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insights

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Effect of COVID-19 tax legislation on NOL carryforwards and carrybacks

As many of you already know, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") substantially liberalizes the ability to carry back and carry forward net operating losses ("NOLs") and in many cases restores the favorable provisions that applied before enactment of the Tax Cuts and Jobs Act of 2017 ("the "TCJA"). The Internal Revenue Service (the "IRS") has taken this liberalization even further by extending filing dates and loosening other NOL-related provisions.

The CARES Act

In summary, the CARES Act: (i) removes the 80% limitation on the use of NOLs enacted by the TCJA with respect to NOLs carried to any taxable year beginning before January 1, 2021, and, thus, NOLs (whether carried forward or carried back) can generally be used to offset fully taxable income in these taxable years; and (ii) provides for a carryback of any NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year in which the NOL arose.

In more detail:

- **Prior to 2018**: NOLs generated in any taxable year beginning on or before December 31, 2017, that are carried forward or carried back to taxable years beginning on or after January 1, 2018, are not subject to the 80% TCJA limitation (i.e., such amounts are **fully deductible**). These NOLs can be carried back two taxable years and carried forward twenty taxable years.

- **During 2018, 2019 and 2020**: NOLs generated in any taxable year beginning after December 31, 2017, and before January 1, 2021, that are (i) carried forward or carried back to taxable years beginning before January 1, 2021, are not subject to the 80% TCJA limitation (i.e., such amounts **are fully deductible**); and (ii) carried forward to taxable years beginning on or after January 1, 2021, are subject to the 80% TCJA limitation (i.e., such amounts **are not fully deductible**). These NOLs can be carried back five taxable years and carried forward indefinitely.

- **After 2020**: NOLs generated in any taxable year beginning after December 31, 2020, that are carried forward to taxable years beginning on or after January 1, 2021, are subject to the 80% TCJA limitation (i.e., such amounts **are not fully deductible**). These NOLs cannot be carried back but can be carried forward indefinitely.

How to generate NOL carryforwards and carrybacks

Taxpayers should consider making accounting method changes, especially in 2020, in order to maximize the amount of any NOL.

How to use NOL carryforwards and carrybacks

In general, unless a carryback period is waived, NOLs will first be carried back to the earliest taxable year and if not used in full will be carried back to the next earliest year and so on before an NOL is carried forward. For example, if an NOL was generated in 2018, the NOL would be carried back first to 2013.

Ideally, NOLs would be carried back to taxable years when the corporation was taxed at a 35% rate (e.g., taxable years beginning prior to December 31, 2017); however, the IRS may deny a carryback, in whole or in part, based on erroneous positions taken in prior taxable years. The carryback of an NOL entitles a corporation to a tax refund, even if the earlier year is closed by the applicable statute of limitations. Taxpayers should be aware that a carryback of an NOL may reopen the limitations period.

As mentioned, as an alternative to carrying back NOLs, the carryback period can be waived. Waivers of NOL carrybacks make sense in some of the following cases: (i) the corporate effective tax rate is higher in future years; (ii) the need to avoid IRS re-examination of prior taxable years; (iii) a purchaser of a corporation wishes to obtain the benefits of NOLs going forward; (iv) to avoid AMT in carryback periods; or (v) a purchase agreement requires the purchaser to share any refunds generated by an NOL carryback with a seller.

Moreover, corporations taking advantage of NOL carrybacks will have to consider, among other factors, the following: (i) whether the membership of a consolidated group has changed, as well as the possible effect of any separate return loss years; (ii) NOL carrybacks cannot be offset against income inclusions under Section 965 of the Internal Revenue Code of 1986, as amended (the "Code"); and (iii) the effect of foreign tax credit carryovers, as well as prior years' tax credits.

In IRS Notice 2020-24, consistent with newly-enacted Section 172 of the Code, a taxpayer (i) may waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019; and (ii) may exclude from the carryback period NOLs arising in 2018, 2019, or 2020 if an inclusion is required in that taxable year by reason of Section 965 of the Code. IRS Notice 2020-24 provides various filing requirements in order to waive carrybacks or exclude NOLs.

Typically, a corporation would obtain what is termed a "quick refund" by filing IRS Form 1139 within twelve months after the end of the loss year. Alternatively, a corporation's refund claim can be filed on IRS Form 1120X within three years of the due date, plus extensions, for filing the original return for the loss year. Both types of refund claims can be reduced by amounts the IRS contends are owed by the taxpayer. In IRS Notice 2020-26, the IRS extended for six months the deadline for filing a tentative carryback adjustment regarding an NOL that arose in any taxable year that began during 2018 and ended on or before June 30, 2019.

Overall, a carryback may generate immediate cash, but, as a practical matter, many corporations will first suffer a taxable loss in 2020, which will delay the cash benefit of any NOL carryback.

Because of the interaction between the new NOL provisions and other sections of the Code, taxpayers should consult their tax advisors prior to filing a refund claim or waiving the carryback period.

Ed Buchholz and Rick Lawton are members of Thompson Coburn's Tax group.

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authorsTest

edward

Edward J. Buchholz

richard

Richard L. Lawton