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Insights

THE U.S. SHOWS IT CARES BY ENACTING TAXPAYER-FRIENDLY MODIFICATIONS TO RULES FOR DEDUCTING NOLS

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Section 2303 of the Coronavirus Aid, Relief, and Economic Security Act (the "**CARES Act**"), enacted on March 27, 2020 (the "**Enactment Date**"), includes taxpayer-friendly modifications to the restrictions placed on the deductibility of net operating losses ("**NOLs**") pursuant to the Tax Cuts and Jobs Act of 2017 (the "**2017 Tax Act**"). In short, with respect to a taxable year beginning before January 1, 2021, the deduction for NOLs is not subject to a cap based on the taxpayer's taxable income for such year, and NOLs arising in a taxable year beginning in 2018, 2019, or 2020 may be carried back to each of the five taxable years preceding the taxable year in which the NOLs arose. Thus, NOLs from 2018 to 2020 can be carried back to recover taxes paid during 2013 through 2017, a time when the corporate tax rate was high as 35%, making the ability to carryback more valuable in terms of dollars saved (as compared to carrying the NOLs forward) , in addition to the cash flow benefits of the refunds.   Special rules apply to life insurance companies, corporations that have elected to be taxed as a real estate investment trust ("**REIT**"), and carrybacks to taxable years in which section 965 of the Internal Revenue Code of 1986, as amended (the "**Code**") applies. In addition, the CARES Act defers the effective time for the limitations on the use of business losses by non-corporate taxpayers (namely, owners of pass-through entities) added to section 461(l) of the Code by the 2017 Tax Act and includes technical amendments to effective dates set forth in the 2017 Tax Act.

Taxable Income Cap on Deductions of NOLs

In general, the 2017 Tax Act revised section 172 of the Code to reduce the percentage of a taxpayer's taxable income that may be offset in carryback and carryforward years from 100 percent to 80 percent (the "**80 percent limitation**"). The 2017 Tax Act applied the 80 percent limitation to NOLs arising in taxable years beginning after December 31, 2017. The CARES Act eliminates the 80 percent limitation with respect to NOLs carried back or forward to taxable years beginning in 2018, 2019, or 2020. With respect to taxable years beginning on or after January 1, 2021, a modified version of the 80 percent limitation continues to apply. Specifically, the total NOLs that may be deducted for a taxable year beginning on or after January 1, 2021, is equal to the sum of (1) the aggregate carryover of NOLs arising in taxable years beginning before 2018 ("**Pre-2018 NOLs**"), *plus*

(2) the *lesser of* (A) the aggregate carryover of NOLs arising in taxable years beginning after 2017, or (B) 80 percent of the amount by which taxable income for such year (computed without regard to deductions for NOLs and pursuant to sections 199A and 250 of the Code) exceeds the Pre-2018 NOLs.

Reinstatement of Carryback Period

Although the 2017 Tax Act retained the two-year carryback period for farming losses and certain insurance companies, the 2017 Tax Act otherwise eliminated the carryback period generally applicable to NOLs. The CARES Act amends section 172(b)(1) of the Code to permit *any* NOLs (i.e., including farming losses and for certain insurance companies) arising in a taxable year beginning in 2018, 2019, or 2020 to be carried back to each of the five taxable years preceding the taxable year of the loss. The CARES Act includes several special rules applicable to the five-year carryback period:

- **REITs**. NOLs generated during a taxable year in which a corporation elected to be taxed as a REIT may not be carried back. NOLs generated during a taxable year in which a corporation did not elect to be taxed as a REIT may not be carried back to any preceding taxable year in which the corporation elected to be taxed as a REIT.

- **Life Insurance Companies**. With respect to NOLS generated by a life insurance company in 2018, 2019, or 2020, the carryback of such NOLs to a taxable year beginning before January 1, 2018, is treated in the same manner as an "operations loss carryback" within the meaning of Section 810 of the Code (as in effect prior to the 2017 Tax Act).

- **Section 965**. If a taxpayer carries back NOLs to a year in which such taxpayer included deferred foreign income in taxable income under the provisions of section 965(a) of the Code (a "**section 965(a) year**"), then the taxpayer is treated as having made the election under section 965(n) of the Code with respect to such taxable year. The election under section 965(n) of the Code generally provides that the determination of the deductible amount of NOLs for the taxable year or the amount of taxable income which may be reduced by carryovers or carrybacks of NOLs to a section 965(a) year excludes (1) the amount included in subpart F income pursuant to section 965(a) of the Code, and (2) certain taxes deemed paid by a domestic corporation.

The CARES Act leaves intact the ability to waive the carryback period for NOLs for any taxable year. In addition, if the five-year carryback period with respect to any NOLs includes one or more section 965(a) years, the taxpayer may elect to exclude all such section 965(a) years from the carryback period in lieu of making the general election to waive the carryback period. The elections to waive the carryback period or to exclude section 965(a) years with respect to NOLs arising in a taxable year beginning in 2018 or 2019 must be made by the due date (including extensions) for filing the taxpayer's return for the first taxable year ending after the Enactment Date.

Modification of Section 461(l)

The 2017 Tax Act added subsection (l) to section 461 of the Code, which subsection generally restricts a non-corporate taxpayer's ability to use NOLs incurred in carrying on a trade or business to offset other types of income, namely, portfolio income such as dividends, interest, and certain capital gains. As originally enacted, section 461(l) of the Code applied to taxable years beginning after 2017 and before 2026. The CARES Act defers the applicability of section 461(l) of the Code to taxable years beginning after 2020 and before 2026.

Technical Amendments

The 2017 Tax Act provided that the changes to the carryback and carryforward periods applied to NOLs arising in taxable years *ending* after December 31, 2017, but the 80 percent limitation applied to NOLs arising in taxable years *beginning* after December 31, 2017. The effect of these provisions of the 2017 Tax Act was that, with respect to a taxpayer with a 2017/2018 fiscal year, NOLs arising in the 2017/2018 fiscal year were subject to the new carryback/carryforward periods but were not subject to the 80 percent limitation. The CARES Act incorporates technical amendments to the effective dates set forth in the 2017 Tax Act, including amendments to align the applicability of the 80 percent limitation and the amendments to the carryback and carryforward periods to NOLs arising in taxable years beginning after December 31, 2017. That is, the CARES Act makes clear that NOLS arising in the 2017/2018 fiscal year are subject to both the modified 80 percent limitation and the carryback/carryforward periods.

Procedures for Claiming Refunds Attributable to Carrybacks of NOLs

Aside from a special rule included for taxpayers with a 2017/2018 fiscal year (discussed below), the CARES Act does not include provisions that modify the generally applicable procedures for filing a claim for refund of taxes attributable to the carryback of NOLs. Accordingly, the following general rules should continue to apply:

- **Refunds of Estimated Taxes Paid by Corporations**. Corporate taxpayers that overpaid estimated taxes may file a claim for a "quickie refund" on Internal Revenue Service ("**IRS**") Form 4466. Such form must be filed after the close of the corporation's taxable year, but on or before the due date (*not* including extensions) for filing the income tax return for such year.

- **Tentative Refunds Attributable to Carryback of NOLs**. Pursuant to section 6411(a) of the Code and the corresponding Treasury Regulations, a taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a carryback of NOLs on IRS Form 1139 (for corporate taxpayers) or on IRS Form 1045 (for non-corporate taxpayers). Such applications must be filed on or after the date of filing the tax return for the taxable year of the NOL and no later than 12 months following the end of such taxable year. For example, a calendar-year corporate taxpayer that incurs NOLs in 2019 and plans to carry the NOLs back to the 2014 taxable year (i.e., the earliest year to which the NOLs may be carried back under the modified rules provided in the CARES Act) must file an application for a tentative carryback adjustment on or after the date such taxpayer files its 2019 corporate tax return and no later than December 31, 2020. The IRS typically processes IRS Forms 1139 and 1045 within 90 days of the filing of the application or, if later, within 90 days of the last day of the month that includes the extended due date for filing the tax return for the year in which the NOLs arose.

- **Refund Claim Pursuant to Amended Income Tax Return**. If the taxpayer is not eligible to use one of the refund claim methods described above, the claim for refund must be made on an amended federal income tax return (e.g., IRS Form 1120-X for corporate taxpayers). Generally, an amended return based on the carryback of NOLs must be filed within three years after the due date (including extensions) of the return for the taxable year in which the NOLs arose. The instructions to IRS Form 1120-X provide that it often takes several months to process an amended tax return, but there is no obligation on the IRS to act (i.e., issue the refund) once processed.

The CARES Act includes a special provision permitting a fiscal year taxpayer to utilize the "tentative refund" procedures discussed above with respect to the carryback of NOLs arising in the 2017/2018 fiscal year. Specifically, the rule provides that, with respect to NOLs arising in a taxable year beginning before January 1, 2018, and ending after December 31, 2017, an application under section 6411(a) of the Code with respect to the carryback of such NOLs will be treated as timely if filed no later than 120 days after the Enactment Date. However, the CARES Act does not include a special provision extending the due date of a tentative refund application (i.e., IRS Forms 1139 or 1045) with respect to the carryback of NOLs arising in the 2018 calendar year. That is, as currently drafted, a calendar year taxpayer that wishes to carryback NOLs arising in 2018 must file an amended income tax return (e.g., IRS Form 1120-X for corporate taxpayers). It is unclear whether the differing treatment of NOLS arising in calendar year 2018 versus fiscal year 2017/2018 was intentional or simply an oversight of the drafters.

Considerations

Corporate taxpayers that paid estimated taxes toward their current year or 2019 federal income tax liability should analyze whether they have overpaid such taxes in light of the modifications to the restrictions on the use of NOLs or as a result of any other relief provided by the CARES Act. If such overpayments exist, such corporate taxpayers should consider filing a claim for a "quickie refund" on IRS Form 4466. Although the Treasury extended the due dates for 2019 income tax returns for all taxpayers, a "quickie refund" claim for 2019 estimated taxes should be filed on IRS Form 4466 no later than April 15, 2020, because extended due dates for tax returns are not taken into account in determining the due date of IRS Form 4466.

In addition, taxpayers considering the potential value of carrying back NOLs to a taxable year beginning before January 1, 2018, should analyze the impact of the alternative minimum tax. The 2017 Tax Act repealed the corporate alternative minimum tax for all C corporations for taxable years beginning after December 31, 2017. Prior to its repeal, the deduction a corporation was allowed in computing its alternative minimum tax liability for an NOL carryover or carry back to a particular tax year could not exceed 90% of taxable income before reduction for any NOL.

Last, taxpayers should consider the impacts of the modifications to the NOL rules on M&A transactions. Since the 2017 Tax Act, planning with respect to NOLs became limited to prospective years. This impacted M&A transactions by increasing negotiations over tax benefits related to deductions generated by the transaction, such as success-based fees and compensatory change in control payments. Taxpayers should consider revisiting purchase and sale agreements entered into after 2017 to determine whether the CARES Act amendments provide opportunities to increase the value of such transaction tax deductions by carrying back any NOLs arising therefrom.

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MEET THE TEAM

Cathryn R. Benedict

St. Louis

cathryn.benedict@bclplaw.com
+1 314 259 2146

Frank A. Crisafi

Atlanta

frank.crisafi@bclplaw.com
+1 404 572 6840

Philip B. Wright

St. Louis / New York

philip.wright@bclplaw.com
+1 314 259 2499