

# Structuring Acquisitive Transactions in Difficult Times

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In the midst of a downturn in the US economy during the COVID-19 pandemic, structuring transactions in a tax efficient manner will become an even more critical component of achieving optimal investment returns. For example, as more and more companies are suffering financial distress, significant operating losses (and potentially valuable tax attributes) may quickly accumulate and uncertainty may increase with respect to a business's ability to generate operating profits in the future. This advisory provides insight into certain federal income tax considerations that buyers and sellers should consider when planning for acquisitive transactions in this difficult and volatile environment.

## Net Operating Loss Limitation

Many businesses may incur net operating losses (NOLs) in 2020 due to the COVID-19 pandemic or other business difficulties. Such NOLs may be even larger than otherwise expected because of (1) increased availability of interest deductions (generally increased from a limit of 30 percent of EBITDA to 50 percent for 2019 and 2020); and (2) the accelerated deductibility of interior non-residential real property improvements under the 2020 Coronavirus Aid, Relief, and Economic Security Act (the CARES Act).

In change of control stock transactions involving corporations with NOLs, Internal Revenue Code Section 382 imposes a limitation on post-sale utilization of pre-change NOLs and certain other corporate tax attributes (e.g., recognized built-in losses) after an "ownership change." For this purpose, an ownership change is generally a greater than 50 percent change in equity ownership of the target corporation, measured over a rolling three-year period. This annual limitation is initially generally calculated based on the equity value of the loss corporation prior to the ownership change, multiplied by the current long-term tax-exempt rate (1.47 percent for May 2020).<sup>1</sup> Importantly, this limitation may be increased to the extent the corporation has net unrealized built-in gains immediately before the ownership change. In such cases, for the five-year period following the ownership change, the Section 382 limitation is generally increased by any recognized built-in gains. Under current law, eligible loss corporations also may elect to increase the Section 382 limitation by certain hypothetical depreciation and amortization deductions that would have been available to an asset purchaser upon a hypothetical sale of the loss corporation's assets (instead of the actual stock sale).<sup>2</sup>

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<sup>1</sup> The limitations on NOL utilization following an ownership change are relaxed in the case of a loss corporation reorganizing under the jurisdiction of a court in a title 11 or similar case. Depending on the circumstances, the corporation may (1) be able to avoid the general NOL limitation (subject to significant conditions including a "toll charge" where its NOLs are reduced by excluding deductions for interest accrued or paid during the part of the tax year ending on the ownership change date and the three preceding years on any debt converted to stock pursuant to the bankruptcy case); or, alternatively, (2) calculate the NOL limitation based on the equity value of the loss corporation after the ownership change (i.e., including the increase in value of the corporation as a result of any debt reduction in the bankruptcy). Also, although unlikely to be raised by the Internal Revenue Service (IRS) in a transaction subject to Section 382, if the principal purpose of buying a corporation, or acquiring assets with a carryover tax basis, is to avoid income tax by using NOLs or the tax basis of the assets, the IRS may disallow any applicable deduction, credit, or allowance. Thus, the parties to an acquisition should engage in legitimate business transactions, which are not motivated principally or solely by tax objectives.

<sup>2</sup> For example, if a corporation held an amortizable intangible (e.g., goodwill) with a fair market value of \$15 million and adjusted tax basis of \$0 for which 15 years of tax amortization would be available to an asset purchaser, the annual limitation increase would be \$1 million (based on \$15 million of gain). However, proposed Treasury Regulations would, if finalized, eliminate this benefit in many cases (including the example above). It is unclear when the proposed Treasury Regulations will be finalized or if they will be finalized in their proposed form in light of the Treasury's frequently more taxpayer friendly stance since the COVID-19 pandemic began.

Generally, a loss incurred during the year when the ownership change occurs is divided between the pre- and post-ownership change periods using a daily proration methodology, with the pre-change losses subject to the Section 382 ownership change limitation. Alternatively, the NOL corporation can elect to “close the books” on the date of the ownership change instead of doing a daily proration. Such election would likely be advisable if losses in the current year are projected to be disproportionately incurred after the ownership change and a closing of the books would ensure such post-ownership change losses can be used by the corporation without a Section 382 limitation.

In light of the potentially onerous limitations on the use of a target corporation’s NOLs after an ownership change, we anticipate it may be tax efficient in many acquisitions to structure a transaction as an asset sale or stock sale treated as an asset sale for federal income tax purposes (by reason of an Internal Revenue Code Section 336 or 338 election) if a seller can fully utilize NOLs against the gain on the asset sale, so that buyers can then get a step-up in tax basis and increased amortization and depreciation deductions in the future without any Section 382 limitation.

### **Allocating Net Operating Losses or Other Tax Benefits Between the Parties to an Acquisitive Transaction**

The parties to many corporate M&A transactions will often negotiate an allocation of or payment for tax benefits attributable to pre-existing tax attributes of the target corporation or transaction related deductions that can be utilized by the buyer post-closing. Sellers frequently may attempt to negotiate for the right to receive compensation from their buyers for future tax benefits that the transferred corporation may obtain from the applicable pre-existing NOLs and/or transaction deductions. Such compensation is often payable through periodic payments after closing as the buyer realizes the tax savings over time (perhaps limited to 2-3 years) but in some cases, through an up-front payment at closing based on a discounted value of estimated future tax benefits. After the Tax Cuts and Jobs Act of 2017 (the TCJA) and prior to the CARES Act, these negotiations typically did not contemplate the possibility of carrying back NOLs because the TCJA generally eliminated NOL carrybacks.

The CARES Act created a new ability for eligible taxpayers to generally carryback NOLs arising in 2018, 2019 and 2020 for up to 5 years.<sup>3</sup> As a result, NOLs may be significantly more valuable in corporate M&A transactions in 2020. Because of the value of NOLs of some target corporations, stock buyers who priced NOLs in their bids, perhaps based on investment banker requests, may ask for representations on the amount of NOLs and the absence of limitations on the use of such NOLs (e.g., because of a previous ownership change).

If a buyer purchases stock of a target with operating losses in the middle of 2020, corporate NOLs attributable to pre-acquisition 2020 tax periods of the target generally can be carried back into the past five target pre-acquisition tax years. Such 2020 NOLs should usually be increased by transaction tax deductions (e.g., 70 percent of investment banker fees, unamortized debt fees and any transaction bonuses). Moreover, the target may be entitled to refunds for carrybacks related to 2018 or 2019 NOLs that have not yet been carried back. Even if 2020 NOLs exceed taxable income for the last five taxable years, they can be carried forward and used to offset 80 percent of taxable income in 2021 and into the future. Well-advised sellers are likely to usually ask to be paid for the tax refunds receivable because of such NOL carrybacks.

In the case where the target is a subsidiary in a consolidated tax group, only the parent of the consolidated group may claim a carryback of the consolidated group’s NOL, including the portion attributable to the subsidiary target. In the absence of an express contractual agreement, the parent will generally receive any resulting tax refund with no clear obligation under the tax laws to pay the refund to the buyer or the target. Thus, buyers should carefully consider the contractual arrangements relating to the purchase of a target with NOLs from a parent of a consolidated group if such buyers want tax refunds related to such target.

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<sup>3</sup> This carryback window notably includes tax years prior to the enactment of the TCJA when the maximum marginal federal corporate income tax rate was 35 percent.

## Prior Transactions

If there was a stock sale of a business prior to March 27, 2020, the effective date of the CARES Act, the parties to such transaction should determine if there are corporate NOLs available to be carried back, and if so, who is entitled to any related tax refunds arising as a result of the CARES Act. Certain contractual provisions to consider include: (1) entitlement to refunds of pre-closing taxes (including refunds resulting from NOLs); (2) seller's right to be paid for the buyer's use of tax deductions/attributes of the target (including NOLs); and (3) tax cooperation provisions (e.g., which may require the buyer to pursue tax refund claims using "reasonable efforts"). Furthermore, the parties may consider entering into a post-closing amendment to the stock purchase agreement to clearly reflect new terms for NOL utilization given the new CARES Act rules. For example, in situations where the applicable contractual arrangements are unclear, the buyer and seller of a corporate target may be incentivized to cause the target to carryback NOLs to prior years and may agree to a new, clearer or different allocation of refunds to quickly effectuate a tax refund from a carryback and a split of proceeds between the buyer and seller.

In the case of transactions treated as asset sales for federal income tax purposes, any NOLs will typically remain with the seller and not be received by the buyer as part of the transaction. Thus, the impact of the enhanced ability to use NOLs under the CARES Act on prior transactions will primarily be limited to prior stock transactions.<sup>4</sup>

## Buying Assets or Partnership Interests

For an operating business held in a "flow-through" vehicle, including a limited liability company (LLC) treated as a partnership for federal income tax purposes, typical structuring objectives may be reversed as a result of the COVID-19 pandemic. Such businesses may be generating significant losses in 2020 (including from enhanced deductions attributable to the CARES Act) and business asset values may be depressed below applicable tax basis. In a sale with some or all of the equity rolling over, the rollover sellers may now prefer a fully taxable "rollover" transaction (instead of a tax-deferred rollover which is the typical preference). Sellers of partnership or LLC interests should also consider the special "hot asset" rules which can result in ordinary income to partnership or LLC owners even if the transaction results in an overall economic loss.

Purchasers of assets or equity in operating businesses taxed as flow-through entities also should be wary of the potential for a stepdown in tax basis in assets (e.g., when the partnership's adjusted tax basis in the assets exceeds the fair market value of the assets by more than \$250,000), thereby resulting in reduced tax depreciation and amortization relative to the pre-sale profile of the business. Buyers will presumably want to take such stepdowns into account in determining the purchase price of a target.

A pre-sale incorporation of a flow-through business also may be considered to take advantage of the lower 21 percent corporate tax rate under the TCJA<sup>5</sup> and/or to avoid any future cancellation of debt issues for owners of a tax partnership (e.g., cancellation of debt exclusions from income are available to an insolvent/bankrupt corporation at the entity level but are applied at the partner level in the case of an insolvent/bankrupt partnership, including an LLC treated as a partnership for federal income tax purposes). Where the asset tax basis is higher than its fair market value, a mandatory stepdown in the corporation's tax basis in its assets on an incorporation of the LLC may also occur.<sup>6</sup>

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<sup>4</sup> A notable exception to this rule of thumb may exist in prior restructurings or other transactions involving distressed companies in which asset purchasers may have negotiated for broader contractual rights than a typical buyer of assets.

<sup>5</sup> In addition, for smaller businesses anticipating a rebound in equity valuations, a collateral benefit of a corporate conversion is the potential eligibility for the exclusion from gross income for gains from the sale of qualified small business stock (QSBS) held for more than five years up to the greater of (a) \$10 million or (b) 10 times the taxpayer's original adjusted tax basis in the QSBS sold under Section 1202.

<sup>6</sup> For example, if a US transferor transfers assets with an adjusted tax basis of \$1 million and fair market value of \$500,000 (i.e., property with a built-in loss because the adjusted tax basis in the property exceeds the fair market value of the property) to a corporation in a Section 351 transaction, the transferor will take a \$1 million tax basis in the stock of the corporation but the corporation's tax basis in the assets will be stepped down to \$500,000, the property's fair market value. However, the transferor and corporation can jointly elect to take the tax basis reduction in the corporation's stock and thereby preserve the corporation's tax basis in the assets received. Using the example above, the election would cause the transferor's tax basis in the corporation's stock to be \$500,000, and the corporation's tax basis in the property would be preserved at \$1 million. This election may make sense if the corporation has a large amount of non-US or tax-exempt shareholders who generally would not recognize gain upon the sale of their shares of stock in the corporation.

## Installment Sales – Interest Charge and Earnouts

**Earnouts:** We anticipate that an increasing number of deals will include an “earnout” component to hedge against the uncertainty of a target’s success in the future and the parties’ different views as to the current value of a business. An earnout generally involves a future payment that may not occur or, to the extent it does occur in the future, the amount is uncertain.

Sellers in an earnout transaction often are eligible to use the installment method of reporting all or a portion of any gain, which generally permits the deferral of gain until payments are received, subject to recharacterization of a portion of the sales proceeds as interest and potentially an incremental interest charge discussed below. The installment sale regulations require different methodologies for calculating the seller’s tax basis recovery (and therefore the applicable gain deferral) from a contingent installment sale, depending on the terms of the sale. If the sales contract provides for a maximum selling price (even if there is a maximum term), then the computation of the portion of the selling price which is a return of basis (i.e., the gross profit ratio) assumes the maximum price will be received and tax basis is recovered as each contingent payment is made. If there is no maximum selling price, but there is a maximum term, the seller’s tax basis in the property sold is allocated ratably over that term (i.e., for each year during the term, the allocated tax basis is the total tax basis divided by the maximum term). Finally, if there is no maximum selling price and no maximum term, then generally the taxpayer’s basis is allocated ratably over a period of 15 years commencing with the date of sale. Given that the federal income tax consequences can vary significantly depending on the applicable method (e.g., gain may be accelerated or deferred into future years based on how the earnout terms are negotiated), sellers’ tax advisors should play a key role in structuring the earnout to achieve the intended results.

**Interest Charge:** We also anticipate that an increasing number of deals will include seller notes which may result in an incremental “interest charge” to the seller calculated by reference to the deferred taxes in the transaction. This incremental interest charge generally applies to sellers having installment sale obligations exceeding \$5 million in total face amount at the end of their tax year. The interest charge payable on an installment obligation is generally equal to the (1) “applicable percentage” of the (2) deferred tax liability (with respect to the obligation) multiplied by the (3) underpayment rate for federal income tax obligations for the applicable month in which the taxable year ends.<sup>7</sup> For pass-through entities, the \$5 million threshold is applied, and the interest charge is computed, at the partner or shareholder level.

## Looking Ahead

As the US economy begins to stabilize and parties to an acquisitive transaction gain a greater understanding of the financial distress and other consequences caused by the COVID-19 pandemic, buyers and sellers should keep in mind that various tax planning techniques exist to structure acquisitions in a tax efficient manner. While the COVID-19 pandemic has caused great uncertainty for dealmaking, it has nevertheless led to various tax planning opportunities that, if done correctly, can help weather the storms as we forge ahead in the current difficult economic and M&A environment.

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<sup>7</sup> For example, if at the close of year 1, seller has \$25 million in gain remaining to be reported in future years and will receive \$25 million in installment note payments, then (1) the “applicable percentage” is 80 percent, i.e., \$20 million (the amount of the note that exceeds \$5 million) ÷ \$25 million (the amount of installment obligations outstanding at the end of the year) and (2) seller’s deferred tax liability is \$5 million, i.e., the \$25 million gain remaining to be recognized at the close of year 1 multiplied by the maximum federal capital gains tax rate of 20 percent. Multiplying the applicable percentage (80 percent) by the deferred tax liability (\$5 million) yields \$4 million, which when multiplied by the underpayment rate for the applicable month (assume 4 percent), results in \$160,000 of interest charge for year 1. Such calculation on interest charge would be recalculated in year 2 and into the future.

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