

What You Need To Know About Transferring Corporations with Accumulated Net Operating Losses

A corporation with accumulated unused losses, called suspended losses, is referred to as a Loss Corporation. What this means is the corporation has accumulated unused losses which can be used as a deduction against future income.

The longer a business loses money the more difficult it becomes to sell the business because most Buyers do not want to purchase a business which is losing money.

A common issue which arises for corporations with existing losses is the corporate owners or their advisors decide to sell the business based on the value of the accumulated losses. The thought is a Buyer will certainly be interested in reducing future taxes by using the accumulated losses as a tax deduction.

It is true that Buyers are certainly interested in reducing future taxes but a question to be answered is..."What is the real value of a corporation with accumulated unused losses?" In other words, "What will a Buyer likely be willing to pay for a corporation with accumulated unused losses?"

Background:

At one time, an important motive for many corporate acquisitions or mergers was the availability of Net Operating Loss or Tax Credit Carryovers in the target corporation that could be used to offset taxable income of the acquiring corporation. Transactions frequently occurred, not for legitimate business reasons, but instead for the purpose of transferring Net Operating Losses. These corporations, with accumulated Net Operating Loss or Tax Credit Carryovers, are referred to as Loss Corporations.

To curb this so called "NOL Trafficking", Congress enacted a series of tax reforms, including IRC Sections 269, 382, 383, 384 and 482. These regulations have greatly restricted the ability to offset an acquiring corporation's taxable income by the Net Operating Loss or Tax Credit Carryovers contained in a Loss Corporation.

In general, the Internal Revenue Code severely limits the use of Net Operating Losses if the Loss Corporation undergoes an ownership change. Typically, an ownership change occurs when 50% or more of the stock has changed hands. An ownership change can also occur as a result of a merger or similar tax-free reorganization.

IRC Section 382 is the code section which places a limitation on the use of Net Operating Losses after an ownership change.

The maximum annual amount of Net Operating Loss that an acquiring corporation can use to offset taxable income after an ownership change date is an amount equal to the value of the Loss Corporation immediately before the ownership change multiplied by

the federal government's published long-term tax-exempt rate. This is referred to as a Loss Offset Limitation.

The long-term tax-exempt rate is the highest of the federal long-term rates determined under IRC Section 1274(d). The published long-term tax-exempt rate, as of the date of this article, is ----- 4.61%.

Business Value and Related Loss Limitation

The Internal Revenue Code allows unused losses to be taken as a deduction against future income. Each year a loss is incurred, those specific losses can be moved into the future for a period not to exceed 20 years. If the losses cannot be used in that 20 year period, the losses expire and are lost forever.

Assuming the corporate federal rate is 34%, the state tax rate is 5% for the corporation and for the corporate shareholders and the federal dividend rate is 15%, if a corporation earns \$2,000,000, the shareholders will ultimately only net \$1,000,000 because of the taxes paid to the various taxing authorities.

If though a \$2,000,000 loss can be used as a deduction against this income, the shareholders will net \$1,600,000.

So the question to be answered is, how much will a Buyer pay for a corporation with accumulated unused losses?

For discussion purposes, let's assume the shareholders try to sell the corporation for \$1,000,000.

Based on the loss offset limitation calculation, as explained in the background section, the annual accumulated loss use limit is \$46,100. The calculation to determine this limit is [Loss Corporation's value before the ownership change \$1,000,000 * federal government's published long-term tax-exempt rate of 4.61% = \$46,100].

This means that \$46,100 can be used annually to offset future income until the applicable losses expire. A maximum of 20 offset years may be possible resulting in \$922,000 of losses used over this period. This will result in approximately a \$300,000 overall net tax savings benefit.

Additionally, IRC Section 382(c) disallows ALL Net Operating Loss Carryovers if after the change in ownership the Loss Corporation does not continue substantially the same trade or business for two years after the ownership change. Thus, the annual loss limitation will be reduced to Zero (\$0) if this requirement is not met.

Thus, if a corporation is losing money, considering the limitation on the use of the loss carryovers and considering the time value of money, what is really going to be the true

value of a loss corporation if the value is being driven by the intent to sell the corporation based on its accumulated unused losses?

In most cases, probably not much.