INSIGHTS

Transaction Tax Deductions Following Tax Reform

June 27, 2019

By: ***Elizabeth L. McGinley***

In connection with the purchase and sale of the stock of a target corporation (a Corporate Target), the target often incurs various transaction costs (Transaction Costs) that may yield significant tax deductions (Transaction Tax Deductions). If such Transaction Tax Deductions are greater than the Corporate Target's current-year taxable income through the date of the sale (Pre-Closing Taxable Income), the purchaser of the Corporate Target may receive the tax benefit of such deductions to the extent they are applied to offset the Corporate Target's taxable income after the closing. Accordingly, the selling stockholders often negotiate for an increase to the purchase price for the stock of the Corporate Target (the Purchase Price) to compensate them for the value of such Transaction Tax Deductions. The enactment of the Tax Cuts and Jobs Act (the TCJA), however, has impacted the value that the parties ascribe to Transaction Tax Deductions and the parties' negotiation of any Purchase Price adjustment related to such deductions.

Overview of Transaction Tax Deductions

In connection with the sale of stock of a Corporate Target, the Corporate Target commonly pays or incurs various Transaction Costs that may be deductible, in whole or in part, by the Corporate Target for federal income tax purposes. Such Transaction Costs may include change-of-control and other compensatory payments, certain professional fees, including attorneys' fees, consulting fees and investment banking fees incurred in connection with the transaction, and certain amounts associated with the payment or refinancing of the Corporate Target's debt at or prior to the closing.

The Purchase Price often is determined, in part, based on the working capital of the Corporate Target as of the closing. In such case, the Corporate Target's working capital, and thus the Purchase Price, is decreased by the cash paid or liabilities accrued with respect to such Transaction Costs at or prior to the closing. As a result, the selling stockholders bear the economic burden of any Transaction Costs, but will not receive any tax benefit except to the extent the associated Transaction Tax Deductions offset the Corporate Target's Pre-Closing Taxable Income. If the Transaction Tax Deductions are applied to offset Pre-Closing Taxable Income, the working capital of the Corporate Target, and thus the Purchase Price, should be increased by either a tax asset or a reduction in accrued income taxes.

If the taxable year of the Corporate Target ends on the closing date, which often is the case,[1] any Transaction Tax Deductions that exceed the Corporate Target's Pre-Closing Taxable Income create a net operating loss (NOL) of the Corporate Target. Absent an agreement to the contrary, the purchaser would not be required to compensate the selling stockholders for the value of such NOL. Accordingly, well-advised selling stockholders may negotiate for an increase to the Purchase Price for the value of such NOL. Purchasers, however, often are reluctant to ascribe immediate cash value to an NOL, particularly if the expected utilization of the NOL is likely to be deferred. Further, the acquisition of all of the stock of a Corporate Target should result in an ownership change for purposes of Section 382 of the Internal Revenue Code (an Ownership Change), and therefore the Corporate Target's pre-Ownership Change NOLs are subject to an annual limitation equal to the Corporate Target's value multiplied by the ***long-term tax-exempt rate*** (the Section 382 Limitation). Accordingly, rather than agree to an immediate Purchase Price adjustment, purchasers may offer to make future payments to the selling stockholders as and when any Transaction Tax Deductions generate cash tax savings.

Transaction Tax Deductions before the Tax Cuts and Jobs Act

Prior to the TCJA, NOLs could be carried back to, and applied to offset taxable income in, the two taxable years of the Corporate Target prior to the year in which the NOL was generated. A Corporate Target with Transaction Tax Deductions that were sufficient to offset all of its Pre-Closing Taxable Income first would seek a refund of estimated income taxes paid for the current tax year, if any. Then, any Transaction Tax Deductions in excess of the Corporate Target's Pre-Closing Taxable Income would generate an NOL that could be carried back and, if the Corporate Target had taxable income in either of the two carryback years, the NOL could yield an additional income tax refund. If eligible to receive such refunds, the Corporate Target would file claims immediately after the closing. The selling shareholders might negotiate for an increase to the Purchase Price for the amount of refunds expected to be received or a covenant that the Corporate Target remit any such refunds to the selling stockholders as and when received.

If the Transaction Tax Deductions were sufficient to offset all of the Corporate Target's Pre-Closing Taxable Income and taxable income for the two carryback years, any such remaining deductions would generate an NOL that could be carried forward to offset taxable income of the Corporate Target for up to 20 years. Such an NOL carryforward, however, would be subject to the Section 382 Limitation if the acquisition of the Corporate Target constituted an Ownership Change, and the NOL's value to the Corporate Target from and after the closing would depend on the timing of its utilization against taxable income and future income tax rates.

Transaction Tax Deductions after the Tax Cuts and Jobs Act

The application of Transaction Tax Deductions, and negotiations regarding which party should receive the benefit of such deductions, have been materially impacted by the TCJA. First, the reduction in the corporate income tax rate caused each dollar of Transaction Tax Deductions to have less value than before the TCJA. Second, the TCJA eliminated the NOL carryback and the 20 year carryforward limit. As a result, Corporate Targets can apply Transaction Tax Deductions to offset any Pre-Closing Taxable Income, which may generate a refund of estimated income taxes paid for the year of the closing, but must carry forward any remaining Transaction Tax Deductions. Further, following the TCJA, NOL carryforwards may be applied to offset only 80 percent of a Corporate Target's annual taxable income (the 80% Limitation), which, in addition to the Section 382 Limitation, further reduces the value of the NOL carryforward to the Corporate Target from and after the closing.

Following the repeal of the NOL carryback, a larger portion of a Corporate Target's Transaction Tax Deductions is likely to be carried forward and the utilization of such NOL carryforward is more likely to be deferred because of the 80% Limitation, thereby reducing the present value of such deductions. As a result, purchasers may be less willing to agree to a Purchase Price adjustment for the use of Transaction Tax Deductions, or may be willing to agree to such an adjustment only with a substantial discount for the expected deferral of any tax benefit. As an alternative, Purchasers may be willing to make cash payments to selling stockholders as and when Transaction Tax Deductions actually generate tax benefits. Such approach, however, requires the parties to agree to a series of assumptions to implement such an arrangement, including assumptions regarding when Transaction Tax Deductions are deemed to be utilized by the Corporate Target, which can add complexity to the parties' negotiations and post-closing administration.

Selling Stockholders Beware

Finally, the repeal of the NOL carryback can present a trap for unwary sellers. Assume the purchaser and selling stockholders do not agree to a Purchase Price increase for the value of any Transaction Tax Deductions, but the Corporate Target is required to pay to the selling stockholders any post-closing refund of pre-closing estimated income taxes on account of Transaction Tax Deductions. Also assume the Corporate Target is a calendar year taxpayer. If the closing occurs on the last day of the fourth quarter, any Transaction Tax Deductions could be applied against the taxable income of the Corporate Target for all four quarters, possibly resulting in a material refund of estimated income taxes paid with respect to such year. If, however, the closing is delayed until the first quarter of the following year, and all Transaction Costs are paid or incurred in such year, the selling stockholders would not be eligible to receive a refund of the prior year's estimated income taxes but, instead, most of the Transaction Costs would generate an NOL carryforward. As a result, the selling stockholders would lose the material refund they were expecting and, unless the purchaser is willing to renegotiate, the selling stockholders would not receive any consideration for the value of the NOL created by the Transaction Tax Deductions.

1 *The taxable year of a standalone Corporate Target, or a Corporate Target that is the common parent of a consolidated group, will end on the closing date if the acquirer is a corporation for state law purposes or a non-corporate entity, such as a limited liability company, that has elected to be classified as a corporation for federal income tax purposes.*