CARES Act permits NOL carrybacks, increases interest deduction limitation

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In brief

Tax relief measures for businesses in the 'Coronavirus Aid, Relief, and Economic Security Act' (the CARES Act) include a five-year net operating loss (NOL) carryback (including a related technical correction to the 2017 'Tax Cuts and Jobs Act' (the TCJA)) and a change in Section 163(j) interest deduction limitations. These measures give businesses greater ability and flexibility to use NOLs and interest deductions to offset their taxable income, providing them with liquidity and a reduced cost of capital as they grapple with the economic effects of the pandemic. While these measures generally are welcome to expand the options available to taxpayers to access additional 'internal' funding, the interplay of these new provisions within the TCJA framework requires careful evaluation of their potential benefit and tax consequences.

In detail

Background

In the TCJA, in connection with lowering the corporate income tax rate, Congress also broadened the tax base, by modifying the ability of taxpayers to take certain deductions into account in computing taxable income. Of specific relevance to the CARES Act, the TCJA eliminated the ability to carry back NOLs for most taxpayers and imposed a limit on the amount of NOL carryovers that could be taken into account each year. The TCJA also revised and broadened the interest expense limitation rules of Section 163(j).

In response to liquidity issues that businesses are facing as a result of the COVID-19 pandemic, the CARES Act temporarily reverses or modifies some of the changes made by the TCJA. First, the CARES Act provides businesses with the ability to amend returns to carry back NOLs and permits such NOLs to fully offset taxable income. In addition, the CARES Act temporarily increases the Section 163(j) limitation to permit businesses to borrow cash at a reduced cost of capital.

NOLs

The TCJA provided that (1) for most taxpayers, NOLs arising in tax years ending after December 31, 2017, could not be carried back to offset income in any prior tax year; and (2) NOLs arising in tax years

beginning after December 31, 2017 and carried over to another tax year are limited to offsetting 80 percent of a corporation's taxable income in such carryover year, computed without regard to the NOL deduction.

The CARES Act allows corporations to carry back their NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021, to each of the five tax years preceding the tax year of the loss. Refund claims with respect to overpayments attributable to such NOL carrybacks are timely if they are filed during the period ending three years after the due date (including extensions) for the tax year of the NOL.

Carryback elections

A taxpayer can elect to waive the entire carryback period for a 2018 or 2019 NOL by filing a statement with the IRS by the due date (including extensions) for filing the taxpayer's return for the first tax year after the enactment of the CARES Act. A carryback waiver election for a 2020 NOL can be filed by the due date (including extensions) for filing the return for the 2020 tax year.

A taxpayer also may elect not to carry back NOLs to a year with an income inclusion by reason of Section 965 (toll charge income). If an NOL is carried back to such a year, then the taxpayer is treated as having made an election under Section 965(n). An election under Section 965(n) essentially precludes a taxpayer from applying an NOL carryover (and now carryback) against toll charge income, thus preserving the ability to utilize NOLs against other future income that may be subject to less favorable treatment than toll charge income.

Furthermore, the CARES Act reinstates the historic pre-TCJA real estate investment trust (REIT) carryback rules, which provide that REITs may not carry back an NOL from a REIT year to any preceding tax year. In addition, if an NOL arises in a non-REIT year, it may not be carried back to any preceding tax year that is a REIT year.

Observation: Carrying back an NOL to a year with toll charge income may result in the corresponding refund being applied to future installment payments due with respect to the toll charge income. A technical correction to the TCJA has been proposed to prevent this result, but that correction was not adopted in the CARES Act. Electing not to carry back an NOL to a year with toll charge income would avoid this result but also could mean carrying the NOL to a subsequent year when the corporate tax rate is 21 percent instead of 35 percent.

Technical corrections

The CARES Act includes a technical correction to the TCJA to make the pre-TCJA carryback rules apply to NOLs generated in tax years beginning in 2017 and ending in 2018. Accordingly, such NOLs are eligible to be carried back to each of the two preceding tax years. A second technical correction provides that tentative refund claims under Section 6411(a) with respect to such NOLs—and elections to reduce the period to which NOLs may be carried back or to revoke an election to forgo any carrybacks—will be treated as timely filed if filed no later than 120 days after the enactment of the CARES Act. Taxpayers making a claim for refund under the NOL carryback provisions of the CARES Act can do so by filing Form 1139, Corporation Application for Tentative Refund, which is ordinarily required to be filed within 12 months of the end of the tax year in which the NOL arose.

Taxable income limitation

The CARES Act temporarily removes the 80 percent of taxable income limitation on the use of NOL carryovers. For taxable years beginning before January 1, 2021, taxpayers now may fully offset their income with NOL carryovers. The CARES Act also amends the limitation on NOL carryovers for tax years beginning after December 31, 2020. Under the revised provision, there is no limit on the use of NOLs generated in tax years beginning before January 1, 2018, but the use of NOLs generated in tax years beginning after December 31, 2017 and carried to a tax year beginning after December 31, 2020, is limited to 80 percent of the excess (if any) of taxable income computed without regard to the NOL deduction and the deductions under Section 199A and Section 250, over the amount of NOL carryovers from taxable years beginning before January 1, 2018.

Observations

Observation: Parties to an acquisition entered into after enactment of the TCJA may not have considered or included language in their legal agreements regarding the ability of the buyer to carry back NOLs generated by the target in 2018 and subsequent tax years to earlier tax years. Now that NOL carrybacks temporarily are available, taxpayers should

consider how carrying back NOLs and amending pre-acquisition returns might be treated under the purchase agreement, including who is entitled to any refund arising from the carryback. Taxpayers also should consider any limitations that might apply to the use and carryback of NOLs.

Observation: The ability to carry back post-TCJA NOLs to offset pre-TCJA income should result in greater cash tax savings/refunds to taxpayers because post-TCJA NOLs now can be carried back to offset pre-TCJA income subject to a 35-percent tax rate, rather than carried forward to offset post-TCJA income subject to a 21-percent tax rate. In addition, taxpayers who had cancellation of indebtedness income in 2018 or 2019 and who reduced NOLs under Section 108(b) should revisit their Section 108 attribute write-down schedules to assess whether the NOLs should be carried back rather than written down under Section 108(b). While the ability to carry back NOLs provides a welcome relief to many corporations experiencing economic impacts from the COVID-19 pandemic, the ability to increase liquidity via the loss carrybacks may not be immediate in most cases. For example, a corporation with a tax year ending December 31, 2020 may not determine its NOL until sometime in 2021.

Observation: While there is no mechanism to request a refund for estimated taxes for the 2020 tax year, a taxpayer can file a Form 4466 now (and until April 15, 2020) to get back estimated taxes from calendar year 2019.

Observation: The consequences of the amended 80-percent limitation on post-TCJA NOLs will need to be considered on a case-by-case basis. However, calculating the limitation based on the excess of taxable income over the amount of pre-TCJA NOLs carried to a tax year raises the potential concern that post-TCJA NOLs may be limited by the full amount of pre-TCJA NOLs, even if the use of those pre-TCJA NOLs is limited by another provision, e.g., Sections 382, 384, and 269 and Treas. Reg. sec. 1.1502-21(c).

Observation: Carrying back an NOL to a year in which the taxpayer recognizes a global intangible low-taxed income (GILTI) inclusion under Section 951A or earns foreign-derived intangible income (FDII) may diminish or eliminate the benefit of the NOL. Specifically, GILTI inclusions and FDII are subject to a reduced rate of tax by reason of the deduction under Section 250, which is limited based on the taxpayer's taxable income and thus lost to the extent an NOL carryforward or carryback offsets GILTI inclusions or FDII. In addition, foreign tax credits associated with a GILTI inclusion may not be carried forward or back, and consequently an NOL carryforward or carryback that offsets GILTI inclusions would result in the loss of those foreign tax credits. Taxpayers in this situation also should consider the impact of the overall domestic loss (ODL) and separate limitation loss (SLL) rules as they relate to foreign tax credits with respect to future GILTI inclusions.

Note: See links to the PwC Insights below for a further discussion of the NOL provisions in the CARES Act and tax accounting considerations and potential impacts to the recording of deferred tax assets (i.e., NOLs).

Section 163(j)

Section 163(j) generally limits the deduction of business interest expense (BIE) in a given tax year to the sum of (1) the taxpayer's business interest income, (2) 30 percent of the taxpayer's adjusted taxable income (ATI), and (3) the taxpayer's floor plan financing interest. ATI is taxable income computed without regard to (1) items not properly allocated to a trade or business; (2) BIE or business interest income; (3) NOLs; (4) the Section 199A deduction; and (5) for tax years beginning before January 1, 2022, deductions allowable for depreciation, amortization, and depletion. Thus, when calculating a taxpayer's ATI, certain deductions are added back to taxable income, and certain income (e.g., business interest income) is subtracted.

The CARES Act amends Section 163(j) for tax years beginning in 2019 and 2020 by increasing the percentage of a taxpayer's ATI from 30 percent to 50 percent for purposes of calculating the limitation under Section 163(j). Except with respect to a partnership, a taxpayer may elect for any year to not increase its ATI percentage from 30 percent to 50 percent. A partnership may only elect to do so for a tax year beginning in 2020. Once made, such an election is revocable only with the consent of the IRS.

For tax years beginning in 2020, the CARES Act provides additional flexibility by permitting a taxpayer to elect to substitute its ATI from its 2019 tax year for its ATI in its 2020 Section 163(j) calculation. Special rules apply with respect to short tax years.

In the case of a partnership, the CARES Act provides that the percentage change does not apply to the 2019 tax year. Instead, 50 percent of any excess business interest expense (EBIE) that the partnership allocated to each partner in 2019 will be treated as paid or accrued by the partner in 2020 and not subject to Section 163(j). The remaining 50 percent of each partner's 2019 EBIE remains subject to the normal rules of Section 163(j). Each partner may elect out of the special rule for 2019. For 2020, the percentage change applies to partnerships unless the partnership (not the partners) elects out of the rule.

Observation: The amendments to Section 163(j) are intended to provide relief to taxpayers by calculating the limitation based on a higher percentage of ATI and allowing taxpayers to substitute their 2019 ATI, which in many cases may be higher than their 2020 ATI due to the economic downturn. Substituting 2019 ATI in 2020 also may result in the best of both worlds for a taxpayer. For example, if a taxpayer has ATI of $200 in 2019 and $100 in 2020, in general, the Section 163(j) limitation would be $100 (i.e., 50 percent of $200) for both years.

Consequences of partnership rules

The partnership rules, however, may have unexpected consequences for some taxpayers. For example, assume A and B (both corporations) are equal partners in partnership PRS, and in 2019 PRS has $100 of ATI and $50 of BIE. To calculate its Section 163(j) limitation, PRS will multiply its ATI by 30 percent, limiting its ability to deduct BIE to $30. Accordingly, PRS will allocate its $20 of total EBIE equally to A and B.

In 2020, pursuant to Section 163(j) as amended, 50 percent of the EBIE allocated by PRS to A and B in 2019 is treated as paid or accrued and not subject to the Section 163(j) limitation (unless A or B elects out of the rule). Thus, each partner may deduct $5 of the EBIE allocated to it in 2019; the ordinary rules of Section 163(j) apply to each partner's remaining $5 of EBIE. Finally, in 2020, PRS will apply the increased percentage, 50 percent, in calculating its Section 163(j) limitation for its 2020 tax year.

In the aggregate, the PRS partners deducted $40 of BIE assuming each applied the special partnership rule for 2019 (i.e., $30 under the normal rules plus an additional $10 under the special rule), whereas a similarly situated corporation would have deducted $50 ($20 more than under pre-amendment Section 163(j)). Thus for 2019, amended Section 163(j) favors partnerships with higher EBIE amounts. To illustrate, if PRS had $100 of BIE in 2019 instead of $50, its Section 163(j) limitation in 2019 remains $30, and PRS allocates $70 of EBIE to A and B. In 2020, 50 percent of the 2019 EBIE is treated as paid or accrued and not subject to the Section 163(j) limitation, allowing A and B to deduct an additional $35, increasing their aggregate deduction to $65, $15 more than a similarly situated corporation.

Election out

Despite what appears to be a clear benefit from the increased limitation for most taxpayers, eligible taxpayers may want to elect out of the provision in certain circumstances. First, the increase may have adverse impacts on interest expense allocations or taxable income limitations. Second, an increase in deductible business interest expense for regular income tax purposes may subject a taxpayer to the base erosion and anti-avoidance tax (the BEAT). In order to be subject to the BEAT, among other requirements, an applicable taxpayer's base erosion tax benefits (i.e., its deductible payments to foreign related parties) generally must be equal to or greater than three percent of all its deductible expenses, including such base erosion tax benefits.

The ordering rules in the BEAT regulations effectively treat deductible BIE under Section 163(j) as first made to related parties, including foreign related parties. Thus, if a taxpayer's Section 163(j) limitation is increased from 30 percent to 50 percent of ATI (thereby increasing the taxpayer's interest deductions), the taxpayer's base erosion tax benefits and, thus, its BEAT liability, also may concomitantly *increase*. The higher BEAT liability may be significantly higher than any additional benefit of the interest deduction for regular income tax purposes. Thus, due to these types of interactions such as with BEAT, a taxpayer may be better suited to elect out of the percentage increase to ATI.

Similarly, if a taxpayer has 2020 ATI that is less than its 2019 ATI, the decision to elect to use 2019 ATI for the 2020 tax year will depend on the taxpayer's circumstances. In some cases, using the higher 2019 ATI amount for the 2020 tax year will give rise to higher deductions for regular income tax purposes, increasing cash tax savings. In other cases, the taxpayer may prefer to use its lower 2020 ATI because taking additional interest deductions for payments to foreign related parties would give rise to a higher BEAT liability.

Observation: To the extent the limitation under Section 163(j) applies to interest deductions of a CFC (e.g., for purposes of determining subpart F income or tested income under the GILTI rules), the amendments to Section 163(j) under the CARES Act, including the aforementioned elections, may also apply at the CFC level.

The takeaway

The CARES Act amendments to Sections 172 and 163(j) should provide welcome relief to businesses impacted by the economic effects of the COVID-19 pandemic. However, taxpayers should assess their respective positions and consider whether any potential items (e.g., SRLY rules, purchase agreement mechanics, and BEAT) could adversely affect the intended benefit sought from the use of these provisions. Further, taxpayers should consider the timing of any cash benefit from the use of these provisions in light of their liquidity needs.

See Also:

- Senate passes 'Phase Three' COVID-19 economic stabilization legislation
- CARES Act: Accounting for the stimulus
- Using tentative refund procedures to access cash from estimated tax overpayment, new NOL carryback

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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