's NOL carryforward or other income tax attributes if it concludes that the M&A transaction was justified solely based on the value of such tax attributes. This discussion summarizes the factors that acquirers and their tax and other professional advisers should consider when structuring an M&A transaction that involves a target corporation with such tax attributes.

IRC Section 269 and the tax loss target corporation

The IRS often applies IRC Section 269 when disallowing tax attributes related to an M&A transaction that it decides was intended to evade or to avoid income tax. While the NOL of a target corporation can be used (with restrictions) to affect the taxable income of the acquirer, the IRS will carefully scrutinize any M&A transactions that are primarily motivated by tax avoidance.

First, the M&A transaction should be structured and economically justified to keep the IRS from disallowing the use of the target corporation's tax attributes. Second, the acquirer should expect that the IRS will limit the annual amount of any target company NOL benefits through the application of IRC Section 382. Section 382 restricts the combined entity's use of NOL carryforwards (and certain built-in losses) following the loss corporation ownership change transaction.

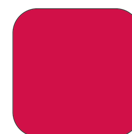
In addition, if the IRS believes that the M&A transaction was primarily motivated by tax considerations, it may apply a number of other statutory provisions to restrict the transaction's income tax benefits. Such statutory provisions are intended to disallow — or to recharacterize — the target corporation's losses and other tax attributes.

Acquisitions to avoid or to evade income tax

Section 269(a) gives the IRS the authority to disallow a deduction, a credit, or any other income tax benefit. These tax benefits may be disallowed if they are obtained by a taxpayer (a corporation or a person) that acquires control of a corporation for the principal purpose of avoiding or evading federal income tax.

The statute language of Section 269 provides a specific definition of control. For the purposes of Section 269, control means ownership of the corporation stock possessing either (1) 50 percent of the combined total voting rights of all classes of stock that are entitled to vote or (2) at least 50 percent of the total value of the shares for all classes of stock. For this purpose, control may be acquired directly or indirectly. The direct acquisition of control typically occurs through a stock purchase or exchange. An indirect acquisition of control may occur, for example, if the corporation itself redeems the shares of certain shareholders, since such a corporate stock redemption could leave a remaining shareholder with a controlling ownership interest.

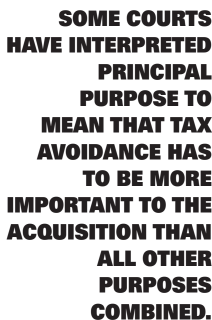
The acquisition of control of the subject corporation must occur in order for the IRS to apply the Section 269 provisions. An example where a court rejected the IRS's application of Section 269 is *Jackson Oldsmobile, Inc. v. United States.*[1] In that decision, the 5th Circuit Court of Appeals upheld the trial court's ruling that there was an acquisition of nonvoting stock that represented less than 50 percent of the corporation's value. This result occurred because one shareholder had owned 100 percent of the corporation's voting stock, both before and after the acquisition of the nonvoting stock.



THE IRS OFTEN APPLIES IRC SECTION 269 WHEN DISALLOWING TAX ATTRIBUTES RELATED TO AN M&A TRANSACTION THAT IT DECIDES WAS INTENDED TO EVADE OR TO AVOID INCOME TAX.

It is noteworthy that voting stock ownership is not the only factor that the IRS looks at to determine who has voting control of the target corporation. Of course, the percentage of voting common stock owned by the acquirer (either an individual or a corporation) is the first factor that the IRS considers. However, sometimes there is evidence that other factors influence who actually has operational control of the target corporation.

This issue (de facto control versus voting stock ownership) was an important consideration in the decision by the Court of Federal Claims in *Hermes Consol. Inc. v. United States.* In this case, the Court of Federal Claims decision states that "the ultimate expression of voting power is the ability to approve or disapprove of fundamental changes in the corporate structure, and the ability to elect the corporation's board of directors."[2]



SOME COURTS HAVE INTERPRETED PRINCIPAL PURPOSE TO MEAN THAT TAX AVOIDANCE HAS TO BE MORE IMPORTANT TO THE ACQUISITION THAN ALL OTHER PURPOSES COMBINED.

In addition, an acquirer (either an individual or a corporation) cannot transfer control from itself to itself. For Section 269 purposes, the IRS may not recognize an acquisition when the taxpayer simply revives its own dormant subsidiary corporation. This result will occur even if the taxpayer uses the subsidiary corporation for a new purpose. This is because the ownership (and operational) control of the target corporation did not change hands. An example of this situation occurred in the Tax Court decision *The Challenger, Inc. v. Comm'r.* In that decision, the Court explained that control must be both relinquished and then reestablished for there to be a change of control.[3]

Definition of tax avoidance as the principal purpose

Treasury Regulation 1.269-3(a) provides an explanation of the principal purpose of the transaction requirement. Tax avoidance becomes the principal purpose of the transaction if it "exceeds in importance any other purpose." This language does not mean that tax avoidance has to be the only purpose (or economic justification) of the M&A transaction. Still, according to the Section 269 regulations, tax avoidance does have to be the principal (or primary) purpose of the M&A transaction.

In a taxpayer-friendly interpretation, some courts have interpreted principal purpose to mean that tax avoidance has to be more important to the acquisition than all other purposes combined. Under this interpretation, the tax avoidance purpose does not merely have to be the single most important purpose of the M&A transaction; it has to be more important than the summation of all other transaction motivations.[4]

Of course, there are numerous strategic and economic justifications for creating a new combined entity through an M&A transaction. These reasons include limiting liability, increasing debt capacity, increasing purchasing power, increasing market concentration and penetration, accessing technology or intellectual property, and many others. Income tax simplification and income tax reduction may also be a valid economic justification for an M&A transaction. However, evading or avoiding income tax cannot be the principal — or the most important — economic justification for the M&A transaction.

Section 269 provides the IRS with the authority to disallow tax benefits when a profitable corporation acquires a loss corporation for the sole purpose of utilizing the target company's NOLs or other tax attributes. As described in the 6th Circuit Court decision in *The Zanesville Investment Co. v. Comm'r.*, the typical Section 269 controversies "have dealt with the sale by one control group to another of a corporation with, typically, a net operating loss carryforward and the efforts of the new control group to utilize this carryforward by funneling otherwise taxable income to a point of alleged confluence with the carryforward."[5]

Source of the NOLs

The IRS may apply Section 269 to disallow the use of preacquisition NOLs and other tax attributes, regardless of which party to the transaction is the source of the tax benefit. In other words, for Section 269 purposes, it does not matter whether the loss corporation is the target corporation or the acquirer corporation. The IRS and the courts may still apply Section 269 to

restrict the use of the preacquisition losses after an M&A transaction.[6]

The IRS has made a few attempts to apply Section 269 to disallow postacquisition losses that taxpayers have applied to postacquisition combined entity income. However, the courts have generally not accepted these applications of Section 269.[7]

Nonetheless, some courts have accepted the IRS's application of Section 269 on a postacquisition basis. These cases have all involved instances in which the acquired corporation had consistently generated operating losses. In these cases, the acquired companies offset the acquirer company's income against the target company's continuing losses. In other words, the courts concluded that the acquirer had made the acquisition to have access to (and enjoy the tax benefit of) the target corporation's expected postacquisition losses.[8]

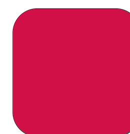
The IRS often considers both the preacquisition and the postacquisition losses of the target company. If such losses do not repeat every year but do occur with some regularity, then the IRS may allege that the target corporation's tax losses were the principal purpose of the price transaction.

The IRS also considers whether the acquirer operates the loss target company differently after the acquisition. For example, assume that Connie Contractor owns the profitable Alpha Company, which is a water, sewer, and pipeline construction company. Connie acquires the stock of Beta Corporation — another water, sewer, and pipeline construction company — with a large NOL carryforward. The income of Alpha is not sufficient to fully benefit from the Beta NOL carryforward (even considering the effect of the Section 382 limitation). Connie also owns Gamma Corporation, which is an unrelated but profitable highway and street construction company. Connie merges Gamma into Alpha to fully utilize the Beta NOL carryforward. The IRS may allege that the principal purpose of the Gamma merger was the evasion or the avoidance of income tax. The IRS may apply Section 269 to disallow Alpha's utilization of the Beta NOL.

The IRS has not been successful in applying Section 269 to block the mere deferral of income tax. In the Tax Court matter *Rocco, Inc. v. Comm'r.*, the IRS claimed that tax avoidance was the taxpayer's principal purpose. The IRS disallowed the taxpayer's ability to use the cash method of accounting. The Tax Court rejected the IRS's position. In its decision, the Tax Court stated that Section 269 applies to "deductions or credits, the allowance of which would result in a permanent reduction of revenue." Rejecting the IRS's position, the Court concluded that the government was "attempting to disallow a benefit which defers the tax but does not result ultimately in the avoidance or the evasion of tax."[9]

Substance over form considerations

The redemption of a shareholder's shares in a loss corporation may trigger Section 269 if the redemption puts another shareholder into a control position. In other words, the IRS may treat such a stock redemption as if it were an acquisition of the loss target corporation. However, the IRS's application of Section 269 may not always prevail in such instances. For example, in the U.S. District Court decision in *Younker Bros., Inc. v. United States*, the Court concluded that nontax motivations were the principal purposes of a shareholder redemption. In this case, the Court rejected the IRS's application of Section 269.[10]



THE REDEMPTION OF A SHAREHOLDER'S SHARES IN A LOSS CORPORATION MAY TRIGGER SECTION 269 IF THE REDEMPTION PUTS ANOTHER SHAREHOLDER INTO A CONTROL POSITION.

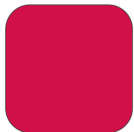
In the Tax Court decision in *Briarcliff Candy Corp. v. Comm'r.*, the Court made it clear that it would broadly consider substance over form in the application of Section 269. The decision states that Section 269 was "broadly drafted to include any type of acquisition which constitutes a device by which one corporation secures a tax benefit to which it is not otherwise entitled."[11] In that decision, the Tax Court accepted the IRS's application of Section 269 to a loss acquirer corporation's purchase of a profitable subsidiary corporation.

The point is that neither the IRS nor the courts will limit the application of Section 269 to the "plain vanilla" M&A transaction where a profitable acquirer corporation buys a target corporation with an NOL carryforward.

Application of Section 269 to a new corporation

Occasionally, the IRS will attempt to apply Section 269 after the taxpayer's formation of a new corporate entity. According to Treasury Regulation 1.269-3(b)(3), Section 269 may apply when an individual owns high-income assets and then transfers those assets to a newly formed controlled corporation that generally produces NOLs.

One example of applying Section 269 to a new corporation involved the musician and comedian Victor Borge. For years, Borge earned a substantial amount of income from his entertainment appearances. He also owned an unincorporated poultry business that consistently generated operating losses. However, the tax law limited the amount of the unincorporated business losses that Borge could apply to offset his entertainment income. Borge incorporated the poultry business, and he contracted through the new (unprofitable) corporation to provide his (profitable) entertainment services.



NORMALLY, THE IRS APPLIES SECTION 269 WHEN A TAXPAYER UTILIZES A CORPORATE FORM TO ENJOY INCOME TAX BENEFITS FROM BUILT-IN OR PREEXISTING CIRCUMSTANCES.

The IRS applied Section 269 and disallowed the offset of the new corporation's losses against the entertainment-related income. Borge challenged the IRS and brought the case to trial. At appeal, the 2nd Circuit Court decision in *Borge v. Comm'r of Internal Revenue* agreed with the IRS. The Appeals Court held that the new corporation was formed for the primary purpose of providing an income tax benefit to Borge, and the Court applied Section 269 to deny the income offset by the corporation's operating losses.[12]

Normally, the IRS applies Section 269 when a taxpayer utilizes a corporate form to enjoy income tax benefits from built-in or preexisting circumstances. The most typical example of this circumstance is when a target corporation has an available NOL carryforward. However, the IRS will apply Section 269 when the taxpayer creates a corporation around an existing business for the principal purpose of obtaining income tax benefits.

Of course, the IRS will not apply Section 269 to disallow tax benefits when there are alternative (not tax-related) purposes for the formation of the corporate entity. In particular, the courts consider these other reasons, not related to taxes, for corporate formation.

For example, the Tax Court decision in *Cromwell Corp. v. Comm'r of Internal Revenue* states that "the formation of a holding company to acquire another corporation is not an universal procedure and is not a 'device' which would distort the income of . . . the principals . . . as comprehended by Section 269."[13]

The S corporation exception to Section 269

According to Revenue Ruling 76-363, Section 269 cannot be applied to disallow any deduction, credit, or other tax allowance of a corporation that has elected to be taxed under Subchapter S. Under the IRC Section 1366 rules for S corporations, such small business corporations pass through income, gains, losses, and deductions to the company shareholders. Accordingly, and practically, Section 269 does not apply to limit the S corporation's deductions, credits, or other tax allowances.

In addition to Revenue Ruling 76-363, the courts have recognized that the status of an S corporation effectively negates the application of Section 269 to disallow income tax benefits at the corporation level. For example, in the Tax Court matter of *Modern Home Fire and Casualty Insurance Co. v. Comm'r.*, the IRS alleged that the principal purpose of the shareholder's use of the S corporation was to offset losses against the corporation's income. The Tax Court's decision concluded that, even if the IRS's allegation was correct (which the Court did not need to rule on), Section 269 would not apply to an S corporation.[14]

The Section 382 NOL limitation

Section 269 is intended to limit tax avoidance or tax evasion related to the acquisition of a target company. In contrast, Section 382 is intended to limit the acquirer's annual use of the acquired NOLs of a target company with an NOL carryforward.

Section 382(g) and (i) describe the test for when the Section 382 NOL limitation is triggered. The Section 382 NOL limitation applies after there is an "ownership change" in the loss target corporation. Such an own-

ership change occurs if the percentage of corporate stock owned by any 5 percent shareholder increases by more than 50 percentage points over the lowest stock percentage owned by that shareholder. The lookback period to test for the 50 percent ownership change is three years.

An ownership change occurs when the loss target corporation is acquired in either a taxable purchase or a tax-free reorganization. A taxable purchase may involve an asset purchase under IRC Section 1060. A tax-free reorganization may involve any of the reorganization structures under Section IRC 368(a)(1)(A) or (C) or (D).

The annual amount of the prechange NOL available to the acquirer is calculated as the fair market value of the target loss corporation at the time of the ownership change multiplied by the applicable federal long-term tax-exempt rate. Section 382(k)(1) defines a loss target corporation as a corporation that is entitled to use an NOL carryback or carryforward or has an NOL for the tax year in which the ownership change occurred.

A loss target corporation also includes any corporation with a "net realized built-in loss." According to Section 382(h)(3)(A), a corporation will have a net unrealized built-in loss if the aggregate adjusted basis of the corporation's assets exceeds the aggregate fair market value of the corporation's assets. This comparison is made just prior to the date of the ownership change that triggers Section 382.

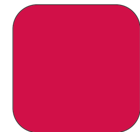
Section 382(h)(1)(B) provides the limitation on the acquirer's use of the target corporation's net unrealized built-in loss. That limitation is that the acquirer corporation treats the net unrealized built-in loss as a preownership change loss that can offset postchange income only to the extent of the aforementioned Section 382 annual limitation.

Section 382(h)(2)(B) provides that a recognized built-in loss is any loss recognized on the disposition of an asset during a five-year period beginning on the ownership change date. The amount of the recognized built-in loss that is treated as a prechange loss is limited to the amount of the net unrealized built-in loss.

Other service challenges to M&A transactions

The IRS may also challenge the income tax motivations behind M&A transactions using other tax provisions and doctrines. The IRS may challenge the M&A transaction under the Section 482 intercompany transfer price rules (and related regulations). The IRS may also challenge the tax impact of the M&A transaction under several nonstatutory legal doctrines. For example, the IRS may attempt to recharacterize an M&A transaction based on the principle of economic substance, the principle of substance over form, the principle of a sham transaction, or the principle of a step transaction.

The M&A transaction should be safe from an IRS challenge under the business-purpose legal doctrine if the transaction is shown to be motivated by a valid business purpose, other than tax avoidance or tax evasion.



THE IRS MAY ALSO CHALLENGE THE INCOME TAX MOTIVATIONS BEHIND M&A TRANSACTIONS USING OTHER TAX PROVISIONS AND DOCTRINES.

M&A transaction planning considerations

There is little that a corporate acquirer can do to avoid the application of the Section 382 limitation on the annual use of acquired NOLs. However, there are numerous factors that a corporate acquirer may consider to avoid (or successfully defend against) the IRS's application of Section 269 in an M&A transaction.

The owners/managers of the acquirer corporation (and the owners/managers of both corporations, in the case of a merger transaction) should contemplate — and document — the following considerations:

1. The acquirer company should have a written acquisition plan of approval by its board of directors. In the case of a merger, both companies should have written merger plans approved by their respective boards of directors. This plan (or plans) should thoroughly document (and quantify, if possible) all of the nontaxation reasons for completing the proposed M&A transaction.
2. To the extent that there are both taxation and nontaxation reasons for the M&A transaction, the written plan (or plans) should make clear that the non-

taxation reasons are the principal reasons for the transaction. The nontaxation reasons may include industry, strategic, and operational considerations. These considerations should obviously be described as the principal transaction drivers.

3. Financial projections for the posttransaction entity should be included in the plan (or plans). These financial projections should, of course, include any of the expected posttransaction income tax benefits and other considerations. However, the posttransaction financial projections should demonstrate that nontaxation factors — that is, operating income, synergies, economies of scale and size, and so forth — are the principal components of the combined entity's expected cash flow.
4. If a profitable entity is acquiring or merging with a loss entity, the posttransaction business plan should demonstrate how the transaction will "turn around" (or make profitable) the business that was previously operating at a loss. If the target corporation's operating loss is expected to be temporary or due to extraordinary circumstances (e.g., the temporary impact of the COVID-19 pandemic), those factors should be described in the posttransaction business plan.
5. A corporation acquiring (or merging with) a target company in a different line of business should particularly describe the business (i.e., nontaxation) reasons for the M&A transaction. There are numerous valid business purposes for such transactions, including planned product/service/geography diversification, access to financing collateral, access to new lines of distribution, reduction of any seasonality effects, access to intellectual property or licenses, and so forth. All such nontaxation reasons should be discussed in the M&A transaction plan (or plans).

M&A ACTIVITY CONTINUES TO BE BRISK IN THE CONSTRUCTION INDUSTRY.

The inclusion of any and all of the aforementioned considerations in written acquisition plans, business plans, strategic plans, and financial projections provides contemporaneous evidence of the business purposes and reasons for the proposed M&A transaction. Such contemporaneous evidence may be very important for use in defending against any IRS challenge of the completed transaction.

Summary and conclusion

M&A activity continues to be brisk in the construction industry. It is uncertain whether this trend in M&A activity is in spite of the pandemic-impacted economic conditions or because of them. Either way, construction industry participants may be faced with M&A pricing and structuring considerations — either as the acquirer entity or as the target entity.

Of course, income tax considerations are an important element in the planning and pricing of any M&A transaction. However, income tax considerations should not be the principal motivation or purpose of the transaction. If tax considerations are the principal transactional purpose, the IRS may allege that the transaction is intended to avoid or evade federal income tax. Particularly if there is a loss corporation as one transaction party, the IRS may attempt to apply Section 269 — or other statutory or judicial provisions — to restrict or disallow the income tax benefits of the transaction.

Accordingly, construction industry participants — and their tax and other professional advisers — should carefully plan for any M&A transaction involving a loss target corporation or other related income tax benefits. Such careful planning should include the impact of the Section 382 limitation on the annual use of acquired NOLs. Such careful consideration should include the thorough documentation of all the nontaxation reasons for — and drivers of — any proposed M&A transaction. ■

NOTES

[1] *Jackson Oldsmobile, Inc. v. United States*, 237 F. Supp 779 (M.D. GA 1964), aff'd, 371 F.2d 808 (5th Cir. 1967).

[2] *Hermes Consol. Inc. v. United States*, 14 Cl. Ct. 398 (1988).

[3] *The Challenger, Inc. v. Comm'r.*, T.C. Memo. 1964-338 (1964).

[4] For an example, see the Court of Federal Claims decision in *U.S. Shelter Corp. v. United States*, 13 Cl. Ct. 606 (1987) and the 5th Circuit Court decision in *Bobsee Corp. v. United States* , 411 F.2d 231 (5th Cir. 1969).

[5] *The Zanesville Investment Co. v. Comm'r. of Internal Revenue*, 335 F.2d 507, 509 (6th Cir. 1964).

[6] See, for example, the 5th Circuit decision in *Supreme Investment Corp. v. United States*, 468 F.2d 370 (5th Cir. 1972).

[7] See, for example, the 3rd Circuit decision in *Herculite Protective Fabrics Corp. v. Comm'r. of Internal Revenue*, 387 F.2d 475 (3 rd Cir. 1968); *op. cit.* note 5.

[8] See, for example, the 1st Circuit Court decision in *R.P. Collins & Co. v. United States*, 303 F2 142 (1st Cir. 1962) and the 3rd Circuit Court decision in *Hall Paving Co. v. United States*, 471 F.2d 161, 262 (5th Cir. 1973).

[9] *Rocco, Inc. v. Comm'r.*, 72 T.C. 150 (1979).

[10] *Younker Bros., Inc. v. United States*, 318 F. Supp 202 (S.D. Iowa 1970).

[11] *Briarcliff Candy Corp. v. Comm'r.*, T.C. Memo 1987-487 (1987).

[12] *Borge v. Comm'r. of Internal Revenue,* 405 F.2d 673 (2d Cir. 1968).

[13] *Cromwell Corp. v. Comm'r. of Internal Revenue*, 437 T.C. 313, 320-21 (1964).

[14] *Modern Home Fire and Casualty Insurance Co. v. Comm'r.*, 1379-68 (1970).