

# CARES Act Net Operating Loss Carryback Rules Create Opportunities, Traps for the Unwary

The Coronavirus Aid, Relief, and Economic Act (CARES Act), signed into law by President Trump on March 27, 2020, made significant changes to the Net Operating Loss (NOL) carryback rules, for both individuals and businesses. Under the Tax Cuts and Jobs Act of 2017 (TCJA), for tax years beginning in 2018 and thereafter, NOL carrybacks are not allowed. Rather, NOLs are carried forward indefinitely but limited to 80 percent of taxable income.

The CARES Act temporarily suspends these provisions. Under the CARES Act, NOLs generated in tax years beginning after December 31, 2017 and before January 1, 2021 (i.e., 2018, 2019 and 2020 for calendar year taxpayers), can be carried back five years and carried forward indefinitely with no limitation. For a more detailed summary of the changes see [this article](#). These changes are a great benefit to taxpayers. They also create, however, significant traps for the unwary.

The new NOL rules provide an opportunity for businesses to carry back a NOL to years where the tax rate on ordinary income was 35 percent versus the current rate of 21 percent. This might generate a tax refund for companies and thus provide immediate cash flow. For individuals, there is not as significant a benefit due to changes in tax rates, however, the CARES Act suspends certain loss limitation provisions for individuals, allowing them to utilize losses that they previously could not use. Thus, the change in the law is very valuable to both businesses and individuals.

Below are some of the key considerations for businesses and individuals.

## Adequate Documentation

At the height of the mortgage crisis, in order to stimulate the economy, the American Recovery and Reinvestment Act of 2009 increased the NOL carryback period from two years to up to five years for tax years beginning or ending in 2008. The goal was to allow taxpayers to quickly carry back losses to profitable years and receive tax refunds. In the years after that change, Reinhart handled numerous IRS audits where the IRS argued that businesses and individuals did not have adequate documentation to claim the NOL.

Taxpayers often failed to document NOLs or keep records supporting the use of

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the loss in an earlier year (e.g., 2003). After all, business owners do not plan to lose money. Further, when a business is losing money, documenting the loss is the owner's least concern. In that the IRS statute of limitations on the assessment of tax is normally three years, many taxpayers believed that 2003 was a closed (i.e., could not be audited) year. However, then and now, the taxpayer has the burden of proving the use of the loss in the year it is carried back to. Thus, if a 2018 loss is carried back to 2013, the taxpayer must prove both the NOL in 2018 and the use of the loss (i.e., the amount of the refund claim) in 2013. Because NOL carrybacks were suspended in 2017 under the TCJA, businesses and individuals have not been anticipating the need to track NOL carrybacks.

Generally, issues such as proof of basis, the passive loss rules under section 469, and the at risk rules under section 465, are far from the forefront of the mind of a taxpayer whose business is struggling. Yet, these are issues that are often raised by the IRS. To defend against audit adjustments under these rules, taxpayers must have adequate records to prove basis, material participation and amounts at risk.

## **Settling A Pending Tax Case**

Taxpayers who are currently under audit for years 2013 to 2018, should be careful about settling these years with a Form 870-AD. This form is commonly used by the IRS Office of Appeals to resolve cases, and it contains a provision that prohibits the filing of a refund claim after settlement. This means that taxpayers who settle an audit of tax years where there is a possible NOL carryback by signing a Form 870-AD may be precluded from claiming a NOL carryback, and thus a refund claim for those years. The IRS Office of Appeals has generally been receptive to allowing taxpayers to add language to a Form 870-AD indicating that the prohibition on filing a refund claim does not preclude a refund claim based upon a NOL carryback.

## **Making an Appropriate Election not to Carry Back a Loss**

Generally, it is preferable to carry a loss back and obtain a refund rather than carry the loss forward. The new statute provides that NOLs are automatically carried back unless a timely election is made to carry the NOL forward. For some businesses and individuals, however, it may be more advantageous to carry NOLs forward as opposed to back (i.e., the prior years had capital gain income and the future years will likely generate ordinary income, which is taxed at a higher tax rate). However, unless an election is made, the law requires that an NOL be carried back to the earliest year within the carry back period where there is

taxable income. An election to forego the carry back and to carry forward the NOL is made on a yearly basis with filing of a tax return. The election must be made by the due date, including extensions of time, for filing the return. For tax years 2018 and 2019, the election must be made by the extended due date of the 2019 return, which is October 15, 2020.

## **Past M&A Transactions**

The ability to carry back NOLs could impact M&A deals that closed in recent years. In an acquisition of a target corporation, the target may become a member of a buyer corporation's consolidated tax group. This often results in a short-period return for the target, which might generate an NOL due to transaction deductions. Because of changes under the TJCA, the NOL could no longer be carried back by the target. However, under the CARES Act, target sellers might have the ability to carry back losses and claim refunds for the preceding five years depending on the agreement of the parties as set forth in the acquisition agreement. Target sellers should review their acquisition agreements and determine if refund claims are available. For sales of a corporate subsidiary of a consolidated group, the common parent of the subsidiary that files the consolidated return might also be entitled to a refund, absent provisions in an acquisition agreement or tax sharing agreement to the contrary.

## **Section 965 Considerations**

Section 965 was enacted in 2017, and requires U.S. shareholders to pay a tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States. The tax was due in 2017, however, taxpayers could elect to pay the liability in eight annual installments. For taxpayers that elected to pay their section 965 liability in installments, the IRS has taken the position that any overpayments of tax must be applied toward the 965 liability. Therefore, if the carry back of an NOL creates a refund of tax, the refund could be applied to pay future section 965 liability installments.

## **Interaction With Other Tax Provisions**

An NOL carryback could reduce deductions or credits claimed in prior years based on a change in the amount of the taxpayer's taxable income. For example, there could be changes to the general business credit, Code section 250 deduction or charitable contribution deductions. Taxpayers should consider the impact on tax attributes when amending returns to reflect an NOL carryback.



## **Pass-through Implications**

NOLs generated by pass-through entities are passed through to the individual owners on a Form K-1 and then reported on the individual owner's tax return. Individuals are able to utilize NOLs subject to certain limitations. Limitations on an individual's ability to utilize an NOL include the personal loss limitations under section 461(l). The CARES Act temporarily modifies the loss limitation rules under Section 461(l), further benefiting an individual's ability to utilize its NOLs and seek refunds.

If you have any questions about how the CARES Act impacts you and your business, please contact your Reinhart attorney.

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