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# Loss and Interest Expense Limits Complicate Deal Negotiations

**by Emily L. Foster**

The 2017 tax law's revised net operating loss limits and the uncertainties around the business interest deduction rules have created greater challenges for target companies negotiating "tax benefits" in acquisition deals.

Mergers and acquisitions activity hasn't seemed to slow because of the Tax Cuts and Jobs Act (P.L. 115-97), but negotiations have become more complex, potentially limiting sellers' bargaining power and requiring buyers to increase their due diligence. The TCJA has introduced complexities for the valuation and negotiation of tax attributes that carry over to the buyer — including NOLs and business interest deduction items — that are generally considered in stock acquisitions of domestic C corporations, Philip B. Wright of Bryan Cave Leighton Paisner LLP told *Tax Notes*.

The acquisition agreement provides the framework for allocating tax risks and benefits between the parties and sets forth the purchase price; the parties' representations, warranties, and covenants; and any indemnification obligations.

The TCJA's provision that eliminates NOL carrybacks and restricts loss carryforwards is "definitely affecting the ways in which some buyers and sellers are approaching certain deal terms," according to David B. Strong of Morrison & Foerster LLP. Under prior law, for example, target companies would want to be compensated for "any tax benefits that might result from deal-related transaction expenses that could be effectively carried back as an NOL to the prior two taxable years," Strong said. That sometimes created a "readily quantified" tax refund that could be returned to the seller, he added.

Because of the repeal of NOL carrybacks, some sellers are instead "trying with mixed success to receive value for either the estimated or actual future tax benefits that may result from any such NOLs that will be carried forward," Strong said.

Sarah-Jane Morin of Morgan, Lewis & Bockius LLP agreed that it's becoming harder for sellers to argue for pre-closing federal tax refunds if they won't benefit from post-2017 NOLs. But target



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companies might have pre-closing refunds from other sources — estimated federal taxes and nonfederal taxes — which could be significant in large domestic acquisition deals, she said.

### Buyers' Perspectives

Under section 172, NOLs are generally limited to 80 percent of net taxable income for losses arising in tax years beginning after December 31, 2017. The TCJA, with some exceptions, eliminated carrybacks while allowing indefinite carryforward of NOLs.

Buyers are less enamored with newly generated NOLs because they are worth less with the corporate rate reduction from 35 percent to 21 percent and the limit on losses allowed in a tax year, Morin said, adding, "That's been an interesting sea change." Previously, acquiring companies focused heavily on preserving the target company's NOLs to the extent possible to offset future taxable income, subject to some section 382 limitations, she said.

While sellers want to be compensated for the NOLs they can't carry back, buyers may be hesitant to pay for NOLs that otherwise might be limited under different code provisions, such as section 163(j), Wright said. That adds to the challenge of negotiating the deal, he said.

Acquiring companies with NOL positions are saying they don't want to compensate sellers for NOLs that carry forward because they won't be able to use them, Wright said. Buyers must include those tax attributes in their returns, which also complicates the negotiations, he said.

With the changes in the law, companies must account separately for NOLs generated before 2018 that remain subject to prior law, Strong said. But because some sellers don't maintain adequate records, the "buyers and sellers are often left to negotiate over which party should bear the burden of bringing the target company into compliance," he said.

### Too Early to Tell

Sellers want to be compensated for their section 163(j) disallowed interest deduction carryovers, but buyers aren't "too excited about that," Julie A. Divola of Pillsbury Winthrop Shaw Pittman LLP said. The buyer's decision on whether to pay for those carryovers is complicated because of uncertainties in determining those amounts and in the buyer's ability to use them to offset future taxable income, she said.

The TCJA amended section 163(j) to limit the business interest expense deduction to the sum of business interest income, 30 percent of adjusted taxable income, and floor plan financing interest. Business interest is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Adjusted taxable income excludes income, gain, deduction, or loss not properly allocable to a trade or business; business interest or business interest expense; deductions for NOLs; deductions under section 199A; and deductions for depreciation, amortization, or depletion for tax years beginning before January 1, 2022.

Taxpayers may carry forward disallowed deductions indefinitely, and the amount of disallowed expense is treated as business interest expense paid or accrued in the next tax year.

It's too early to tell how significant the section 163(j) issues will be in deal negotiations, Wright said. Target companies probably don't know what their interest deduction excess limitation is, while buyers must assess their situation, determine if the seller's limitation has value, and if it does, figure out how to conduct due diligence and price it, he said.

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Buyers will likely increase their due diligence on the target company's debt, focusing on the carryforwards of disallowed business interest deductions, Joseph M. Pari of KPMG LLP said. Under some circumstances, the buyer may ask for the seller's specific representations on the carryforward amounts, or those may be subsumed in the broad representations concerning payment of taxes and proper filing of all tax returns, he said.



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Pricing of the target company's excess limitation, if it's considered an attribute, could be challenging, particularly if a company is purchasing part of a consolidated group, Wright said, noting that Treasury hasn't determined how the group's limitation will be allocated among members. According to Notice 2018-28, 2018-16 IRB 492, Treasury and the IRS plan to address that question and other consolidated group issues, such as the treatment of disallowed interest deduction carryforwards when members leave and join a group, including whether those carryforwards are subject to a separate return limitation year. In May acting IRS Commissioner David Kautter said the target date for section 163(j) proposed regulations is late summer or early fall.

As companies' business interest expense limitations build up and the IRS issues more guidance, the disallowed interest deduction carryovers and the excess limitations could become relevant in structuring and negotiating deals, Wright said.

### Dealing With Uncertainty

Companies have accepted "that they won't have all the answers to some . . . pretty important questions" and have continued executing M&A deals despite the uncertainty, according to Morin. She noted that buyers and sellers have been negotiating specific items and factoring into acquisition agreements "what they need to feel comfortable going forward without having regulations or other guidance."

Generally, when the parties have questions on how to interpret the law, they determine their position and proceed with the deal, Pari said. Although contracts occasionally have "change of law" provisions, they typically don't provide for a change of interpretation — that is, they don't specify alternative actions depending on how Treasury might interpret the law, he said. "In my experience, [that] would be highly unusual," he added.

Items with limited exposure tend to be factored into the purchase price, while items that could significantly affect the purchase price would be more prominent in the agreement, according to Divola. But the TCJA hasn't been in effect long enough to see what contractual provisions should be considered customary for some of those issues, she said.

In some deals, the parties agreed not to amend the terms or adjust the purchase price when the IRS later provides more clarity on the rules, such as those concerning the section 965 transition tax, Morin said. She noted that in other situations when the IRS issued guidance that was relevant to a deal still in negotiations, the parties modified the contract language and, in some cases, restructured the business transaction.

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"The lack of regulatory or other guidance in certain areas is an extremely important issue in the context of some transactions," which has led to unique contractual provisions to deal with the uncertainty, according to Strong. Typically, the parties agree to file returns consistent with any future definitive guidance or, in the continuing absence of guidance, take a position the parties consider reasonable "based on either good-faith discussions or an identified range of allowable options," he said.

According to Divola, post-closing refunds could become more meaningful when the seller has to, or the parties agree to, take a conservative approach interpreting a new or amended provision that later differs from Treasury guidance. The seller wants to be compensated for benefits the buyer could realize, she added.

Generally, if the parties are of relatively equal size, the seller tends to have more leverage negotiating refund benefits, Divola said. But in deals with "a big buyer and a small seller, it's always been an uphill battle to get post-closing refunds, and I think that that continues to be true," she said. ■



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