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Global Tax Alert

US CARES Act provides relief for multinational private companies and individuals with business losses

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Executive summary

Among the tax provisions introduced by the *Coronavirus Aid, Relief, and Economic Security (CARES) Act*, enacted on 27 March 2020, are two that may be of particular interest for multinational private companies and individuals with business losses: a temporary relaxation of certain restrictions on using net operating losses (NOLs) under Internal Revenue Code[1] Section 172 and a temporary suspension of certain limits on using excess business losses under Section 461(l). This Tax Alert provides insights that may help companies and individuals access the benefits of these provisions.

Given that these taxpayer-favorable changes are temporary, timely action is essential. Multinational private companies and individuals should consider using financial modelling to assist in determining the best use of tax attributes, such as NOLs, and analyzing the interaction of various tax provisions. They should also evaluate restructuring opportunities that may permit greater use of certain tax attributes.

Building a better working world

Detailed discussion

Net operating losses

Background: Section 172(c) defines an NOL as the amount by which a taxpayer's business deductions exceed its business gross income. For noncorporate taxpayers, certain items may not be included in the NOL calculation, such as deductions for personal exemptions, capital losses in excess of capital gains, Section 1202 exclusions of the gain from the sale or exchange of qualified small business stock, and nonbusiness deductions (e.g., alimony and most itemized deductions).

Under the *Tax Cuts and Jobs Act* (TCJA), the NOL rules limited taxpayers' ability to use NOLs to 80% of taxable income, disallowed the carryback of NOLs arising after 2017, and made the carryforward of NOLs indefinite.

Temporary changes made by CARES Act: The CARES Act temporarily suspends the TCJA's 80% limitation on the use of NOLs for tax years beginning after 31 December 2017, and before 1 January 2021. Unless a taxpayer elects otherwise, the CARES Act also allows taxpayers to carry back five years NOLs arising in tax years beginning after 31 December 2017, and before 1 January 2021. Taxpayers may still carry forward NOLs if they decide against carrying them back.

Discussion: Refunds from NOL carrybacks are intended to provide taxpayers with immediate liquidity. The CARES Act's suspension of Section 461(l), discussed in more detail later, addresses the same concern by allowing taxpayers to use NOLs to offset certain non-business income. The cash benefit may be "super-charged" for taxpayers given that lower-tax-rate losses in post-TCJA years may be carried back to offset income taxed at a higher tax rate in pre-TCJA years, when marginal tax rates were generally higher.

When determining whether to amend earlier year returns to reflect an NOL carryback, taxpayers with international businesses should consider the interaction of the carryback provisions with the following items:

Section 965 transition tax: Taxpayers can elect to waive carryback under Section 172(b)(3) for NOLs arising in tax years beginning in 2018 or 2019, thus only carrying back NOLs arising in 2020. When applying the five-year carryback, new Section 172(b)(1)(D)(v)(I) permits taxpayers to elect to exclude Section 965 years from the carryback period.

If an NOL is carried back to a Section 965 year, however, new Section 172(b)(1)(D)(iv) deems a Section 965(n) election to have been made for that Section 965 year. With that election, taxpayers can choose not to apply an NOL to their Section 965 income in the transition year. Revenue Procedure 2020-24, however, limits the deemed Section 965(n) election to the portion of the NOL carried back under Section 172(b)(1)(D)(i) to the Section 965 year, thereby preventing that carried-back NOL from offsetting the Section 965 inclusion. The deemed Section 965(n) election applies even when a taxpayer previously did not make or revoked an election under Treas. Reg. Section 1.965-7(e)(2)(ii)(B)).

Revenue Procedure 2020-24 also clarifies that taxpayers who carry back an NOL to a Section 965 transition year might not receive a refund. Rather, the refund will be applied against any outstanding transition tax liability.

Another important factor to consider is that amending a tax return for a transition tax year requires applying finalized transition tax regulations, which were not issued at the time of the original filing. This could negatively impact the transition tax liability initially calculated.

Foreign tax credits: An NOL deduction claimed in a carryback year could significantly affect a taxpayer's foreign tax credit (FTC) position. In particular, it can:

- Decrease FTCs utilized in a carryback year
- Generate an overall domestic loss (ODL), overall foreign loss (OFL), or separate limitation loss (SLL), depending on the source of the NOL

These outcomes can affect a taxpayer's ability to claim FTCs on prior-year filings and future returns.

By reducing a taxpayer's overall tax liability, an NOL carryback may reduce the utilization of FTCs originally claimed in the carryback year. As such, an NOL carryback may increase a taxpayer's FTC carryover from that year, which in turn may provide additional FTCs for subsequent years. In a Section 965 transition tax year (whether 2017 or 2018), those FTCs could reduce the taxpayer's transition tax liability in future installments.

The effects of an NOL deduction on FTC utilization in the carryback year apply whether the NOL source is foreign or domestic. For example, a US-source NOL may either create or increase an ODL account to the extent the US NOL offsets foreign-source income. Such an ODL may be beneficial in a subsequent tax year, as it later allows US-source income to be recharacterized as foreign source. Likewise, a foreign-source NOL may either create or increase an OFL or SLL to the extent a foreign loss offsets either US-source income or foreign-source income in a separate basket. Such an OFL or

SLL could be detrimental in a subsequent tax year, including a Section 965 transition tax year, as it may require the foreign-source income to be recharacterized as US source (or another basket of foreign-source income), thus limiting the use of FTCs in that year.

To the extent an NOL decreases the use of FTCs against a Section 951A Global Intangible Low-Taxed Income (GILTI) category, those FTCs are lost, as GILTI-related FTCs cannot be carried forward. Negative effects could also come from allocating a foreign NOL against various baskets of foreign-source income, which would reduce available foreign-source income for purpose of taking FTCs.

Timing: The temporary ability to use NOLs against 100% of taxable income applies for only three tax years — 2018, 2019 and 2020 — two of which have already passed for calendar-year taxpayers. Section 6411 allows a taxpayer to apply for a tentative carryback adjustment of the tax liability for a prior tax year that is affected by an NOL carryback provided in Section 172(b). Under Treas. Reg. Section 1.6411-1(b)(1), noncorporate taxpayers must apply for the adjustment using Form 1045. Treas. Reg. Section 1.6411-1(c) requires the forms to be filed within 12 months of the close of the tax year in which the NOL arose. Revenue Procedure 2020-26, however, grants a six-month extension of time to file Form 1045 to taxpayers with an NOL that arose in a tax year that began during calendar year 2018 and ended on or before 30 June 2019.

Under these rules, a taxpayer that chooses to carry back an NOL to tax year 2018 would ordinarily be required to file Form 1045 by 31 December 2019, which had passed at the time the CARES Act was enacted. Under Revenue Procedure 2020-26, this deadline is extended to 30 June 2020.

Deferral of Section 461(l)'s limit on net business losses for noncorporate taxpayers

Background: The TCJA introduced the "excess business loss" limitation as an additional loss limitation for noncorporate taxpayers, such as individuals, trusts and estates. Noncorporate taxpayers may not deduct more than US$500,000 (for joint filers)/US$250,000 (for other taxpayers) of their business losses against non-business income, such as dividends and interest, subpart F income and GILTI, to name a few. For partnerships and S corporations, Section 461(l) applies at the partner or shareholder level and considers a taxpayer's allocable share of entity-level items of income, gains, losses and deductions.

The limitation also applies to individual taxpayers that own controlled foreign corporations with either global intangible low-taxed income or subpart F income. Additionally, adjustments to an individual's foreign-source income were necessary to account for the suspension of a current-year excess business loss when computing foreign tax credits associated with non-business income and the impact on ODL, SLL and OFL accounts.

Temporary changes made by CARES Act: The CARES Act postpones the effective date of Section 461(l) until tax years beginning after 31 December 2020.

Discussion: By suspending the loss limitation in Section 461(l), the CARES Act allows noncorporate taxpayers to use 100% of excess business losses arising in tax years 2018, 2019 and 2020 against other investment income. Similarly, taxpayers may use their excess business losses to offset GILTI and subpart F inclusions in those tax years. In the international context, foreign-source income adjustments are no longer necessary to account for the impact of a Section 461(l) limitation on the foreign tax credit.

The CARES Act also makes several technical corrections to Section 461(l) that apply after 2020. Under these corrections, taxpayers do not:

- Consider NOL deductions under Section 172 and qualified business income deductions under Section 199A when calculating excess business losses
- Consider deductions for losses from the sale or exchange of capital assets in increasing a Section 461(l) limitation
- Include items attributable to the trade or business of performing services as an employee in the Section 461(l) calculation

Additional considerations for distressed taxpayers

As part of their current tax-planning, taxpayers should consider the actions they might take now to improve their future economic position, such as restructuring global businesses, making strategic acquisitions and undertaking foundational tax-planning. Taxpayers should also understand the income tax implications of modifying existing loan obligations, cancelling indebtedness, and fluctuating exchange rates.

Key takeaways for multinational private companies and individuals

- Electing a five-year NOL carryback could affect a taxpayer's FTC and transition tax positions. Depending on the source of the NOL, it may be more beneficial to maintain prior FTC positions and carry NOLs into future years.
- Taxpayers that choose to carry a post-2017 NOL back to a Section 965 transition year may not be eligible for a refund unless the carryback results in an overpayment of their Section 965 transition tax liability.
- Postponing Section 461(l)'s limitation on excess business losses may help individual taxpayers temporarily blunt the impact of the TCJA's broad expansion of the US controlled foreign corporation regime without complex planning or Section 962 elections.
- As always, tax modelling is critical to determine the most advantageous use of loss attributes and the taxpayer-favorable provisions of the CARES Act.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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