## The CARES Act and CNOLs: Avoiding Unanticipated Consequences

To the Editor:

Congress has passed and President Trump has signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136). The CARES Act resurrects a five-year net operating loss carryback rule, in recognition of the immediate cash flow needs of American businesses and the valuable counter-cyclical role that NOL carrybacks can provide in a time of widespread financial stress.

Absent from the CARES Act's NOL provisions are rules or guidance with respect to the application of the five-year carryback to the NOLs of an affiliated group of corporations that file a consolidated return. Moreover, consolidated filers can no longer rely on a temporary regulation that provided helpful guidance in the context of the previous five-year NOL carryback provision, because that regulation expired without finalization and thus is missing in action during the present crisis.[1]

We write to raise awareness of certain issues that have arisen and will arise in the context of consolidated returns. In particular, the five-year NOL carryback provision is likely to have unexpected retroactive impact on acquisitions and dispositions completed during the carryback period. We also note that for the congressionally-intended relief to be achieved in the context of consolidated filers — which comprise a small minority of corporations but the overwhelming majority of corporate business assets and activities[2] — it is important that Treasury and the IRS promptly issue some form of guidance on which taxpayers can rely that addresses these common issues. Therefore, for the reasons described below, we recommend the issuance of a notice, to be subsequently followed by regulations, allowing consolidated groups to effectively make a "split waiver election" for consolidated net operating losses (CNOLs) arising in tax years beginning after December 31, 2017, but before January 1, 2021, even though such an election would be untimely under the current regulations.[3] We also recommend that the government consider providing relief similar to that provided in Notice 2000-53, 2000-2 C.B. 293, to allow acquiring consolidated groups to determine the NOL carryovers of acquired subsidiaries without regard to the CARES Act changes to the NOL carryback rules.

### The Basic Rules

**The CARES Act.** Corporations that have incurred or will incur an NOL[4] in tax years beginning after December 31, 2017, and before January 1, 2021, generally are allowed to carry back these NOLs for up to five tax years.[5] Taxpayers may elect to relinquish the entire five-year carryback period with respect to a particular year's NOL, with the election being irrevocable.[6] In addition, taxpayers are allowed to elect to

[1] *See* T.D. 9490 (promulgating reg. section 1.1502-21T). Consistent with the section 7805(e)(2) three-year "sell by" date, the regulation expired June 21, 2013. Reg. section 1.1502-21T(h)(9)(ii).

[2] *See* IRS, "Statistics of Income — 2013; Corporation Income Tax Returns," Table 19.

[3] As described later, similar guidance was promulgated following the enactment of the five-year NOL carryback provision in 2009. *See* reg. section 1.1502-21T(b)(3)(ii)(C).

[4] An NOL is defined as the excess of allowable deductions over gross income. Section 172(c).

[5] CARES Act section 2303(b)(1), adding section 172(b)(1)(D)(i)(I) to the code. (For simplicity, we disregard the CARES Act's special NOL carryback rules for real estate investment trusts and life insurance companies.) Under the timing rules of section 172(b)(2) and reg. section 1.172-4(b)(1), NOLs are required to be carried back to the earliest of the tax years to which the loss may be carried. *See also* reg. section 1.1502-21(b)(1).

[6] Section 172(b)(3). *See also* reg. section 1.1502-21(b)(3)(i). Elections to forgo the five-year carryback of NOLs arising in tax years beginning in 2018 and 2019 must be made by the due date (including extensions) for filing the taxpayer's return for the first tax year ending after March 27, 2020 (the date the legislation was signed into law). CARES Act section 2303(b)(1), adding section 172(b)(1)(D)(v)(II) to the code. Elections to forgo the five-year carryback of NOLs arising in tax years beginning in 2020 must be made by the due date (including extensions) for filing the return for the tax year of the loss (*e.g.*, 2020).

exclude section 965 transition-tax inclusion years from the carryback period.[7]

**Consolidated Return Regulations.** A corporation that generates an operating loss in a tax year does not report a separate NOL if the corporation joins in the filing of a consolidated return for the year. Rather, if the consolidated group overall generates an operating loss, it is the group that reports the loss in the form of a consolidated CNOL.[8] The Supreme Court has noted that there is no concept of a separate NOL in the consolidated group setting.[9]

If any CNOL that is attributable to a member may be carried to a "separate return year" of the member, the amount of the CNOL that is attributable to the member is apportioned to the member and the apportioned loss is carried to the separate return year.[10] If carried back to a separate return year, the apportioned loss may not be carried back to an equivalent or earlier consolidated return year of the group.[11]

A consolidated group may make an irrevocable election (general waiver election) under section 172(b)(3) to relinquish the entire carryback period with respect to a CNOL for any consolidated return year.[12] To make a general waiver election, the consolidated group must include a statement in its income tax return for the consolidated return in which the losses arises.[13]

In addition, a consolidated group generally is permitted to make an irrevocable election (split waiver election) to relinquish, with respect to all CNOLs attributable to a member, the portion of the carryback period for which the member had been a member of another consolidated group.[14] This election is not available where the acquired member was not part of a consolidated group immediately before joining the acquiring group.[15] This election is filed on a particular statement, which must be filed with the acquiring group's return for the tax year in which the acquired member joined the acquiring group.[16]

## Examples

A common example can help illustrate the importance of the split waiver election.[17]

**Example 1:** On June 30, 2018, P acquired all of T's outstanding stock from X, the common parent of the X consolidated group. T had been a member of the X group since at least 2016. The P group did not file a split waiver election with its 2018 tax return, because P and its advisors were aware that as under then-applicable law, it was not possible to carry back any NOL, and thus no portion of a post-acquisition CNOL — even if attributable to T — could be carried back to a tax year of T when T was a member of the X group.[18] Due to unforeseen events, the P group incurs a significant loss in 2020, $100x of which is attributable to T.

Absent a general waiver election, the P group's 2020 CNOL will be carried back to the first year of the five-year carryback period, and the $100x apportioned to T generally will be carried back to the X group's 2016 tax year (and, if not absorbed, to the X group's 2017 and 2018 tax years).[19] To the extent the apportioned loss offsets taxable income of the X group and generates a refund, the X group would receive that refund

[7] In particular, in lieu of making a general waiver of the carryback period, a taxpayer may elect to exclude from the five-year carryback period any tax year in which the taxpayer has an amount includable in its gross income by reason of the section 965 transition tax. CARES Act, section 2303(b)(1), adding section 172(b)(1)(D)(v)(I) to the code.

[8] Reg. section 1.1502-21(e) defines a CNOL as the excess of deductions over gross income, as determined under reg. section 1.1502-11(a).

[9] *United Dominion Industries Inc. v. United States*, 532 U.S. 822, 830 (2001) ("We think it fair to say, as United Dominion says, that the concept of separate NOL 'simply does not exist.'") (internal citation omitted).

[10] Reg. section 1.1502-21(b)(2)(i).

[11] *Id*. An equivalent year is defined in reg. section 1.1502-21(b)(2)(iii).

[12] Reg. section 1.1502-21(b)(3)(i).

[13] *Id*.

[14] Reg. section 1.1502-21(b)(3)(ii)(B).

[15] *Id*.

[16] *Id*.

[17] For purposes of these examples, unless stated otherwise, P is the parent of a consolidated group and T is a target corporation, all entities are includable corporations and calendar year taxpayers, none of the entities is engaged in a farming or insurance business that would have allowed it to claim a loss carryback under the rules of section 172 as in effect immediately prior to the CARES Act, and there are no contractual provisions (*e.g.*, in a stock purchase agreement) addressing loss carrybacks or a related refund claim.

[18] In contrast, T's attributed portion of a consolidated net capital loss incurred by the P group could be carried back to a tax year of T in which T was a member of the X Group. *See generally* section 1202; and reg. section 1.1502-22(b). This continues to be the case following the passage of the CARES Act. However, there is no equivalent to the general or split waiver election available for consolidated net capital loss carrybacks.

[19] The separate return limitation year (SRLY) rules of reg. section 1.1502-21(c) can limit the X group's absorption of the apportioned loss in the X group.

even though the apportioned loss was sustained by T while it was a member of the P group.[20] This is great news for X, because as the parent of the X group it will receive the tax refund relating to the apportioned loss.[21] Absent any contractual provision in the relevant stock purchase agreement between X and P, X may well be entitled to keep the refund and enjoy the liquidity boost occasioned by the P group's loss without having to compensate P.[22] P can avoid this result, though to do so P must make a general waiver election and waive the entire carryback period for the entirety of the P group's 2020 CNOL, and thereby give up a tax refund that may be critical to the cash needs of its business.

This example shows that the split waiver election is time-barred for 2018 acquisitions, even though at the time of the filing of the P group's 2018 tax return there likely was no reason to make the election. Moreover, X and P would have had little occasion to negotiate contractual terms addressing the carryback of a post-acquisition P group CNOL to a pre-acquisition year of T, because the NOL carryback rules had been repealed for most corporations.

Not all issues, however, can be resolved under a split waiver election.

**Example 2:** On January 31, 2019, P acquired all of T's outstanding stock from X, the common parent of the X consolidated group. T had been a member of the X group at all times from its formation in 2012. The negotiated price of the acquisition contemplated that T would carry into the P group its attributed portion of the X group's 2018 CNOL, and pursuant to the parties' stock purchase agreement X elected to waive under the unified loss rule any stock loss it might have had in T in order to preserve the NOL allocable to T.[23] The P group, which files on a June 30 year-end basis, reported a substantial profit for its tax year ending in 2019 and deducted on that return a portion of the X group's loss that had been apportioned to T. Meanwhile, X intends to carry back its 2018 CNOL under the CARES Act, and has sufficient capacity to fully absorb its 2018 CNOL.

As a result of the CARES Act, the X group's 2018 CNOL, including T's attributable share, will be fully absorbed in the five-year carryback period, and leave T with no loss to carry into the P group. Thus, the new five-year carryback would effectively change the economics of the deal and provide the benefit of T's attributable share of the X group's 2018 CNOL to the X group instead of the P group. As with the prior example, good news for X, less so for P, and perhaps not what Congress may have intended to accomplish with the CARES Act.

## Prior Experience

We have been here before, at least with respect to an extended NOL carryback rule intended to provide for liquidity. Congress previously enacted a five-year NOL carryback rule (former section 172(b)(1)(H)) in response to the so-called Great Recession.[24] To address the application of the former section 172(b)(1)(H) to consolidated groups, Treasury and the IRS issued reg. section 1.1502-21T. Very generally, former section 172(b)(1)(H) provided taxpayers the ability to elect, for a single tax year within a specified period, an NOL carryback period of up to five years. Certain aspects of former section 172(b)(1)(H) that are addressed in reg. section 1.1502-21T are not relevant to the five-year carryback created by the CARES Act,[25] and former section 172(b)(1)(H) required taxpayers to affirmatively elect to carry back an NOL (in contrast to the CARES Act, which requires taxpayers to carry back an NOL absent an election

[20] Reg. section 1.1502-77.

[21] Reg. section 1.1502-77(d)(5).

[22] *See Rodriguez v. Federal Deposit Insurance Corp.*, 140 S. Ct. 713 (2020).

[23] Reg. section 1.1502-36(d)(6).

[24] *See* former section 172(b)(1)(H), as enacted by section 13(a) of the Worker, Homeownership and Business Assistance Act of 2009, P.L. 111-92, 123 Stat. 2984, 2992-2993 (2009), and as described in Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 111th Congress," JCS-2-11, at 162-165 (2011). Former section 172(b)(1)(H) was repealed by section 221(a)(30)(A)(i), Division A, of the Tax Increase Prevention Amendments Act of 2014, P.L. 113-295, 128 Stat. 4010, 4041 (2014). *See also* Mark P. Keightley, "COVID-19: Potential Role of Net Operating Loss (NOL) Carrybacks in Addressing the Economic Effects," Congressional Research Service IN11240, at 2 (Mar. 16, 2020) (citing a series of recent congressional extensions of the carryback periods applicable to NOLs).

[25] For example, the CARES Act, unlike former section 172(b)(1)(H), does not contain a taxable income limitation for the carryback of an NOL to the fifth tax year of the carryback period or a requirement to elect to apply the carryback with respect to an NOL arising in a single specific year.

to waive the carryback). However, the ability to effectively make an "untimely" split waiver election, which was provided in reg. section 1.1502-21T(b)(3)(ii)(C), is an aspect of the regulations that is particularly relevant and worth reinstating in light of the CARES Act.

In Example 1 above, allowing a split waiver election for P's acquisition of T would allow the P group the intended liquidity benefit of the five-year NOL carryback without potentially transferring a tax refund arising from losses incurred while T was a member of the P group to the X group. The P group likely would have made a split waiver election in the context of the original transaction, had it known that the NOL carryback provisions would be reinstated. We believe authorizing "untimely" split waiver elections would provide for results that are more consistent with the reasonable expectations of the parties to acquisitions and dispositions within the carryback period and better facilitate the liquidity benefits intended by the five-year carryback provision.

In Example 2 above, consideration should be given to creating a new consolidated return election to allow P to preserve the economic deal agreed to in the original transaction. A precedent for a new election in this context is the one that was adopted in Notice 2000-53. The notice addressed a situation where taxpayers were in an interim period where the separate return loss year (SRLY) overlap rule[26] was to be effective but regulations had not yet been issued. The effect of adopting the SRLY overlap rule was that certain qualified stock purchase[27] acquisitions of corporations that occurred in the interim period (interim sales) could result in the application of the SRLY overlap rule and result in a corresponding increase in the amount of NOLs that a selling group could absorb, thus leading to adverse consequences to certain parties to an interim sale. This is illustrated by the following example.

**Example 3:** On March 31, 1999, P acquired all of T's outstanding stock from X, the common parent of the X consolidated group. X had acquired T in 1996 from an unrelated seller, at a time when T had NOL carryforwards of $100x. The X group's use of T's NOL carryforwards was limited by concurrent section 382 and SRLY limitations. The X group was profitable, but T experienced further losses while a member of the X group; as a result, the X group was unable to utilize any of T's NOL carryforwards due to the SRLY limitation.

Under the final SRLY regulations issued in June 1999,[28] X's 1996 acquisition of T was subject to the SRLY overlap rule. Thus, T's $100x of carryforward NOLs could now be used without regard to a SRLY limitation by the X group in 1999.[29] The use of T's $100x of carryforward NOLs in the X group would still be limited by section 382, but the section 382 limitation may allow a much greater utilization of such NOLs than the amount that was permitted under the SRLY limitation that had previously applied to T's NOL carryovers in the X group. To the extent the X group was able to utilize T's carryovers courtesy of the retroactive application of the SRLY overlap rule, T's NOL carryforwards would have been concomitantly reduced prior to its joining the P group. However, the acquisition may have been negotiated on the basis that T's $100x NOL carryforwards had not been used in the X group as a consequence of the SRLY limitation. Thus, the SRLY overlap rule in this instance may have disrupted the reasonable expectations of the parties.

Accordingly, the notice was issued to allow a departing member of a consolidated group to elect to unilaterally determine its NOL and capital loss carryovers to post-acquisition years by treating the SRLY overlap rule as not applying.[30] In Example 3 above, this would have preserved T's $100x of NOL carryforward for potential

[26] Reg. section 1.1502-21(g).

[27] A qualified stock purchase, defined in section 338(d)(3), generally includes a corporate buyer's acquisition of 80 percent or more of the outstanding stock of a target corporation in a taxable purchase from an unrelated seller.

[28] T.D. 8823.

[29] Although the SRLY overlap rule applied to X's 1996 acquisition of T under the final regulations, the use of T's $100x of carryforward NOLs in 1997 and 1998 would not be adjusted.

[30] Notice 2000-53 applied to acquisitions that were made in an "interim period," defined as a tax year of the consolidated group to which the SRLY overlap rule regulations applied but prior to the issuance of the 1999 final regulations.

future use by the P group. The election provided by Notice 2000-53 did not affect the treatment of the selling consolidated group, and therefore some or all of T's $100x of NOL carryforward could also be used by the selling consolidated group, as the 1999 final regulations eliminated the SRLY limitation on T for 1999. However, in many cases, this "double benefit" of allowing the use of the same NOL carryforward by both the selling and acquiring consolidated groups would be mitigated or eliminated by the corresponding reduction in T's stock basis,[31] which would increase the gain (or decrease the loss) recognized by X on its sale of T to P.

Examples 2 and 3 are quite similar in that they illustrate situations where a significant change in law disturbed the legitimate expectations of the parties, resulting in a detriment to the acquiring group that could not have been reasonably foreseen as of the acquisition. The government should consider an approach similar to Notice 2000-53, in which the selling group applies existing law but the acquiring group may elect to determine its NOL carryover into the acquired group without regard to the CARES Act carryback rule. As noted above, the "double benefit" created by allowing the same NOLs to be utilized in two groups under this approach would be mitigated or eliminated in many cases by the corresponding investment adjustments to the stock basis of the target subsidiary in the hands of the selling group. Further, this approach is fully consistent with the general intent of Congress to provide for immediate liquidity in the face of a severe economic shock without undermining the contractual agreements that were previously agreed upon. For example, this approach would, in Example 2, prevent the potential necessity of the P group to amend its 2019 return and pay additional tax, a result directly contrary to the intent of the enactment of the CARES Act NOL provisions.[32]

### Recommendation

Therefore, we would hope that guidance similar to reg. section 1.1502-21T(b)(3)(ii)(C)(2) will be issued to allow the consolidated groups to make an "untimely" split waiver election for CNOLs arising in tax years beginning after December 31, 2017, but before January 1, 2021. It appears appropriate to apply the same restrictions on this "expanded" split waiver election as applied under reg. section 1.1502-21T(b)(3)(ii)(C)(2) (for example, to require any other corporations joining the acquiring group that were affiliated with the electing member to also make the election). We would also hope that the government will consider relief similar to that in Notice 2000-53 to allow acquiring groups to determine NOL carryovers without regard to the CARES Act changes to the NOL carryback rules.

Given the continuing uncertainty and immediacy of the liquidity constraints faced by businesses, we believe that providing certainty in this area is a priority. Therefore, we recommend the issuance of a notice, to be subsequently followed by regulations, consistent with the above.

Finally, with respect to the general waiver election, we note that reg. section 1.1502-21T(b)(3)(i) currently requires that a general waiver election is filed with the consolidated group's income tax return for the consolidated return year in which the loss arises. We also recommend that the above notice explicitly provide that, consistent with new section 172(b)(1)(D)(v)(II),[33] a general waiver election may be made by a consolidated group, with respect to an NOL arising in a tax year beginning in 2018 or 2019, by the due date (including extensions) for filing the consolidated group's income tax return for the first tax year ending after the date of the enactment of the CARES Act.

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[31] *See* the investment adjustment rules of reg. section 1.1502-32.

[32] Alternatively, it might reduce P's refund if it were to generate a CNOL in 2020 and carry that loss back to 2019.

[33] *See* CARES Act section 2303(b)(1).

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