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Don't Ignore a Target's NOLs

The price and structure of your deal can depend on them

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Undoubtedly, the market will be seeing more target companies with accumulated net operating losses ("NOLs") for federal income tax purposes as a result of the current recession. Corporations generate an NOL to the extent that their current year tax deductions exceed their current year taxable income. Subject to certain conditions and limitations, federal income tax law permits a corporation that incurs an NOL in a given tax year to use that NOL to reduce taxable income in other tax years. Specifically, an NOL that is incurred in one year may be carried back to each of the preceding two tax years to offset taxable income reported in those years. The recently enacted Recovery Act extends the carryback period to five years for certain small businesses. Any remaining NOL after the carryback, or all of the NOL if the carryback is waived, is then carried forward to each subsequent tax year after the tax year the loss is incurred to offset future taxable income for up to 20 years.

Depending on the circumstances, the availability of these NOL carryforwards may be an important consideration in deciding whether to structure an acquisition of a target corporation as a stock deal or as an actual asset deal (or, as a stock deal that is deemed to be an asset deal for tax purposes, but that is a topic for another day).

Deals structured as taxable asset sales will not have any NOL carryforwards transferred over to the buyer. Such NOLs will stay with the selling corporation and/or the selling corporation group and may be used to offset the selling corporation's gain on the sale of its assets – assets which will now have a fair market value basis in the hands of the buyer with the resulting increased depreciation and amortization deductions. Therefore, if the target corporation's NOLs are sufficiently large, the parties should consider whether it is more efficient to have the target corporation sell its assets and use its NOLs to offset any resulting income tax on such sale or instead for the buyer to purchase the stock (and in effect the NOLs) of the target.

Generally, where the parties settle on a stock deal, the NOL carryforwards of a target "C" corporation will transfer with and be available to the target corporation. Accordingly, a target corporation's NOL carryforwards that exist as of the closing date represent an economic asset of the target – the possible reduction of future income taxes. Thus, these NOLs may be of some value to some buyers, even in this dismal market. However, our experience has shown that when deal makers are negotiating the purchase price for a target's stock they will often either fail to address the potential value of these NOLs or at least fail to address the value early enough in the process to make a meaningful difference. In addition, if the issue does arise in price negotiations, buyers often argue that the market price for NOLs is "pennies on the dollar."

Our experience is that many sellers are

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leaving a potentially significant portion of their business' value on the table. The not-so-dirty little secret is that NOL carryforwards may be of significant value to certain buyers. Some of these buyers may actually reflect to varying degrees the true value of these NOLs in their bid prices, but some may not. Accordingly, should a seller sit idly by and let a buyer take a valuable asset without paying for it? On the other hand, should a buyer who takes into account the value of target's NOLs in its bid price not ask for greater contractual safeguards regarding those NOLs?

This article discusses some of the many factors that may impact the value of the NOL carryforwards of a domestic C corporate target and then describes some negotiation tactics and contract provisions that buyers and sellers may wish to consider. This article assumes that the parties have already settled on a stock deal involving a target with NOLs that will transfer to the buyer and therefore should have some value.

Factors impacting the value of NOLs

The value of a target corporation's NOL carryforwards as of the closing date should approximately equal the present value of the expected reductions in future cash tax payments from the utilization of the NOLs in later tax years. Assuming this is the proper valuation method, a number of factors impact this analysis. We will highlight the major ones.

Probability of Future Taxable Income. Perhaps the most significant factor impacting the value of NOL carryforwards is the probable amount and timing of future taxable income. Clearly, the sooner the NOLs are expected to be absorbed by future taxable income, the greater the value of the NOLs should be on a present value basis. However, the timing of future taxable income should be examined in light of the remaining life of the NOL carryforwards. Recall that NOLs may be carried forward 20 years from the year the losses were incurred (and NOLs generated in tax years ending prior to August 5, 1997 can only be carried forward for 15 years). Accordingly, a target corporation that incurred NOLs in different tax years could have various NOL carryforwards that are set to expire at different points in time. For example, a target corporation could have NOL carryforwards that are set to expire in two, five, and ten years from the closing date if the losses were incurred far enough back in time. If this target corporation (or its new consolidated group) is not expected to have much income for the first few years following its acquisition, the value of the NOL carryforwards with the two-year remaining life would be suspect, absent some creative tax planning.

A target corporation's NOLs should be more valuable to a buyer if there is a strong probability that the target itself will absorb its own NOLs through its own future taxable income. However, even if the target's ability to absorb the NOLs itself is questionable, the target's NOLs may still be quite valuable to some buyers depending on the buyers' particular circumstances and objectives. For example, tax law permits the NOLs of the target corporation, subject to limitations (see some limitations discussed below), to be used to offset the future taxable income of not only the target corporation, but also the future taxable income of other members of its consolidated group of corporations (even if they were not consolidated at the time that the loss was originally incurred). Thus, if the buyer is a member of a profitable consolidated group of corporations, the target's NOLs may be of significant value to such buyer and its consolidated group even if the target's own income projections are not particularly strong.

On the other hand, if a corporate buyer and its consolidated group have a weak profitability forecast or have their own NOL carryforwards, the buyer may be less interested in the target's NOL carryforwards. Likewise, a buyer that is a partnership or an individual may place a lower value on a target corporation's NOLs since tax law does not permit a target corporation's NOLs to be used to offset the taxable income of an individual or a partnership.

This discrepancy explains why different buyers may bid very different amounts for the same target corporation solely on the basis of the buyer's ability to utilize NOL carryforwards.

Amount and Accuracy of NOL Carryforwards. Another significant and obvious factor impacting the value of NOL carryforwards is the amount of the NOLs and the buyer's comfort level with the accuracy of the purported amount of the NOLs. The amount of NOLs that a target reports on its tax return may be subject to IRS challenge. The target corporation may have erroneously understated income or overstated deductions in prior years. A buyer's comfort level should increase to the extent the IRS has already audited the target corporation's prior tax returns. We should point out, however, that buyers may not derive much comfort from the fact that the applicable statute of limitations has expired for the years in which the losses were incurred. While the IRS may not reopen tax returns for closed tax year for pur-

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poses of redetermining the target's liability for those years, the IRS may nevertheless audit closed tax years for purposes of denying an NOL carryforward deduction taken in a later open tax year.

A buyer may also gain further comfort if the seller has elected to not carryback its NOLs. Such an election by the seller avoids a situation where a buyer's purchased NOLs is ultimately reduced because a year prior to the year the NOL was incurred is determined to have more income than originally thought; therefore, more of the NOL must be carried back to that previous year before it is carried forward to subsequent years and ultimately transferred to the buyer.

A buyer's comfort level should also increase to the extent the buyer has conducted adequate due diligence procedures with respect to the target corporation's NOL carryforward amount and remaining carryforward periods. Often, however, it is quite difficult to make these determinations in the due diligence process, at least not in the typical timeframe provided. Of course, a buyer's comfort level should also increase to the extent the Seller provides contractual protections regarding the amount and accuracy of the NOLs (as discussed further below).

Section 382 Limitation. Another important factor impacting the value of NOLs is whether the use of NOLs is subject to any limitations under tax law. The most relevant limitation is the one imposed by section 382 of the Internal Revenue Code of 1986 (the "Section 382 Limitation"). In general, the Section 382 Limitation limits the extent to which a target corporation that experiences an "ownership change" may offset taxable income in any post-change taxable year by pre-ownership change NOLs. The Section 382 Limitation may also apply to the recognition in a post-change year of "built-in losses" in the target's assets that existed on the change date. In general, the amount of income in any post-change year that may be offset by the target's NOLs is limited to an amount determined by multiplying the value of the target corporation immediately before the ownership change by the long-term tax-exempt interest rate. The long-term tax-exempt rate has been averaging around five-percent in recent months.

Example. Assume a target corporation had a value of $20 million immediately prior to an ownership change. Accordingly, the amount of taxable income in a post-change tax year that may be offset by the target's pre-change NOLs would be limited to $1 million (5% x $20 million). Since existing tax law sets a maximum carryforward period of 20 years, the value of any target NOLs in excess of $20 million in this example may be too speculative for the buyer to value.

We note, however, that if a target has an overall net built-in gain in its assets at the time of the ownership change, the annual limitation described above may be increased (subject to certain conditions and limitations) by the subsequent recognition of gains from the sale of the target assets to the extent the value of the asset exceeded its cost basis as of the change date. Thus, all things equal, a buyer may place more value on a target corporation's NOL carryforwards to the extent the buyer expects to offload some of the target's built-in gain assets. However, we note that the IRS has issued a notice which permits taxpayers to adopt an approach that may increase the annual Section 382 Limitation for an amount relating to built-in gain assets without actually having to sell such assets.

In general, a target corporation has an ownership change when one or more five-percent (or greater) shareholders increase their stock ownership in the target by more than 50 percentage points over the lowest percentage ownership of each such shareholder at any time during the preceding three year testing period. Thus, when a buyer acquires all the stock of the target corporation, there is clearly an ownership change and the amount of post-closing income that may be offset by the pre-change NOLs will typically be subject to the Section 382 Limitation. In addition, some or all of the NOL carryforwards that exist as of the closing date may be subject to not only the Section 382 Limitation as a result of the ownership change that occurs on the closing date, but also to other Section 382 Limitations as a result of ownership changes that may have occurred prior to the closing date. If an NOL carryforward is subject to more than one Section 382 Limitation, the most restrictive limitation is applied.

Example. Assume target corporation incurs an NOL of $10 million in 2006. Assume there was no income in 2007, but target corporation had an ownership change on December 31, 2007 when the target corporation was worth $50 million. The pre-change NOLs would be subject to Section 382 Limitation of $2.5 million ($50 million x 5%). For 2008, assume target had taxable income of $8 million. Due to the earlier Section 382 limitation, only $2.5 million of the $10 million of NOL carryforwards could be used to offset the 2008 income. Assume target patented some valuable technology and a buyer paid $100 million to acquire all of the stock of target on January 1, 2009. The Section 382 Limitation for the January 1, 2009 ownership change would be $5 million (5% x $100 million). The unused NOL carryforward of $7.5 million,

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however, remains subject to the more restrictive $2.5 million Section 382 Limitation.

A buyer will place greater value on NOLs to the extent it is comfortable that the target corporation's NOLs are not subject to a prior, more restrictive Section 382 Limitation. Again, a buyer can derive some comfort by performing due diligence procedures to ferret out any prior ownership changes and through contractual protections, some of which are described below.

Miscellaneous factors. Special issues arise when a target is a member of a consolidated group. Under the newly promulgated "unified loss rule," the tax attributes of the target, including its allocable share of the group's consolidated NOL, may be decreased after the transaction if the seller incurs a loss on the sale of its target shares and fails to elect to reduce its basis to eliminate the loss. It should also be noted that when a target corporation is purchased from a consolidated group, the target's allocable share of the group's consolidated NOL will not be ascertainable until the close of the group's tax year, which often will not be ended by the purchase of target from the selling consolidated group. Thus, some or all of the target's anticipated NOLs may be used to offset the income earned by other members of the selling consolidated group in the period from closing to the normal end of the selling consolidated group's tax year..

Other potential factors impacting NOLs include limitations imposed by the alternative minimum tax and possible future changes to applicable tax laws (e.g., possible changes to the corporate tax rates and carryforward and carryback periods).

Negotiation tactics and contract provisions

We believe that far too often the topic of NOLs is not discussed among the principals in a deal to any great extent or, if it is, at least not soon enough. However, we feel there are at least a couple of scenarios where the buyer or seller may want to address the issue head-on at an early stage of a deal.

First, a seller should consider taking a head-on approach where (1) the target corporation has significant NOLs; (2) the seller is confident about the quality and amount of the target's NOLs (confident enough to stand behind the NOLs if need be with contractual safeguards as described below); and (3) it is reasonably likely that taking this approach will result in an increase in the purchase price. If the seller does not take this approach, it risks leaving money on the table. Before taking such an approach, however, a seller may wish to confirm the amount and quality of a target's NOLs through its own due diligence.

Second, if a buyer is paying some amount for NOLs that is greater than "pennies on the dollar," it may want to take a head-on approach in order to seek explicit contractual protections that it would not otherwise obtain. Unless the topic of NOLs is brought up early in price negotiations or explicitly mentioned as an assumption in a buyer's bid, a buyer may have a more difficult time obtaining guarantees from the seller regarding the target's NOLs when the parties' tax lawyers begin negotiating the tax provisions of the purchase agreement. Often in deals where the topic is not broached soon enough, the most a buyer can hope for is a representation that the target has not undergone a prior ownership change for purpose of the Section 382 Limitation. In these cases, we believe it is unusual for a buyer to get any explicit assurance regarding the amount and remaining life of a target's NOL carryforwards. Indeed, a seller may even insert a provision explicitly carving out any guarantees regarding the amount and quality of the NOLs. Note that sellers may want to include such a provision because certain standard seller representations – such as the representation that the target's tax returns are materially correct – are broad enough to arguably provide the buyer with more protection than the seller intended.

One would expect some correlation between the amount and type of contractual protections to be provided and the price being paid for the NOLs. As discussed, if the buyer is paying pennies on the dollar, it should expect to receive an equivalently low level of protection from the seller. If the buyer is paying something more, but less than full value, perhaps a seller should, for example, agree to provide representations regarding the amount and quality of NOLs, but with some ceiling on damages.

Perhaps a better, but more complicated approach, is for the parties to eschew representations for which damages may be open-ended for more clearly defined purchase price adjustment mechanisms. For example, the parties could agree to make purchase price adjustments based on an agreed formula that takes into account any changes to specific underlying assumptions (e.g., assumptions regarding the amount of closing date NOLs that will leave with a target corporation, the lack of prior Section 382 Limitations, and the remaining carryforward periods for the NOLs).

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If the future utilization of the target's NOLs is questionable (for example, because the future taxable income of the target or its new consolidated group is difficult to forecast) another approach is to have the buyer pay the seller as a purchase price adjustment some agreed amount or percentage of future tax savings if and when the NOLs are actually utilized. In this case, sellers at least have a shot at benefiting from the target's NOLs and preventing a possible windfall to the buyer should future earnings prove favorable. The approach may of course be attractive to buyers since buyers would not have to come out of pocket until they actually realize the tax savings. It also has the added benefit of keeping both parties' interests aligned in the use of the NOLs since they both benefit from maximizing the buyer's use of the NOLs.

Since NOLs may be carried forward for 20 years, few buyers and sellers will want to be entangled for this long. Accordingly, the parties may want to consider adding a sunset provision on any such purchase price mechanics. Because the time value of money is one of the most important factors, perhaps most of the value may be captured in a relatively short sunset period. However, if a seller wants more of a clean break at closing, it should be prepared to accept a lower purchase price for the NOL carryforwards from the buyer.

Conclusion

As described above, depending on the circumstances, buyers and sellers may find it beneficial to specifically raise and discuss the value of a target's NOL carryforwards and related contract provisions early in their price negotiations. To do otherwise may result in a lower purchase price to a seller or an overpayment by a buyer. In any event, this is yet another reason to involve your tax lawyer as early in a deal as possible.

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