



# Dealing with Losses: CARES Act Changes, Debt Restructuring, and Other Strategies for a Strong Future

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## Net Operating Losses – The CARES Act

### Changes

Amended section 172 to allow a net operating loss (NOL) from tax years beginning in 2018, 2019, or 2020 to be carried back for five taxable years (see section 172(b)(1)(D)).

Temporarily removes the 80% of taxable income limitation to allow an NOL to fully offset income.

- The 80% limitation is set to apply to taxable years beginning after December 31, 2020.

# Net Operating Losses

## Net Operating Losses – The CARES Act

### Technical Corrections to TCJA

Allows NOLs arising in a tax year beginning in 2017 and ending in 2018 to be carried back two taxable years and carried forward 20 years with no 80% taxable income limitation.

Clarifies how to determine the NOL limitation in taxable years that have pre- and post-TCJA NOL carryforwards.

- NOL deduction is equal to the pre-TCJA NOLs plus 80 percent of the remaining taxable income (after reduction by pre-TCJA NOL carryovers).

## Net Operating Losses – The CARES Act

### Reminders

NOLs are carried back to the earliest year of the carryback period and then forward to the year immediately preceding the year in which the NOL was generated.

Taxpayers cannot select how many years to go back – NOLs must be carried back 5 taxable years or 2 taxable years depending on when the NOL was generated.

Short taxable years count for purposes of the carryback period.

Must file election to waive carryback to preserve use of NOLs as carryforwards.

- NOLs deemed utilized in carryback even if taxpayer does not apply for

## Net Operating Losses – The CARES Act

### NOL Carrybacks

NOLs Generated in Taxable Years Beginning in 2017, 2018, 2019, and 2020							
2013	2014	2015	2016	2017	2018	2019	2020
35%	35%	35%	35%	35%	21%	21%	21%
		X	X	NOL			
X	X	X	X	X	NOL		
	X	X	X	X	X	NOL	
		X	X	X	X	X	NOL

# Net Operating Losses – The CARES Act

## M&A Considerations/Observations

Taxpayers that have engaged in M&A transactions should review the definitive agreements to determine whether (i) losses may be carried back to years when the target was owned by the seller and (ii) they address which party is entitled to the benefit of the carryback.

Questions to consider:

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# Net Operating Losses – The CARES Act

## Considerations – Post-acquisition CNOL

# Net Operating Losses – The CARES Act

## Considerations – Post-acquisition CNOL

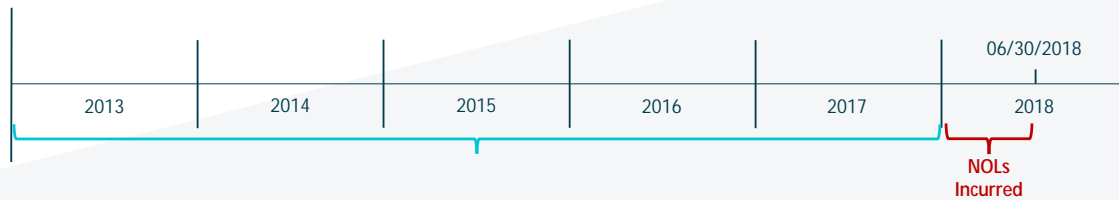
- Alternatively, the buyer consolidated group may make an irrevocable election to waive all CNOLs attributable to the target corporation for the portion of the carryback period during which it was a member of another consolidated group (otherwise known as a “split-waiver election.”) (see Treas. Reg. Sec. 1.1502-21(b)(3)(ii)(B)).
- The split-waiver election must be filed with the buyer consolidated group’s original income tax return for the year in which the corporation became a member.
- Because many companies didn’t contemplate NOL carrybacks post-TCJA, they likely didn’t make the split-waiver election.
- To provide relief to buyer consolidated group’s, IRS and Treasury released temporary regulations allowing the buyer consolidated group to effectively file a

# Net Operating Losses – The CARES Act


## Example – Pre-acquisition NOL

Target, a calendar year taxpayer, was acquired in a taxable stock acquisition on 06/30/2018 that ended its tax year.

Target incurred significant NOLs in the period from 01/01/2018 to 06/30/2018 and buyer has taxable income in the post-acquisition periods.



## Section 382(h)

- Basic limitation after an ownership change: long-term tax exempt rate times fair market value of the LossCo
  - If a LossCo has “net unrealized built-in again” (NUBIG) at time of an ownership change, the annual 382 limitation during first 5 years is increased by” recognized built-
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## Notice 2003-65 - Example

- LossCo has one asset, IP, and \$25mil of NOLs. On date of ownership change, LossCo is worth \$100mil
  - Base 382 limitation:
    - \$890,000 per year in losses
    - \$186,900 in cash tax benefit
  - 1374 Approach:
    - No increase in 382 limitation unless IP is sold
  - 338 Approach:
    - Amortization deduction in Hypothetical Sale: \$6,666,666 per year
    - Annual limitation in first 5 years is increased by \$6,666,666 per year
    - Cash tax benefit: \$1.4mil per year

# Treatment of Deferred Revenue

- Proposed Regulations provide:
  - Prepaid income received prior to the ownership change but attributable to post-ownership change performance is not RBIG
  - RBIL in Tw 21UT.9(1-1(7(B)-36d)2.6(ies1.84)-15.7(i)2.6(iefr)2(r)1(ed)4.5()-03.2(t)2.6(ie)

## 2020 Proposed Regulations

- January 2020 Proposed Regulations introduced a much-welcomed transition period
  - Regulations are effective 30 days after finalized (the “effective date”)
  - Regulations do not apply to ownerships changes that occur after the effective date but that are pursuant to:
    - A binding agreement in effect on or before the effective date
    - A transaction that has been publicly announced or appeared in an SEC filing on or before the effective date
    - Bankruptcy court order on or before the effective date or
    -

## NOL Poison Pills - Basic

- NOL carryforward is a valuable asset
  - Less valuable after TCJA
- Example:
  - Assume: \$10 mil in NOLs, 21% tax rate, 80% Limitation, 5% discount rate

Year	Taxable Income	NOL Utilized	Tax Savings	PV
1	\$2 mil	\$1.6 mil	\$336,000	\$320,000
2	\$2 mil	\$1.6 mil	\$336,000	\$304,762
3	\$2 mil	\$1.6 mil	\$336,000	\$290,243(2)-4/MCI (

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## NOL Poison Pills – Key Terms

- NOL Poison Pill disincentivizes acquisitions of significant blocks of stock (e.g., 5% or more)
- Rights are issued to stockholders via dividend
  - Each stockholder is granted a right to purchase shares of company stock at a discount in the event of (1) the acquisition by a third party of 4.99% or more of company stock without Board approval, or (2) an announcement of a tender or exchange offer that would result in a third party acquiring 4.99% or more of company stock
- When a “triggering event” occurs, all stockholders other than the one who triggered the rights may exercise their rights and purchase common stock at a discount
- Results in significant dilution (economic and voting) to the third party acquirer
- Delaware Supreme Court upheld an NOL Poison Pill in *Versata Enterprises Inc. v. Selectica, Inc.*, but noted that whether an NOL Poison Pill is reasonable depends on the specific facts and circumstances of the case.

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## NOL Poison Pills – Key Terms

Rights are designed to give the Board maximum flexibility to consider and respond to any acquisition of shares by a third party that may jeopardize the Company's future use of its NOLs

The Board generally has authority to amend or repeal the plan at any time, subject to its fiduciary duties

Prior to a triggering event, rights will not have any impact on the Company's capital structure and will have no economic impact for the Company or its stockholders

Historically, a rights plan is a deterrent device designed to give the board appropriate leverage and opportunity to consider issues in accordance with its fiduciary duty; rights plans are generally not "triggered" because the economic impact to the triggering party is too severe

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## NOL Poison Pills – Pros and Cons

### Pros

- Deters acquisitions that could impair or destroy the value of the NOLs
- Encourages third parties interested in acquiring the Company to negotiate with the Board
- Creates time to evaluate proposals and develop alternative strategies

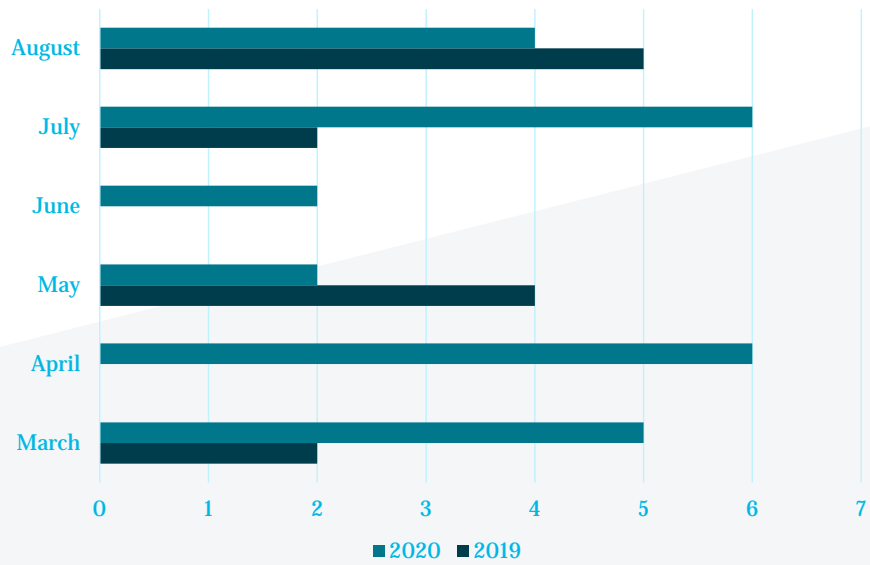
### Cons

- Do not prevent stock acquisitions that could impair or destroy the value of the NOLs
- Disfavors all acquisitions of more than 5% of the Company's stock (whether hostile or friendly)
- May increase the threat of proxy fights and shareholder lawsuits
- Could result in adverse investor reaction (especially if not put up for shareholder approval)

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## Summary of NOL Poison Pills

- 132 companies have implemented NOL Poison Pills in past ten years
- 72 still in effect



## Limitation on Business Interest Expense cont'd

- Any amount disallowed under §163(j) is carried forward indefinitely as BIE paid or accrued in the succeeding taxable year.
- §163(j) generally applies to all taxpayers, and applies at the entity level, with special rules for partnership or S corporation level debt.
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## Limitation on Business Interest Expense cont'd

TPs can elect to use ATI for last TY beginning in 2019 to determine §163(j) limitation

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### Definition of Interest

4 categories, including an anti-avoidance rule. §1.163(j)-1(b)(22).

**Category 1**—Amounts paid, received, or accrued as compensation for use or forbearance of money under debt instrument, or treated as interest under other provisions of Code or regs.

**Category 2**—Swaps with significant nonperiodic payments treated as two separate transactions:

- On-market, level payment swap and
- A loan, which must be accounted for separately, with time value component under §1.446-3(f)(2)(iii)(A) recognized as interest expense by payor and interest income by recipient.
- Exceptions for cleared swaps and swaps required to meet margin or collateral requirements of federal regulator.
- Delayed applicability date to September 14, 2021, although TPs can opt in, and anti-avoidance rule will apply. §1.163(j)-1(c)(3)(i).

## Definition of Interest, cont'd

### Category 3—Other amounts treated as interest, including:

- Bond issuance premium, ordinary income or loss on CPDIs, substitute interest payments on repos or securities lending transactions not entered into in the ordinary course of TP's business, ordinary gain under §1258 (conversion transactions), income on factored receivables.
- Category 3 was narrowed significantly by deleting: Items from derivatives that alter TP's effective cost of borrowing or yield, loan commitment fees, debt issuance costs and guaranteed payments for the use of capital under §707(c).
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## Definition of Interest, cont'd

### Category 4 anti-avoidance rule:



## Definition of ATI

**Starts with TTI**, which is taxable income under §63, but without regard to §163(j) limitation or disallowed BIE carryforwards. §1.163(j)-1(b)(1), (b)(43).

**Additions** for BIE (other than disallowed BIE carryforwards); NOL deduction; §199A deduction; deduction for depreciation, amortization and depletion (for taxable years beginning before 1/1/22); deduction for capital loss carryback or carryover; and deductions or loss not properly allocated to non-excepted trade or business.

**Subtractions** for BII; floor plan financing interest expense; anti-double counting adjustment; income or gain not properly allocated to non-excepted trade or business; and deemed inclusions of subpart F income and GILTI properly allocated to non-excepted trade or business, net of §250 deduction.

## Anti-Double Counting Adjustment, cont'd



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### C Corporations

- Basic framework of 2018 proposed rules was maintained.
- All interest expense and interest income of C corporation is per se BII and BIE allocable to C corporation's trade or business. §1.163(j)-4(b)(1).
- Disallowance and carryforward of deduction for BIE does not affect whether or when BIE reduces TP's earnings and profits. §1.163(j)-4(c).
- Current year BIE is deducted in the current taxable year before any disallowed BIE carryforwards from prior taxable year are deducted in that year.
- Disallowed BIE carryforwards are deducted in the order they arose, beginning with the earliest taxable year, subject to certain limitations (e.g., under §382). §1.163(j)-5(b)(2).
- Disallowed BIE carryforwards are "inheritable" tax attributes under §381 (subject to §382 and/or SRLY limitations). §1.381(c)(20)-1.
- Acquirer's ability to use transferor's disallowed BIE carryforwards in first tax year ending after a §381(a) acquisition is limited, based on similar rule as for acquired NOLs. §1.381(c)(1)-1 and 1.381(c)(1)-2.

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## C Corporations, cont'd

### Interaction with §250 Deduction

- §163(j) limitation is based in part on TP's ATI. §250 generally provides a deduction based on amount of FDII and GILTI of domestic corporation, subject to a limitation based on taxable income (the greater TP's taxable income for purposes of §250, the greater the allowable deduction).
- Prior proposed regs provided that ATI was determined without regard to the limitation on the §250 deduction (resulting in lower ATI).
- Service determined that further study is required to determine the appropriate rule for coordinating Code provisions that limit the availability of deductions based, directly or indirectly, upon TP's taxable income.
- Until additional guidance is effective, TPs may choose any reasonable approach (which could include an ordering rule or simultaneous equations) as long as approach is applied consistently for all relevant taxable years.

## Consolidated Groups

- Single §163(j) limitation applies at consolidated group level, consistent with §163(j), Notice 2018-28 and 2018 proposed regs. §1.163(j)-4(d)(2).
- Consolidated group's ATI is group's taxable income, and is determined generally disregarding intercompany transactions with offsetting items.
- Intercompany obligations generally are disregarded for purposes of computing ATI, BII and BIE. Result is that consolidated group's BIE subject to limitation is determined by reference to external BIE, rather than with respect to member that ultimately bears cost of borrowing (through on-loans, internal financing).
- Exception for repurchase premium deductible under §1.163-7(c) from deemed satisfaction of obligations that become intercompany obligations. §1.163(j)-4(d)(2)(v)(B). Service determined that it should not matter which member of consolidated group repurchases external debt.

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## Consolidated Groups, cont'd

- Current year or disallowed BIE of departing member treated consistently with consolidated NOLs under §1.1502-21(b).
- Retained and carried forward to departing member's first separate return year to extent not used by consolidated group for taxable year including departure date or otherwise reduced.
- Under unified loss rule of §1.1502-36, disallowed BIE is treated as a deferred deduction subject to reduction or reattribution in connection with transfer of loss share.
- Anti-avoidance rule provides that arrangements entered into with a **principal purpose** of avoiding §§

## CFCs

### Why does it matter if §163(j) applies to CFCs?

- Potential to increase subpart F income, and GILTI tested income.
- Can limit subpart F income, and GILTI tested income included in determination of US shareholders' §163(j) limitation.
- Reduces tax efficiency of locating debt offshore to maximize value of interest deductions.
- Final regs continue to exclude from ATI of US shareholders subpart F income inclusions, GILTI inclusions and §78 gross-up on deemed paid taxes; proposed regs include adjustment to ATI for portion of subpart F income and GILTI inclusions for CFC group member that is attributable to CFC's ETI.
- Anti-abuse rule applies to certain intra-group interest payments made with a principal purpose of reducing US shareholders' tax liability when CFC group election is not in effect.
- Final

## CFCs cont'd

Proposed regs include quasi-consolidated group concept with single §163(j) limitation (with each CFC allocated its share of limitation).

- Limitation computed for CFC group by determining ATI, BIE and BII on separate company basis and then aggregating.
- Transactions between members of CFC group and items of income and expense arising from indebtedness between CFC group members are taken into account in determining ATI of CFC group.
- ATI computations take foreign taxes into account.

Modified requirements for group election:

- 80% (direct or indirect) value test, but group parent can be applicable CFC or US person.
- CFCs with ECI can be included (non-ECI items).
- CFC financial services subgroup eliminated.

CFC group election revocable after 60 months and then can't be made for again for another 60 months.

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