

Click to print or Select 'Print' in your browser menu to print this document.

Page printed from: <https://www.law.com/newyorklawjournal/2020/04/15/income-tax-relief-under-covid-19-legislation/>

Income Tax Relief Under COVID-19 Legislation

In their Taxation column, David E. Kahen and Elliot Pisem discuss the Coronavirus Aid, Relief, and Economic Security Act, particularly focusing on the loosening of limitations on the use of net operating loss carryovers and carrybacks by corporate and non-corporate taxpayers and of “excess business losses” by non-corporate taxpayers, including shareholders in S corporations and owners of equity interests in entities treated as partnerships for tax purposes.

By **David E. Kahen and Elliot Pisem** | April 15, 2020



Elliot Pisem and David E. Kahen

The Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136, also known as the CARES Act), enacted in March 2020, includes income tax benefits intended to improve the cash flow of taxpayers burdened by the economic consequences of the COVID-19 pandemic. We focus in this article on the loosening of limitations on the use of net operating loss (NOL) carryovers and carrybacks by corporate and non-corporate taxpayers and of “excess business losses” by non-corporate taxpayers, including shareholders in S corporations and owners of equity interests in entities treated as partnerships for tax purposes.

Other income tax changes made by the CARES Act, but not discussed below, include amelioration of limitations on the deductibility of interest under Internal Revenue Code (Code) §163(j), reclassification of certain leasehold improvements for depreciation purposes to permit more rapid cost recovery through deductions for depreciation (effectively fixing an unintended glitch created by tax legislation in 2017), and acceleration of tax credits for certain prior year minimum tax obligations imposed on corporations.

Background

The rules regulating the application of NOL deductions to reduce the income of corporations and other taxpayers in years other than the year of the loss have changed frequently over the years. The term “net operating loss” is defined in §172(c) as the excess of deductions allowed by chapter 1 of Subtitle A of the Code over the gross income of the taxpayer. That excess is computed with certain modifications, and the availability of the loss is further limited under other rules, including those relating to capital losses of corporations (Code §1212(a)) and to the use of losses following an ownership change with respect to a corporation (Code §382).

Under the Code as in effect prior to the CARES Act, NOLs arising in taxable years beginning after 2017 could not (with very limited exceptions) be carried back, but they could be carried over to each taxable year following the year of the loss, with no “outside date.” The use of an NOL incurred in any post-2017 year in any one subsequent taxable year could not exceed 80% of the taxable income for that subsequent year, computed without regard to the NOL deduction. NOLs arising in 2017 and earlier years could generally be carried back for two taxable years (unless the carryback period was waived) and carried forward for 20 taxable years.

New Law

The CARES Act has loosened these limitations in the case of losses carried to 2019 and 2020. The full amount of the NOL carryovers and carrybacks to such a taxable year may be used as a deduction to offset taxable income. Therefore, the use of NOLs by a taxpayer in a taxable year ending Dec. 31, 2020 (for example) is not limited to 80% of taxable income for that year, even if those NOL’s arose in a post-2017 year.

In the case of a taxable year beginning after 2020, the pre-CARES Act rules are scheduled to resume application, such that the NOL deduction will be limited to (1) the aggregate NOLs from taxable years beginning before 2018 (to the extent not already used before 2021) and (2) the excess of (a) 80% of taxable income for that year as determined without regard to NOL deductions over (b) the losses from taxable years beginning before 2018 carried over to the year. Section 172 as amended by the CARES Act now further provides that taxable income is determined for this purpose without regard to any deduction allowable under §199A (relating to qualified business income of non-corporate taxpayers) or under §250 (relating to certain deductions allowable in respect of foreign-derived intangible (FDI) income and global intangible low-taxed income (GILTI)).

Under Code §172(b) as amended by the CARES Act, a NOL arising in a taxable year beginning after 2017 and before 2021 may be carried back for up to five taxable years (and remains eligible for carryover to the extent not used in those earlier years). As under prior law, a taxpayer eligible for a carryback period may relinquish the carryback period, but only in its entirety (setting aside certain special rules relating to years with income inclusions under Code §965), in respect of a NOL for any taxable year. The election to waive the carryback must generally be made by the due date (taking extensions of time to file into account) of the return for the taxable year of the NOL for which the election is to be made, and, once made, will be irrevocable for that taxable year. (As discussed below, however, the IRS has issued guidance providing additional flexibility as to the timing of the waiver of the carryback and changes to such a waiver.)

Most corporations will not yet have filed their tax returns for 2019, and thus should be in a position to claim NOL deductions for 2019 (and 2020), including by way of carryback, on the original filed return for the year in which the loss arose. Such carrybacks may be particularly attractive where the carryback permits the loss to be used in a pre-2018 year, when corporate income tax rates were higher than the current rate of 21%.

Corporations and other taxpayers may also qualify under Code §6411 to apply for a carryback adjustment by filing Form 1139 or Form 1045, with the resulting tax adjustment to be refunded, generally, within 90 days of application under §6411(b). The application must generally be made within 12 months after the end of the year in which the loss arose, but IRS Notice 2020-26 grants an extension of an additional six months for such applications with respect to taxable years beginning on or after January 1, 2018, and ending by June 30, 2019, such that an application with respect to a loss for (say) calendar year 2018 could be made by June 30, 2020.

The issues to be weighed in determining whether to claim a benefit from a NOL through a carryback on an original or amended return can be complicated, however, and include (without limitation) the amount of the anticipated federal tax benefit, whether a concomitant benefit will be available for state and local income or franchise tax purposes, and the potential for further scrutiny of issues in the year for which the amended return is filed (if an amended return is required) as well as in the carryback years.

Further, in a statement dated April 8, 2020, the IRS recommended that taxpayers await further instruction from the IRS on the filing of tax refund claims that may be available under the CARES Act, before using “traditional processes” to obtain such refunds. Additional information regarding such refund claims will be posted to the [irs.gov](https://www.irs.gov) website.

Those considering a carryback under IRC §6411 or otherwise, or the waiver of a carryback period, should also review Rev. Proc. 2020-24, which provides further guidance regarding the time and manner and potential effect of such elections. In particular, §4.01 of Rev. Proc. 2020-24 provides that a taxpayer within the scope of the revenue procedure may elect under §172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019 by attaching a statement to its federal income tax return filed for its first taxable year ending after March 27, 2020. A separate statement must be attached for each of the taxable years for which it is making this election, and the statement must state that the taxpayer is electing to apply §172(b)(3) under Rev. Proc. 2020-24.

The issues may be still more complicated if a 2018 loss (which could result from the application of other income tax changes under the CARES Act, such as with respect to depreciation of leasehold improvements) relates to a partnership. Some of these complexities arise from provisions of the Bipartisan Budget Act of 2015 (BBA) and related regulations, concerning audit-related adjustments of partnership tax items. A recent revenue procedure (Rev. Proc. 2020-23, 2020-18 IRB __) permits certain partnerships that are subject to the BBA rules and meet requirements discussed in the revenue procedure to file amended returns for partnership taxable years that began in 2018 and 2019, before Sept. 30, 2020.

The extent of state income tax or franchise tax NOLs and the impact on the use of those NOLs should also be considered before a decision is made to carry back or waive a carryback period for federal income tax purposes. Section 607 of the New York Tax Law was recently amended by state revenue-related legislation (see S. 7508-B and A. 9508-B, Part WWW) to provide that, for taxable years beginning before 2022, amendments made to the Code after March 1, 2020, will not be taken into account under the New York Tax Law, in order to avoid the state tax revenue loss that would otherwise result from certain of the changes in federal tax law referenced above. Other state and local taxing jurisdictions have or may “decouple” in a similar way.

Non-corporate taxpayers should also take note of changes made to subsection (f) of §461, added to the Code in 2017. That provision prevents non-corporate taxpayers (including partners in partnerships and shareholders of S corporations), in respect of taxable years beginning after 2017 and before 2026, from claiming a deduction for “excess business losses,” with the result that such losses cannot be used to offset

income from other sources in the same year. “Excess business loss” is defined as the sum of a taxpayer’s deductions attributable to trades or businesses, over the sum of the aggregate gross income or gain of the taxpayer attributable to such trades or businesses plus \$250,000 (\$500,000 in the case of a joint return, with both amounts being adjusted for inflation after 2018).

The Cares Act amended §461(f) so that the disallowance of excess business losses will not apply for taxable years beginning before 2021. Taxpayers who were adversely affected by §461(f) with respect to tax obligations reported on a return already filed for 2018 or 2019 should consider whether an amended return should be filed.

The CARES Act also made changes of a technical nature to address ambiguities in §461(f) as originally enacted. For example, the revised language makes clear that an excess business loss not deductible in one year will be considered part of the taxpayer’s net operating loss carryover for any subsequent taxable year. The revised language also provides that whether or not a taxpayer has an excess business loss will be determined without regard to deductions, gross income, or gains attributable to the performance of services as an employee—such that the use of an excess business loss to offset wage income is generally precluded.

Observations

Taxpayers and their tax advisers will be under considerable time pressure in the next few months to analyze the impact, and make decisions in light of the tax law changes referenced above, not only because of the need to identify and apply for tax refunds as rapidly as possible under the current exceedingly difficult business circumstances, but also because of constraints imposed by the due dates for tax returns. To the extent that these changes affect tax obligations for 2019, those returns will generally be due, even with extensions, by Sept. 15 or Oct. 15, 2020, in respect of corporations and partnerships with calendar year taxable years. The tentative carryback rules referenced above, in combination with IRS Notice 2020-26, impose potentially tighter timing constraints with respect to losses relating to tax years that began in 2018.

David E. Kahen and **Elliot Pisem** are members of the law firm of *Roberts & Holland*.

Copyright 2020. ALM Media Properties, LLC. All rights reserved.