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Growing Complexity in the Tax Aspects of Transactional Negotiations

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Over the past few years, U.S. tax laws have undergone an unparalleled number of sweeping changes that have profoundly impacted corporate and partnership transactions. The Tax Cuts and Jobs Act (TCJA), enacted in 2017, was the most comprehensive reform of U.S. tax law since 1986. The Coronavirus Aid, Relief and Economic Security Act (CARES Act), enacted in 2020 in response to the COVID-19 pandemic, significantly modified certain aspects of the TCJA, including retroactively in part. Beginning in 2018, the Bipartisan Budget Act of 2015 (BBA) generally subjected partnerships to a new audit regime that includes entity-level income tax assessments in stark contrast to the long-standing principle that income taxes in respect of a partnership are imposed solely on the partners.

The Biden administration has recently taken office with a Democratic-controlled Congress and its own slate of legislative and regulatory priorities, including the promise of additional legislation to address the pandemic's impact on the economy. In anticipation of that, it is useful to take stock of the transformative effect that the BBA, TCJA and CARES Act have had on many tax aspects of corporate and partnership transactions, as it portends the types of novel complexities, opportunities and challenges on the horizon.

Corporate Transactions

One example, among many, of the growing complexity in corporate M&A and restructurings is the treatment of tax attributes, such as net operating losses (NOLs) and interest expense deductions, that often play an important role in pricing and structuring. Prior to the TCJA, an operating loss, including to the extent attributable to interest expense, could generally be used to fully offset taxable income in the year generated. To the extent the loss exceeded that year's income, the resulting NOL could be carried back up to two years or forward up to 20 years to offset taxable income without limitation (assuming no ownership changes that could cause the tax attributes to become subject to the so-called "Section 382 limitation").

Within the relative simplicity of that pre-TCJA regime, if a target corporation were acquired in a stock purchase, the seller and buyer often could, in a relatively straightforward manner, allocate the tax savings attributable to so-called "transaction tax deductions," such as those arising from compensation payments, professional fees and debt financing expenses incurred by the target in connection with the sale transaction. Because transaction expenses typically reduce the price to be paid to the seller, the parties often agreed that the seller should be entitled to any tax refunds generated by the deductible expenses. Carrying back an NOL resulting from such transaction tax deductions to a pre-closing tax period for a cash tax refund was often preferable to carrying the NOL forward to a post-closing tax period, because the carryforward approach would require the parties to either negotiate an upfront payment for the NOL or agree to an often-complicated "pay as you go" approach whereby the buyer paid the seller for the attributes as they were utilized.

Alternatively, if a target corporation had sufficient attributes, the target could fully offset any gain resulting from the sale with its own attributes, and a buyer could acquire the target's business (and obtain a basis step-up that could reduce

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its own tax liability) by way of an actual or deemed asset acquisition. Such a structure is commonly referred to as a “Bruno’s transaction” and is often employed in a distressed sale or bankruptcy restructuring in which a corporation’s NOLs are otherwise expected to become devalued as a result of the Section 382 limitation.

Following passage of the TCJA and CARES Act, and regulations promulgated thereunder, calculations regarding the use of tax attributes have become multifaceted, leading to more complex deal negotiations in many transactions. The TCJA effectively segregated pre-2018 NOLs, post-2017 NOLs and post-2017 interest expense deductions into three separate attributes, the latter two of which are subject to new and different limitations and carryover rules. For example, although post-2017 NOLs generally cannot be carried back like pre-2018 NOLs, they generally can be carried forward indefinitely but can offset only a portion (80%) of the taxable income in any year. The same applies to post-2017 interest expense deductions but with a different annual limit than post-2017 NOLs. The CARES Act then created more tranches of these attributes by providing another set of carryback and carryforward rules for NOLs generated in the 2018-20 time frame while temporarily loosening, for certain years, some of the limitations imposed by the TCJA on post-2017 NOLs and interest expense deductions.

The impact of these sweeping legislative changes on negotiating the tax aspects of corporate acquisitions has been significant. It was generally assumed in transactions negotiated after the TCJA, but prior to the CARES Act, that an NOL generated from significant transaction tax deductions could be carried forward only, and negotiations in that regard therefore centered on whether and how the buyer would compensate the seller for the future use of that NOL. The possible approaches have included no payment, upfront payment by buyer to seller at a discounted rate, or future payments by buyer to seller as NOL carryforwards are used in post-closing periods.

Given the TCJA’s annual limitation on the utilization of a post-2017 NOL, and the potential for its utilization to offset domestic income taxed at a 21% rate or offshore earnings generally taxed at a 10.5% rate, the negotiations could get elaborate. The CARES Act amplified that complexity by introducing the ability to carry back certain post-2017 NOLs, thereby creating the potential that an NOL resulting from significant transaction tax deductions could be (1) carried back to generate a refund by offsetting pre-TCJA income at a 35% tax rate, (2) carried back to generate a refund by offsetting post-TCJA income at a 21% or 10.5% tax rate, (3) carried forward to be utilized in a post-closing period, or (4) some combination of those. Moreover, the changes made by the CARES Act were retroactive in part, potentially undermining the assumptions made in already-negotiated transactions.

The treatment of Bruno’s transactions has shifted under the TCJA and the CARES Act as well. The TCJA instituted an annual limitation on the utilization of post-2017 NOLs and post-2017 interest deductions, creating the potential that the asset-level gain recognized in a Bruno’s transaction might not be fully offset by existing attributes regardless of their magnitude. By temporarily removing the TCJA’s annual limitation on the usage of NOLs for deals closing in 2020, the CARES Act temporarily revived Bruno’s transactions in which asset-gain was fully offset by the seller’s attributes. However, given the menu of ways those attributes could potentially be used, detailed analysis and modeling has been required to map out the pros and cons of effectuating a Bruno’s transaction as compared to undertaking a different transaction structure that maintains the existing tax attributes.

Future legislation that may be enacted during the Biden administration, combined with newly promulgated regulations, will likely exacerbate the complexities and expand the range of opportunities in the corporate transactional context. In particular, the Biden administration has expressed the desire to provide more pandemic-related stimulus.

Given the possibility that such legislation could, similar to the CARES Act, prospectively or retroactively change the TCJA’s rules regarding NOLs and interest expense deductions, it would be prudent for acquisition agreements to hedge by addressing a range of possibilities with respect to NOLs and similar tax attributes.

Partnership Transactions

Transactions involving entities taxed as partnerships have been complicated by an assortment of recent statutory and regulatory changes akin to, and at times even more complicated than, those impacting corporate transactions. Although the new audit regime of the BBA has long been anticipated, regulations providing greater clarity were not issued until beginning in 2018, and audits under such regime have only recently begun.

Buyers of partnership interests are now encouraged to broaden their pre-acquisition diligence efforts, given the potential that an assessment for pre-closing taxes could be collected from the partnership after the closing. The BBA contains elective provisions that could mitigate or eliminate that result, including so-called “push-out” elections; however, costs are associated with those mechanisms, and therefore, negotiations around the ability of the partners to trigger their usage are often difficult.

Moving Forward

Predicting future tax law changes and their precise impact on transactions is a difficult task. Nevertheless, it is clear that the interaction between statutory changes made over time (and across different presidential administrations), combined with ever-increasingly complex regulatory guidance, will continue to generate transactional structuring challenges and opportunities that will need to be closely monitored and prospectively taken into account in negotiations.