

NOL Treatment on Federal Corporate and Individual Tax Returns: Challenges for Preparers

TUESDAY, JUNE 16, 2020, 1:00-2:50 pm Eastern

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NOL Treatment on Federal Corporate and Individual Tax Returns: Challenges for Preparers

Changes Under the CARES Act, the Proposed 382 Regulations, Calculating the Section 382 Limitation



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Agenda

Topic	Minutes
Overview of the NOL Operating Rules, including new carryback rules	25
Special issue with NOLs for corporate return taxpayers	30
Section 382 ownership change restrictions	25
Restrictions and allowances in calculating NOLs for individuals	30
Pass through Allocations	20

Objectives

By the end of this course, you will be able to deal with these and other problematic aspects of NOLs:

- The change in NOL carryback and NOL carryback rules for individuals and corporations
- New procedures for submitting Forms 1139 and 1045
- When Section 382 change in ownership limitations apply
- The effect of the proposed regulations on Section 382 limitations
- Challenges in allocating NOLs to shareholders of pass-through entities

Subchapter C and Consolidated Return Considerations

Summary of CARES Act NOL & AMT Provisions

- NOLs arising in taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2021 are eligible for a five-year carryback.
 - Section 965 and FTC consideration
- NOLs arising in taxable years beginning prior to Dec. 31, 2017 and ending after Dec. 31, 2017 are eligible for a two-year carryback.
- 80% taxable income limitation suspended for taxable years beginning before Jan. 1, 2021.
- Minimum tax credits immediately refundable in 2019 with the option to elect to refund in 2018.

Alternative Minimum Tax Implications

- No guidance has been released on the issue of whether an alternative tax NOL (ATNOL) exists.
- There are currently two competing approaches:
 - TCJA “repealed” the corporate AMT per H.R. Rept. 115-466 which would imply a corporation has no ATNOL for taxable years beginning after Dec. 31, 2017.
 - Various case law supports a position that the corporate AMT is not repealed, but instead has a 0% tax rate.
- Applicability of adjustments and preference items is unknown.
- WNT has contacted Treasury and the IRS for more guidance.

General Transaction Considerations

- Transaction agreements should address ownership of the refunds.
- Who files the carryback claim and who receives the refund?
- To the extent losses are carried back creating a minimum tax credit or releasing other tax credits, consideration may need to be given to sections 382 and 383.
 - Companies that had not been loss companies may retroactively become subject to section 382
- M&A transactions (mergers and liquidations) could impact available carrybacks
- Allocations of deductions within a consolidated group become more important
 - Which members have the best carryback opportunities?
 - Next-day rule considerations

General Transaction Considerations (cont.)

- P forms MergerSub which merges with and into T, a stand-alone corporation, with T surviving. P then causes T to merge with and into P's newly created subsidiary S. S has no prior business activity. The group generates a \$200 NOL with \$100 attributable to S. Which tax years can the S NOL be carried to?
- What considerations should you take into account?
 - F reorganization?
 - Offspring rule?
 - Was a section 338(h)(10) election made?

Consolidated Return Considerations

- **Offspring Rule** – Regs. Sec. 1.1502-21(b)(2)(ii)(B)

Example 1:

- Consolidated Group forms new sub, S, on Dec. 31, 2016. The consolidated group generated a consolidated NOL (CNOL) in the tax year ended Dec. 31, 2018. A portion of that CNOL is attributable and apportioned to S.
- The consolidated group may carry back those NOLs attributable to S in 2018 to the 2013 consolidated return year, prior to S being a member.
- If the common parent was not filing a consolidated return in the carryback year, the common parent could carry back S's apportioned CNOL to the common parent's separate year return assuming the parent was not a member of another consolidated or affiliated group.

Consolidated Return Considerations (cont.)

- **Acquired corporation NOLs**

- A consolidated group cannot carry back NOLs of an acquired loss subsidiary to years prior to the loss sub joining the consolidated group.
- The loss sub can itself carryback its apportioned amount of the CNOL to its own separate return years
- What if the loss sub was a member of another consolidated group prior to joining the new consolidated group?
- The old consolidated group would be required to file the carryback claim and would receive the refund.

Consolidated Return Considerations (cont.)

- **Acquired corporation NOLs (cont.)**

- Regs. Sec. 1.1502-21(b)(3)(ii)(B) provides for an election to relinquish, with respect to all CNOL attributable to the acquired member, the portion of the carryback period when the sub was a member of another cons. group.
- This election must be filed with the original return of the consolidated group's first return including the acquired sub.
- If this election was not made, to keep the acquired member's apportioned CNOL from being carried back to the seller group's consolidated return, the new consolidated group must waive the carryback period entirely for the loss year in question, which is an all-or-nothing election.

Consolidated Return Considerations (cont.)

- **Acquired corporation NOLs (cont.)**

Example 2:

- P owns 100% of the stock of S and files a consolidated return. On Dec. 31, 2017, S acquires the stock of T who was a part of another consolidated group.
- On P's originally filed 2018 return, its first return with T as a member, P did not make the election under Regs. Sec. 1.1502-21(b)(3)(ii)(B).
- In 2019, P incurs a CNOL of \$90, \$30 of which is apportioned to T. If P wishes to carryback its losses from 2019, the \$30 of CNOL apportioned to T must be carried back to T's prior consolidated group first to the extent the prior consolidated group has taxable income in the carryback period.
- P has the option to forego the five-year carryback period, however such election would apply to the full \$90 CNOL.

Consolidated Return Considerations (cont.)

- **Departing member NOLs**

- Where a loss member leaves a consolidated group, the consolidated group first uses that member's NOLs to offset income in the consolidated return year of the departure.
- Then the loss member carries over any of its remaining NOLs to its first separate return year (or the first return year of another consolidated group).
- Loss of a member that left the group in 2019 is eligible for group carryback prior to carry forward

International Tax Implications of the NOL Carryback

Impact of NOL Carryback on Foreign Tax Credits

- Absorption of NOL carryback may “release” previously utilized FTCs and allow them to be carried back/forward (back 1 year, forward 10)
 - As a result, taxpayers may have a greater FTC carryforward from the NOL carryback year
 - Must file **Form 1120x** to claim newly released credits in carryover year
 - Global intangible low-taxed income (GILTI) FTCs do not carryforward
- A domestic-source NOL carryback may create, or increase, an overall domestic loss (ODL) account that may be beneficial in a subsequent tax year
 - A U.S. source NOL deduction first offsets domestic income. Any excess offsets foreign income, reducing the FTC limitation and creating or increasing an ODL account that may be recaptured in a subsequent year

Impact of NOL Carryback on Foreign Tax Credits (cont.)

- A foreign-source NOL carryback may create, or increase, a separate limitation loss (SLL) or overall foreign loss (OFL) account, which could be detrimental in a subsequent tax year, including in the section 965 transition tax year
 - A foreign-source NOL deduction first offsets foreign income. Any excess offsets domestic income, creating or increasing an OFL account
- Current FTC regulations do not provide transition rules to address the carryback of branch and GILTI separate limitation losses (SLLs)

NOL Carryback to a Post-TCJA Year

- Taxpayer carries back 2020 NOL to its 2018 and 2019 taxable years (assume no taxable income in pre-2018 tax years)
- Any GILTI inclusion for 2018 and 2019 is effectively subject to a 21% rate **with NO relief for double tax**
 - Carryback to 2018 and 2019 may result in 21% tax attribute (an NOL deduction) offsetting FDII and GILTI; section 250 deduction eliminated with no future recapture
 - GILTI FTCs eliminated with no carryforward

Pre-CARES Act Results			
	2018	2019	2020
Taxable Income (Loss)	\$200	\$200	\$(400)
Corporate Tax Rate	21%	21%	21%
Tentative Tax	\$42	\$42	\$ –
Current FTCs allowed (all GILTI)	\$12	\$12	\$ –
Post-FTC Net Liability	\$30	\$30	\$ –
Post-CARES Act Results			
Taxable Income (Loss)	\$200	\$200	\$(400)
NOL Carryback <i>*No FTC carryforward for excess GILTI FTCs</i>	\$(200)	\$(200)	\$ –
Refund	\$30	\$30	\$ –
FTC Carryforward (cumulative)	\$0*	\$0*	\$ –

Interaction with Section 965

- **The CARES Act provides two options for how the five-year carryback interacts with a section 965 inclusion year:**
 - Taxpayers may elect to “skip” **all** section 965 inclusion years as part of the carryback period
 - Otherwise, taxpayers are deemed to have made a section 965(n) election to forego offsetting the section 965 inclusion with its 2018-2020 NOL carrybacks
- **Section 965(n) in TCJA**: Taxpayers could make an election on an original return to exclude a section 965 inclusion when computing:
 - a current year NOL for a section 965 inclusion year, or
 - the amount of a section 172(a) deduction for a section 965 inclusion year
- Thus, under TCJA, a section 965(n) election could create or increase a current year NOL

Interaction with Section 965 (cont.)

- **CARES Act**: Deemed election means taxpayers can only use an NOL carryback to offset non-section 965 income
 - IRS recently indicated that new deemed section 965(n) election only applies to a CARES Act carryback of an NOL into a section 965 inclusion year. (Sec. 4.02 of Rev. Proc. 2020-24)
 - As such, deemed election does not apply to a loss arising in the section 965 inclusion year; taxpayer stuck with decision made on original return filed. As there is some inequity here, taxpayers likely to lobby for different answer
- Taxpayers that use NOL carrybacks in a section 965 inclusion year are, for now, still stuck with IRS approach to refunds and overpayments with regard to section 965(h) eight-year installment liability
 - No refunds for a section 965 inclusion year unless section 965 liability has been fully paid

No Election to Skip Section 965 Inclusion Year – NOL Carryback Without FTCs

Even if the election to skip the section 965 inclusion year is not made, NOL carryback does not decrease section 965 inclusion due to deemed section 965(n) election.

Pre-CARES Act Results						
	2015	2016	2017	2018	2019	2020
Taxable income	1,000	1,000	1,000	1,000	1,000	(5,000)
Corporate tax rate	35%	35%	35%	21%	21%	21%
Non-965 tax liability	350	350	350	210	210	-
965 Inclusion			3,000			
Tax @ 10% after 965(c) deduction			300			
Total tax liability	350	350	650	210	210	0
Post-CARES Act Results						
Taxable income	1,000	1,000	1,000	1,000	1,000	(5,000)
Carryback	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	
Corporate tax rate	35%	35%	35%	21%	21%	21%
Non-965 tax liability	0	0	0	0	0	-
965 Inclusion			3,000			
Tax @ 10% after 965(c) deduction			300			
Total tax liability	0	0	300	0	0	0

No Election to Skip Section 965 Inclusion Year – NOL Carryback with FTCs

- NOL carryback eliminates 2015 and 2016 taxable income, creating a \$40 FTC carryforward to 2017
- These FTCs will be used against the transition tax regardless of whether taxpayer elects to skip the section 965 year for purposes of carrying back the 2020 NOL
- For 2017, the \$350 of regular tax previously paid + \$60 of newly released credits available to offset the section 965 inclusion would fully pay off the section 965 tax liability, such that a refund should be available – presumably for the excess of \$410 over the balance due for the transition tax (\$300, less any prior installment payments)

Post-CARES Act Results						
	2015	2016	2017	2018	2019	2020
Taxable income	1,000	1,000	1,000	1,000	1,000	(5,000)
Carryback	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	
Corporate tax rate	35%	35%	35%	21%	21%	21%
Non-965 tax liability	0	0	0	0	0	-
965 Inclusion			3,000			
Tax @ 10% after 965(c) deduction			300			
Tentative tax	0	0	300	0	0	0
FTCs claimed	20	20	20 60	10	10	
FTC carryforward (cumulative)	20	40	0	0*	0*	
Total tax liability	0	0	240	0	0	0

*Assume 100% of 2018-2020 FTCs were GILTI basket

Should a Section 965 Inclusion Year be Skipped?

Taxpayers should model both scenarios

- Reasons a taxpayer may want to skip the section 965 inclusion year(s):
 - A section 965 inclusion year is 2018 (because of 11/30 CFCs) and reducing the non-section 965 taxable income adversely impacts the section 250 deduction, section 163(j), or BEAT modified taxable income calculation
 - Profile is more favorable in 2019
 - FTC carryforwards from pre-TCJA years would expire if the NOL is utilized in the section 965 inclusion year(s)
 - If 2017 is a section 965 inclusion year, using the NOL would result in FTC carryforwards being claimed in a post-TCJA year, which would reduce the regular tax against which BEAT liability is determined
 - Although IRS guidance does not allow refunds for overpayments of regular tax liability or section 965 liability for the section 965 inclusion year until the entire liability is paid, refunds of regular tax liability are allowed for future years that are within the 8-year installment window (e.g., 2018 and 2019 after a 2017 section 965 inclusion year)
- On the other hand, if 2017 is a section 965 inclusion year, the rate arbitrage (21% vs. 35%) makes using the NOL generally favorable if the taxpayer does not need the cash

Election to Skip Section 965 Inclusion Year

Election to skip a section 965 inclusion year could be beneficial if, for example, expiring FTCs are available to offset other taxable income that year or, in a cash crunch, skipping the year facilitates a refund in a subsequent year.

Post-CARES Act Results						
	2015	2016	2017	2018	2019	2020
Taxable income	1,000	1,000	1,000	1,000	1,000	(4,000)
Carryback	(1,000)	(1,000)	0	(1,000)	(1,000)	
Corporate tax rate	35%	35%	35%	21%	21%	21%
Non-965 tax liability	0	0	350	0	0	-
965 Inclusion			3,000			
Tax @ 10% after 965(c) deduction			300			
Tentative tax	0	0	650	0	0	0
FTCs claimed	20	20	20 60			
FTC carryforward (cumulative)	20	40	0	0*	0*	0*
Total tax liability	0	0	590	0	0	0
Refund	(350)	(350)	0**	(210)	(210)	0

*Assume 100% of 2018-2020 FTCs were GILTI basket

**No refund in section 965 inclusion year until entire section 965 liability paid off

- The IRS, on April 17, issued Rev. Rul. 2020-08 in which it announces that it is suspending two existing revenue rulings (Rev. Rul. 71-533 and Rev. Rul. 68-150) and reevaluating its position regarding the applicable statute of limitations period in instances in which NOL carrybacks result in FTC carrybacks to earlier periods
 - For example, an NOL carryback to a 2013 taxable year could result in FTCs previously claimed in 2013 being released and carried back to the 2012 taxable year (Excess FTCs)
 - Rev. Rul. 2020-08 states that the IRS is reconsidering whether the 10-year limitation period should apply to overpayments attributable to Excess FTCs resulting from NOL carrybacks, or instead whether a three-year limitation period should apply
 - For the time being, taxpayers may continue to apply the 10-year statute of limitations while the IRS reconsiders its position

Procedural Aspects of Filing Form 1139 and Form 1045, Application for Tentative Refund

CARES Act and NOLs – Carrybacks

- Different ways to carry back NOLs
 - Form 1120X vs. Form 1139
 - Statute of limitations for assessments or offsets
 - Benefits of Form 1139 filing
 - 90-day processing time
 - Taxpayers can raise much needed liquidity faster
 - Limited examination
 - Refund release before JCT review of refunds over \$5M (corporations) and \$2M (individuals)
 - Available for NOLs arising in 2018, 2019 and 2020
 - Recovery of 100% of pre-TCJA alternative minimum tax (AMT) credits is allowed in TY 2019, or 2018 if elected

CARES Act, Notice 2020-26 and Eligible Carryback Loss Years

- CARES Act in combination with Notice 2020-26 made the filing of the Form 1139 available to carry back losses from calendar years 2018, 2019 and 2020 to the preceding 5 years
- Special rules for **losses** incurred in 2018 calendar year and fiscal years that began in 2018 ended on or before June 30, 2019:
 - Due date to file Form 1139 is extended to June 30, 2020
 - For the same taxpayer the deadline to claim minimum tax credit (AMT) via Form 1139 is extended to December 30, 2020
 - If both are claimed on the same form – the due date June 30, 2020.
 - Scope: Carrybacks are limited to NOLs **only** – no other attributes
 - Include legend at top of the Form 1139: “Notice 2020-26, Extension of Time to File Application for Tentative Carryback Adjustment”

CARES Act, Notice 2020-26 and Accelerated AMT Credit

- Special rule to accelerate Alternative Minimum Tax (AMT) credit
 - Section 2305(a) of the CARES Act amended section 53(e) of the Code to accelerate the recovery of 100% of any remaining minimum tax credits in its taxable year beginning in 2019, as opposed to 2021
 - Section 2305(b) added section 53(e)(5) to the Code to permit a corporation to elect instead to recover 100% of any remaining minimum tax credits in taxable year beginning in 2018
 - Can be claimed on Form 1139 separately or together with NOL carryback
 - Include legend: “Electing to Take 100% Refundable Credit Amount in 2018- Per CARES Act Section 2305(b)”
 - If claimed together with NOL carryback “NOL Carryback and Electing to Take 100% Refundable Credit Amount in 2018 – per CARES Act Section 2305(b)”

CARES Act, Rev. Proc. 2020-24 and Eligible Carryback Loss Years

- CARES Act granted fiscal year filers, that were inadvertently restricted by TCJA, to carry back losses generated in fiscal years beginning before Jan. 1, 2018 and ending after Dec. 31, 2017.
 - Carry back claim can be filed using Form 1139 or Form 1120X
 - Due date of the Form 1139 is on or before July 27, 2020
 - Two year carryback only
- Include legend on top of Form 1139
 - “NOL Carryback of loss is available pursuant to special rule under section 2203(d)(4) of CARES Act”

CARES Act, Rev. Proc. 2020-24 and Eligible Carryback Loss Years (cont.)

- Elections to waive carryback for such taxable years:
 - “*Filed pursuant to Rev. Proc. 2020-24*” to the top of the amended return, Form 1045 or 1139;
 - Amended Return, Form 1045 or 1139 to contain only taxpayer’s name, address and taxpayer identification number;
 - Indicate the IRC section (172(b)(3)) under which the election to waive carry back is being made and the period for which it applies

Rev. Proc. 2020-24, Carryback Waiver or Exclusion of Section 965 Years from Carryback

- All section 965 years can be excluded from the carryback period for NOL arising in taxable years beginning in 2018, 2019, or 2020
 - When to file:
 - For the tax years of NOL arising in 2018 and 2019, an election must be made no later than the due date, including extensions, for filing taxpayer’s Federal income tax return for the first taxable year ending after March 27, 2020;
 - For the tax years of NOL beginning after December 19, 2019 and before January 1, 2021, no later than the due date, including extensions, for filing loss year return;
 - What to file:
 - Election statement attached to: Amended return, Form 1139 or the original year return;
 - Include legend:
 - “The taxpayer is electing to apply § 172(b)(1)(D)(v)(I) under Rev. Proc. 2020-24”
 - State the taxable year in which the NOL arose,
 - State the taxpayer’s section 965 years.”

CARES Act and NOLs – Carrybacks

Waiver of 5 year carryback for tax years beginning after December 31, 2017 and before January 1, 2021

- Done like any other NOL carryback waiver under section 172(b)(3)
 - On a timely filed, original return and is irrevocable
 - For the NOL arising in 2018 and 2019, election is due by the tax return due date (including extensions) for the first taxable year ending after March 27, 2020.
 - Separate statement for each year must be attached to such tax return
 - State that the waiver is made under Rev. Proc. 2020-24 and section 172(b)(3)

CARES Act and NOL Carrybacks – Temporary Procedures

- Temporary procedures for submission of tentative refund claims allow Forms 1139 to be faxed to **844-249-6236**
- Fax cannot exceed 100 pages
- We recommend attaching a cover letter, a POA (include loss year and all carryback years), and include tax practitioners' phone number, so the IRS can contact the representative, if any questions. Use the cover letter to provide an overview of the filing.
- The numbers on the Form 1139 must exactly match the numbers on the IRS records
 - Difficult to do while the IRS is shut down
 - Make sure the numbers match previously IRS made or Taxpayer made adjustments (earlier filed Forms 1139 or processed amended returns)

CARES Act and NOL Carrybacks – Temporary Procedures

- Temporary procedures provide step-by-step description of how to:
 - prepare Form 1139 to request a tentative refund of the refundable prior year minimum tax credits
 - Certain documents must be attached to such filing
 - Prepare Form 1139 and claim both an NOL carryback and the 100% refundable minimum tax credit
 - Line-by-line instructions and description of the documents to attach
 - <https://rsmus.com/what-we-do/services/tax/federal-tax/tax-controversy/updates-to-fax-submission-procedures-for-forms-1139-and-1045.html>

CARES Act and NOL Carrybacks – Temporary Procedures (cont.)

- [Additional](#) FAQs added to temporary procedures on May 1, 2020
- Taxpayers must file an original loss year tax return before they can file their Form 1139. This return can be e-filed.
 - If the Form 1120X is filed electronically, Taxpayers can submit Form 1139 via fax
- Taxpayers can also file an amended tax return to adjust the loss. This amended return can be e-filed (if eligible or required) or paper-filed
 - If the Form 1120X paper filed, Taxpayers should submit the Form 1139 and Form 1120X in the same envelope for filing.
 - Caution: There may be longer processing times, because the amended return will need to be processed first

CARES Act and NOL Carrybacks – Filing of Loss Year Return Using Estimates

- If you are considering filing an “initial” Form 1120 for 2019 using the best estimates of the net operating loss to support the Form 1139 and you are planning to later supersede that return once all information is available, consider the following:
 - File an extension of time to file (Form 7004) before July 15, 2020 and before the filing of the “initial” Form 1120 that is using estimates
 - This return will support the filing of Form 1139
 - The “initial” Form 1120 can be later superseded with the “final” return including any corrections or additions to the filing such as elections, international information returns, disclosures, etc. The superseding return must be filed on or before the extended due date

Section 382 – Limitations After an Ownership Change

Section 382: Limitations After an Ownership Change

§382 Calculating the Limitation

§382 – Calculating the Limitation

- Annual limitation is the value of the equity of the company (with adjustments) multiplied by the LTTR
- Additional rules apply if LossCo is either a net unrealized built in gain (NUBIG) or loss (NUBIL) corporation
 - NUBIG/NUBIL amount is considered to be zero if not greater than the lesser of (a) \$10 million or (b) 15% of the FMV of company assets immediately before the ownership change
- If a NUBIG: Recognized built in gains (RBIG) increase the annual limitation to the extent of NUBIG
- If a NUBIL: Recognized built in losses are subject to the annual limitation as if they were net operating losses
- The recognition period is the sixty month period following an ownership change

§382 – Calculating the Limitation

Primary adjustments to value:

- In the money options (potentially an increase)
- Corporate contractions in conjunction with the ownership change
 - LBO is the most common example

§382 – Calculating the Limitation

In the money options:

- In general, the “in the money” portion of options increases the equity value

Corporate contractions:

- Redemptions and similar transactions
- Example:
 - P acquires LossCo for \$100M
 - P funds the acquisition with cash and debt incurred by the Target of \$40M
 - What equity value should you use for §382 purposes?

§382 – Calculating the Limitation

Carryover of unutilized limitation

- The annual limitation for a subsequent tax year is increased by the cumulative amount of prior year unutilized limitation
- Example:
- LossCo incurs an ownership change and has an annual limitation of \$100 1/1/18
- LossCo generates losses in '19 & '20
- Cumulative limit is \$300 at the end of '20

§382 – Ordering Rules

- Oldest NOLs first – subject to the §382 limitation
- Example:
 - LossCo generated NOLs in 2010 through 2016
 - \$500 each year (\$3,500 total)
 - LossCo incurred an ownership change 12/31/13
 - Annual limitation of \$100
 - LossCo generates \$3,000 in taxable income in 2017
 - What is the order of the utilization of the NOLs?
 - \$200 of 2010 pre-change NOLs (\$100 limit in 16 & 17)
 - Entire \$1,500 of post change unlimited NOLs

Section 382: Limitations After an Ownership Change

Section 382: NUBIG/NUBIL & RBIG/RBIL

Notice 2003-65 and Proposed Regulations

§382 – Built in Gains & Losses

Notice 2003-65:

- Provides safe harbor rules for the determination of a loss company as a NUBIG/NUBIL
- Provides two approaches for determination of a loss company's RBIG/RBIL
 - §338 approach (generally favorable to a NUBIG)
 - §1374 approach (generally favorable to a NUBIL and not addressed in these slides)

§382 – Built in Gains & Losses

NUBIG/NUBIL under Notice 2003-65:

- Determine amount realized if immediately prior LossCo:
 - Sold all assets (including intangibles) in an arm's length transaction at FMV to a party that assumed all liabilities
 - Less deductible liabilities
 - Add/Less §481 adjustments that would be triggered upon a sale
 - Add RBIL that would not be allowed under §§382 & 383
 - Based upon S Corp §1374 BIG Regulations

§382 – Built in Gains & Losses

§338 Method:

- Hypothetical §338 transaction
 - Determine AGUB based upon value of equity on the date of change
 - Favorable to NUBIG Companies
- In determining RBIG & RBIL LossCo looks to income and deductions that would have occurred in a §338 transaction and compare to actual tax items
 - Including depreciation & amortization

§382 – Built in Gains & Losses

§338 Method:

- Adopts “wasting asset” approach
- Depreciation & amortization in excess of (or below) regular tax that would have occurred under a §338 transaction is treated as RBIG (or RBIL)

§382 – Built in Gains & Losses

Example:

- Corporation X has a §382 ownership change on 1/1/2018 with 2% LTTR and \$151M in NOL
- \$10 of equity value (\$200k annual limitation)
- \$460M of debt
- \$20M of tax basis in the Company's assets (no tax basis in intangibles and assume all appreciation is in intangibles)
- RBIG is \$30M/yr as a result of “wasting assets”
 - $\$10\text{M} + \$460\text{M less } \$20\text{M basis} = \$450\text{M NUBIG}/15 = \$30\text{M RBIG}$
- Entire \$151M is available in the first 5 years

Proposed Regulation on built-in gains

- Proposed regulations, if finalized, would withdraw Notice 2003-65
- Proposed regulations would retain, in large part, the calculation of NUBIG/NUBIL from Notice 2003-65
- Would adjust treatment of certain liabilities
- Proposed regulation would adopt, in large part, the §1374 approach for determining RBIG/RBIL
- Would adjust treatment of contingent liabilities
- Proposed regulations would NOT adopt a §338 wasting approach

Proposed Regulation on built-in gains

Example under the proposed regulations :

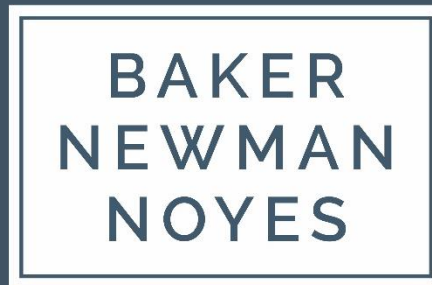
- Corporation X has a §382 ownership change on 1/1/2018 with 2% LTTR and \$151M in NOL
- \$10 of equity value (\$200k annual limitation)
- \$460M of debt
- \$20M of tax basis in the Company's assets (no tax basis in intangibles and assume all appreciation is in intangibles)
- RBIG is zero unless taxable dispositions of intangibles occur
- \$1M (compared to \$151M) is available in the first 5 years

Proposed Regulation on built-in gains

- If finalized:
 - Would significantly impact life sciences, technology, and distressed companies
 - Would only apply to prospective ownership changes after finalization
 - Would reduce deferred tax assets significantly
 - Could impact M&A beyond pricing

NOL Treatment on Federal Individual Tax Returns

John Hadwen



NOL Basics and Procedures for Individual Taxpayers

NOL Provisions – Carryback Overview

A Net Operating Loss (NOL) generally results when a taxpayer's business expenses exceed income from all sources.

Per IRC section 172, a taxpayer who sustains this type of loss in one year can spread the loss over several years. This may generate refunds which can provide additional capital.

Prior to TCJA (pre-2018 tax years), NOLs ordinarily could be carried back two taxable years and forward 20 taxable years.

NOL Provisions – Carryback Overview

TCJA

- NOLs can no longer be carried back.
 - Carryforward indefinitely
- NOLs can only offset 80% of taxable income
- Taxpayers can no longer fully eliminate their tax liability with NOLs.

CARES Act Modifications to TCJA

- NOLs arising in tax years 2018, 2019 or 2020 can be carried back 5-years
- Elect to carryforward indefinitely
- NOLs can offset 100% of taxable income for tax years beginning before January 1, 2021. (May still be subject to AMT)

NOL Provisions – Carryback Overview

NOL Generated in Tax Years	Eligible for Carryback	Carryforward period	Percent of Taxable Income to Offset
Beginning on or before December 31, 2017	2 tax years	20 tax years	100% of taxable income (Subject to AMT limitation)
Beginning after December 31, 2017 and beginning before January 1, 2021	5 tax years	Indefinite	100% of taxable income (prior to 2021) 80% of taxable income (after 2020)
Beginning on or after January 1, 2021	No carryback except for certain farming businesses	Indefinite	80% of taxable income

NOL Provisions – Carryback Overview

IRC section 172(b)(1)(A)(i) requires that the loss be carried to the earliest year first, unless an election is made in the year the NOL is generated to permanently forego the carryback.

Any amount not absorbed should be carried to each subsequent year and thereafter until fully absorbed.

In addition, a taxpayer may file claims resulting from several carryback loss years to the same gain year.

Overview of NOL Carryback Claim

Two alternatives for carrybacks exist: Form 1045 and Form 1040X.

Form 1045 differs from Form 1040X:

1. Concerning the time to file,
2. Whether verification is before or after the issuance of the refund, and
3. The method of making audit adjustments.

The background, documentation, research, and computations are the same.

IRS Form 1045

Form 1045 must be filed within one year of the loss year.

- Notice 2020-26 provides a 6 month extension for filing 2018 Form 1045 until June 30, 2020.

Applications generally are processed by the IRS within 90 days of receiving a taxpayer's properly **completed** application.

- Be sure to attach required forms listed in instructions to Form 1045 for the year of loss to avoid delays or disallowance of tentative refund.

Starting April 17, 2020 Form 1045 can be **temporarily** faxed to the IRS at 844-249-6237.

IRS Form 1040X

Form 1040X may be filed anytime within the later of: 3 years after the due date (including extensions) of the loss year; or the date as extended by an IRC section 6501(c)(4) extension agreement for the loss year return; or other periods referred to in Rev. Rul. 65-281. (IRC sections 6511(c) and (d)(2)).

Refunds based on Form 1040X generally are not released to taxpayers before the Form 1040X enters the audit stream. Any adjustments would be made using the claim processing procedures outlined in Internal Revenue Manual (IRM) 4510.

Election to waive NOL carryback

Waiver of 5 year carryback for applicable tax years (2018, 2019, and 2020)

- This is similar to other NOL carryback waivers under section 172(b)(3) and consists of a statement included with a timely filed, original return. The election is irrevocable.
 - An amended return may be filed within 6 months of the due date of the return (excluding extensions) to make this choice if election missed.
- However, for NOL arising in tax years beginning in 2018 and 2019, such election is due by the tax return due date (including extensions) for the tax year ending after March 27, 2020.
 - Rev. Proc. 2020-24 provides guidance on the manner of making such waiver. A separate statement for each tax year being waived.

Waiver of certain section 965 carryback years

- See guidance in Rev. Proc. 2020-24.

Election to waive NOL carryback

If the taxpayer fails to assert the election under IRC 172(b)(3) to permanently forego carrying back the NOL, the IRS's default position procedurally is that any carryforward must be reduced by the amount of NOL that would have been diminished if the carryback had been filed. This can result in permanent loss of refunds, solely as a result of an overlooked election.

Post-2020 NOL Usage

Two-Step Calculation starting in 2021

- Adopts the Bluebook's suggested statutory correction effective for taxable years beginning after December 31, 2020.

- Revised calculation
 - First use pre-TCJA NOL (tax years beginning before 12/31/2017)
 - Then are allowed the lesser of:
 - NOLs arising after 12/31/2017 OR
 - 80% of taxable income (without section 199A [qualified business income] or section 250 deductions [FDII and GILTI]) minus pre-TCJA NOLs

Post-2020 NOL Usage - Example

Example: Taxpayer has \$100 of 2017 NOL, \$100 of 2020 NOL, and \$200 of 2021 taxable income (breakeven for 2018 and 2019). Taxpayer first offsets 2021 taxable income with pre-TCJA NOL (\$200 minus \$100). 80% limit applies to this amount (80% of \$100, or \$80). Therefore only \$80 of 2020 NOL is usable ($\$80 < \100). Taxpayer has revised taxable income of \$20.

Calculating and Using NOLs for Individual Taxpayers

NOLs for Individual Taxpayers

In principle, an NOL generally results when a taxpayer's business expenses exceed income from all sources.

1. Deductions from a trade or business
2. Losses from a partnership or S corporation which flow through to the partners or shareholders
3. Rental property
4. Deductions for business-related expenses as an employee (although not deductible for most taxpayers for 2018 through 2025)
5. Deductions for casualty and theft losses

Per IRC section 172, a taxpayer who sustains this type of loss in one year can spread the loss over several years. This may generate refunds which can provide additional capital.

Losses from a partnership or S corporation

Partners or shareholders may be able to use their separate shares of the partnership's or S corporation's business income and business deductions to compute their individual NOLs.

The amount of the loss passed through to the individual's tax return is contingent upon the individual's basis and involvement in the entity.

Without basis and active participation, losses are suspended.

Level of Loss Limitations for Individuals

1. Section 1366 (S Corps) /Section 704 (Partnerships)– Basis Limitations
2. Section 465 – At-Risk Limitations
3. Section 469 – Passive Activity Losses Limitations
4. Section 461(l) – Excess Business Loss Limitations
[Suspended until tax years beginning after 12/31/2020]
5. Section 172 – Net Operating Losses

Excess Business Losses – Section 461(I)

TCJA

- Individual, Trusts, and Estates can only use \$250,000 (\$500,000 for joint filers) of business loss to offset non-business income.
- Remainder of loss is carried forward to following year

CARES Act Modification

- Provision is suspended until tax years beginning after December 31, 2020
- Business losses can fully offset taxable income and potentially generate NOL

The repeal of Section 461(I) is not elective. As a consequence, if a taxpayer who is subject to limitation in a prior year does not amend, the IRS could adjust downward the amount of that taxpayer's loss carryforward. If the taxpayer's statute of limitation for the relevant year (i.e., 2018 or 2019) is closed at the time of the adjustment, then the taxpayer would lose the relevant benefit.

Calculation of NOL

STEP 1: Compute Negative Taxable income

To convert the taxpayer's taxable income per return (usually stated at zero) to true negative taxable income:

- Subtract the standard deduction or the itemized deductions from adjusted gross income.
- The net result is negative taxable income. This amount is also referred to as the “statutory” loss.

This step is necessary since the tax return will generally not show negative taxable income.

Calculation of NOL

STEP 2: Make modifications to arrive at the NOL.

These modifications eliminate personal deductions. The net result is a loss resulting solely from business, casualty or theft.

In general, the following items are not allowed in computing an NOL:

- Capital losses in excess of capital gains.
- The section 1202 exclusion of the gain from the sale or exchange of qualified small business stock.
- Nonbusiness deductions in excess of nonbusiness income.
- The NOL deductions from other years.
- The section 199A deduction for qualified business income.
- The section 199 deduction for income attributable to domestic production activities (DPAD).

Calculation of NOL – Example #1

Example: Greer owns a candy store. She is single and has the following income and deductions on her Form 1040 for 2019.

INCOME		DEDUCTIONS	
Wages	\$15,000	Net Loss from business	\$50,000
Interest	500	LT Capital Loss	2,000
Section 1231 Gain	<u>10,000</u>	Standard Deduction	<u>12,200</u>
Greer's total income	<u>\$25,500</u>	Greer's total deductions	<u>\$64,200</u>

Greer's deductions exceed her income by \$38,700 (\$64,200 – \$25,500). However, to determine whether she has an NOL, certain deductions are not allowed.

Calculation of NOL – Example #1

Example #1 – Continued

The following deductions are not allowed:

Nonbusiness LT Capital Loss	\$ 2,000
Nonbusiness deductions (Standard Deduction less interest income)	<u>11,700</u>
Total adjustment to net loss	<u>\$13,700</u>

Greer's NOL for 2019 is \$25,000

Total Income	\$ 25,500
Total Deductions less adjustments	<u>(50,500)</u>
NOL (if Negative)	<u>\$(25,000)</u>

Calculation of NOL – Example #2

Example: Erin owns a Wine shop. She is single and has the following income and deductions on her Form 1040 for 2019.

INCOME		DEDUCTIONS	
Wages	\$50,000	Net Loss from business	\$175,000
Interest	1,200	Net LT Capital Loss	100,000
Section 1231 Gain	<u>200,000</u>	Standard Deduction	<u>12,200</u>
Erin's total income	<u>\$251,200</u>	Erin's total deductions	<u>\$287,200</u>

Erin's deductions exceed her income by \$36,000 (\$287,200 – \$251,200). However, to determine whether she has an NOL, certain deductions are not allowed.

Calculation of NOL – Example #2

Example #2 – Continued

The following deductions are not allowed:

Nonbusiness ST Capital Loss	\$ 100,000
Nonbusiness deductions (Standard Deduction less interest income)	<u>11,000</u>
Total adjustment to net loss	<u>\$111,000</u>

Erin’s NOL for 2019 is zero

Total Income	\$ 251,200
Total Deductions less adjustments	<u>(176,200)</u>
NOL (if Negative)	<u>\$ 75,000</u>

The NOL Deduction

When an NOL is carried to another year, two possibilities exist.

The NOL can either be:

1. Fully absorbed or
2. Not fully absorbed.

The NOL Deduction

The deductions or exclusions, which may need to be recomputed because of the decreased adjusted gross income, include the following:

1. Deduction up to \$25,000 of passive activity losses from rental activities as per IRC section 469(i)
2. Exclusion of social security and Tier 1 railroad retirement benefits as per IRC section 86
3. Deductions for individual retirement accounts as per IRC section 219(g)
4. Exclusion of U.S. Savings Bond interest used for educational purposes as per IRC section 135(b)
5. Medical expense deductions as per IRC section 213(a)
6. Casualty loss deduction as per IRC section 165(h)
7. Miscellaneous itemized deductions as per IRC section 67(a)
8. Total itemized deductions as per IRC section 68(a)
9. Phase out of exemptions as per IRC section 151(d)(3)

Regarding items (1) through (4), above, if more than one applies, you recompute them in the order listed above, using the recomputed AGI after applying the NOL deduction and any previous items on the list above.

The NOL Deduction

The reduction in AGI due to an NOL carryback has no effect on the individual's deduction for charitable contributions.

IRC section 170(b)(1)(F) provides that the contribution base for determining percentage limitations is the AGI without regard to any NOL carrybacks.

An NOL carryback can also free up unclaimed federal tax credits and other tax attributes from closed tax years. If the NOL carryback results in credits no longer being used in the closed year, these items are eligible to be carried forward.

NOL not Fully Absorbed

NOLs not fully absorbed require intervening year modifications.

IRC section 172(b)(2) requires that modifications be made to taxable income to determine how much of the NOL is used up in that year, and how much can be carried to the preceding year.

NOL not Fully Absorbed – Steps

Step 1

Start with the taxable income for the 5th preceding tax year

- For this purpose such taxable income takes into account the NOLs (carryforwards or carrybacks) from all years prior to the loss year. IRC section 172(b)(2)(B).

Step 2

Add back the following modifications:

- a) Personal exemptions.
- b) Net capital loss deduction.
- c) Modifications relating to Real Estate Investment Trusts, if they apply.

NOL not Fully Absorbed – Steps

Step 3

Make the adjustments to items which are based upon, or limited by, a modified AGI.

- a) Adjustments to exclusions or deductions based on or adjusted by AGI (discussed earlier)
- b) Itemized Deductions (discussed earlier)
 - Charitable contributions may also need to be adjusted but this involves some special rules.

Step 4

The result is the modified taxable income of the 5th preceding year.

NOL not Fully Absorbed – Steps

Step 5

The modified taxable income is subtracted from the NOL calculated for the loss year. The balance, if any, is the NOL carryover to the 4th preceding year.

Step 6

The above process is again applied to determine the modified taxable income of the 4th preceding year and such amount is subtracted from the NOL carryover to see if there is any excess to be carried to the 3rd preceding year.

Step 7

This process is repeated until there is no remaining NOL carryover.

NOL not Fully Absorbed – Example

Rue runs a doughnut shop. In 2019, she has an NOL of \$30,000 that she chooses to carry back to 2014. She has no other carrybacks to 2014. Rue's original 2014 return contained the following income and deductions:

Wages	\$25,000
Interest Income	200
Capital loss	<u>(\$2,000)</u>
Adjusted gross income	\$23,200
Standard Deduction	(\$ 6,200)
Personal Exemption	<u>(\$ 3,950)</u>
Taxable Income	<u>\$13,050</u>

Rue's \$30,000 carryback NOL will eliminate her positive 2014 taxable income. She uses Form 1045 Schedule B to calculate the amount of the NOL absorbed in 2014, and the amount that should be carried over to 2015 and/or future years.

Statute of Limitation on Claims

A claim for refund relating to an NOL carryback generally must be filed within the later of:

- 3 years after the due date of the return (including filing extensions) for the loss year; or
- The period set forth in IRC section 6511(c) as to the loss year (that is, 6 months after the extended date for assessment set forth in an IRC section 6501(c)(4) agreement concerning the loss year). IRC sections 6511(d)(2)(A) and 6511(c).

Exception to the General Rule

The claim statute under IRC section 6511(a) for the carryback (gain) year expires either:

- 3 years from the date of filing of the carryback year return, or
- 2 years after the tax is paid, whichever is later.

This claim period can be extended by an IRC section 6501(c)(4) agreement as to the carryback year.

NOL Documentation

For both the Form 1045 and the Form 1040X refund requests, records for the loss year and the carryback/carryover year(s) **MUST** be kept together.

Records should be kept for any tax year that generates an NOL for 3 years after the later of the NOL Year or the last year the carryforward was used.

- Keep in mind that post-2017 NOLs are carried forward indefinitely.
- IRS is permitted to re-compute taxable income in closed tax years to adjust NOL and charitable contribution carryovers to open years.
Barenholtz, 784 F.2d 375 (Fed. Cir. 1986)

NOL Corrections

Springfield St. Railway Co., 312 F.2d 754 (Ct. Cl. 1963), allowed a taxpayer to adjust its NOL carryback amount absorbed in a closed year to claim a refund in an open one. The court concluded that the same statute of limitation for carryback items should apply to taxpayers requesting a refund as to the IRS when assessing tax.

The IRS refers to Rev. Rul. 81-88 in Internal Revenue Manual Section 4.11.11.6(10), explaining that "errors in a closed year are corrected for purposes of determining the taxable income of an open year."

NOL Corrections

In Rev. Rul. 82-49, the IRS expanded the application of Springfield to the investment tax credit.

- Although this IRS guidance concerns the now mostly expired investment tax credit, it should apply to other credits as well. The investment tax credit is part of the Sec. 38 general business credit, so other general business credits, including the Sec. 41 research credit, should be eligible for a similar adjustment.

No IRS guidance or case law addresses how to adequately notify the IRS of an adjustment to a carryover amount (NOL or tax credit) made for a closed tax year. It might be advisable to include a short written statement in the year the carryover item is adjusted, to explain the reason for the change.

- Currently, there is no guidance that would allow a pass-through entity to adjust an item of taxable income in a closed year.

NOLs and a Change in Filing Status

Separate to joint return - Treat the separate carryback or carryover as a joint carryback or carryover.

Joint to separate returns - Figure each of your carryovers separately.

NOLs and a Change in Marital Status

If the taxpayer and spouse were not married to each other in all years involved in figuring NOL carrybacks and carryovers, only the spouse who had the loss can take the NOL deduction. If you file a joint return, the NOL deduction is limited to the income of that spouse.

NOL Carryovers When Taxpayer Dies

NOL carryovers are deductible only by the taxpayer who sustained the losses, and they cannot be transferred to or used by another taxpayer, including the surviving spouse.

NOLs generally can be traced to specific business interests, so unless both spouses have losses, the CPA should be able to attribute the carryover to the spouse who generated the loss.

Whatever amount of a decedent's NOL that remains used in the year of death is lost. Rev. Rul. 74-175 specifically addressed NOL carryovers, providing that only the taxpayer who sustained the loss can use these carryovers.

Alternative Minimum Tax (AMT) NOLs

Under Code Sec. 56(a)(4), taxpayers can take an alternative minimum tax (AMT) NOL deduction in calculating their alternative minimum taxable incomes (AMTI).

Under the AMT rules, use of an NOL is limited to 90% of a taxpayer's income (after the taxpayer has modified the NOL for the adjustments under IRC sections 56 and 57 and preference items under section 58). State tax laws frequently permit NOLs to be carried forward only and often for much shorter periods than the IRC allows. Indeed, some states make no provision at all for taxpayers to use NOLs.

Potential for Permanent Tax Savings

NOLs generated in 2018, 2019 and 2020 can be carried to pre-TCJA years to recover tax paid.

Loss can be used to offset income tax at higher rates:

- i.e. 39.6%* for individuals pre-2018 tax years and 29.6%** post-2017.

Accounting method changes can accelerate deductions or defer revenue and increase NOL.

- Timing issues

* Assumes highest tax bracket

** Assumes highest tax bracket and full utilization of the Section 199A deduction.

Accounting Method Changes Can Create NOLs

Some changes are now available for any “small business taxpayer,” defined as a taxpayer that has average annual gross receipts of \$26 million or less (2019 tax years) for the three prior tax years and is not a tax shelter. Options include the ability to:

- Use the cash method of accounting instead of the accrual method of accounting (Sec. 448(c));
- Currently deduct rather than capitalize additional uniform capitalization (UNICAP) costs to inventory (Sec. 263A(i));
- Treat inventories as non-incidental materials and supplies or use an inventory method that conforms to their financial accounting treatment of inventories (Sec. 471(c)); and
- Not account for long-term construction contracts using the percentage-of-completion method (PCM) of accounting (Sec. 460(e)(1)(B)).

QIP Corrections

Amend prior year tax return(s)

- Require to re-compute taxable income for a prior year(s)
- Allowed for 2018 and 2019
- Required if revoking /making bonus depreciation or ADS election

File Form 3115

- Entire impact of change is pushed through current return
- New accounting method change with simplified filing requirements

Amended Partnership Returns

Bipartisan Budget Act of 2015 (BBA) changed the rules for amending partnership returns.

- Default rule is a true up adjustment in the current tax year (not an amended tax return and carry back to year of change).

Rev. Proc. 2020-23 allows a concession until September 30, 2020 for BBA partnerships to file an amended return for the 2018 and 2019 tax years to take into account tax changes brought about by the CARES Act as well as any other tax attributes to which the partnership is entitled by law.

Final Thoughts

- State NOL Differences
- Don't forget Election to waive NOL carryback, if applicable
- Complex modeling may be needed to determine carryback or carryforward:
 - Prior year tax attributes
 - Current year tax attributes
 - Need for cash now
 - Permanent tax savings
 - Procedural Challenges

Questions and Answers?

BAKER
NEWMAN
NOYES

**Thank you for your time and
attention!**

**BAKER
NEWMAN
NOYES**