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CARES Act: Impact of revised net operating loss rules in M&A transactions

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The recently enacted Coronavirus Aid, Relief, and Economic Security Act (CARES Act) revised the federal net operating loss (NOL) rules in a manner that may allow businesses and their owners to receive cash refunds of taxes paid in prior tax years. These modified NOL rules will also have an impact on mergers and acquisitions (M&A) transactions that have closed in recent years or that are being negotiated now.

CARES Act modifications to NOL rules

The ability to carry NOLs to prior and future taxable years has frequently changed over time. Most recently, the Tax Cuts and Jobs Act (TCJA) enacted in late 2017 modified the NOL carryback rules effective for tax years beginning in 2018. Following the TCJA, and prior to the CARES Act, NOLs could not be carried back to offset taxable income in prior years but could be carried forward indefinitely.

The CARES Act now allows taxpayers to carry back certain NOLs to each of the five taxable years preceding the taxable year in which the NOL arises. NOLs generated in a taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021, (e.g., NOLs generated in 2018, 2019 or 2020 by a calendar year taxpayer) must be carried back five years unless the taxpayer makes an irrevocable election to waive the entire carryback period. Many businesses that have been financially impacted by the novel coronavirus (COVID-19) pandemic may be in an NOL position for 2020 and can avail themselves of these carryback rules to obtain cash refunds of taxes paid in prior tax years.

Further, the TCJA limited NOL usage to 80 percent of taxable income. The CARES Act temporarily removes the 80 percent limitation, reinstating it for tax years beginning after 2020. This change permits NOLs carried back to prior years to offset up to 100 percent of taxable income in those years.

The ability to carry back NOLs up to five years may result in larger tax refunds due to tax rates being higher in years prior to 2018. The TCJA substantially reduced tax rates for tax years beginning in 2018. Under the TCJA, corporate tax rates were reduced from 35 percent to 21 percent, and individual and trust rates were reduced from 39.6 percent to 37.0 percent (or 29.6 percent if the full qualified business income deduction applies). NOLs carried back to tax years prior to 2018 will offset income taxed at higher rates and produce larger refunds than carrying forward the NOLs to future years.

In addition to the NOL modifications, the CARES Act also temporarily increased the business interest deduction limitations, temporarily eliminated the non-corporate excess business loss deduction, and retroactively corrected the treatment of qualified improvement property as 15-year property for depreciation purposes, making this property eligible for 100 percent bonus depreciation.

The information contained herein is based on a summary of legal principles. It is not to be construed as legal advice and does not create an attorney-client relationship. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

As a result of these changes, taxpayers that did not have an NOL in 2018 or 2019 under the prior rules may now have one as a result of the CARES Act modifications. For example, taxpayers that purchased qualified improvement property in 2018 or 2019 may now be able to amend their returns for those years to claim 100 percent bonus depreciation on the property in the year of purchase, which could result in the creation of an NOL in those years.

Impact on M&A transactions

NOLs are frequently generated in M&A transactions as a result of the target company paying substantial transaction bonuses, option cash-out payments, and investment banking and legal fees that generate tax deductions in excess of the target company's operating income for the year of the transaction.

The impact of the CARES Act modifications to the NOL rules will depend on whether the target company is a pass-through or a corporate entity and whether the sale is structured as an equity sale or asset sale for income tax purposes. In the case of transactions involving flow-through entities such as partnerships and S corporations, these seller transaction deductions generally pass through to the owners and generate NOLs at the owner level.

With regard to transactions structured as asset sales for tax purposes, any NOLs generated by the sale are retained by the seller. Both before and after the enactment of the CARES Act, the buyer in these types of transactions is generally unable to avail itself of NOLs generated by the target or its owners. However, in the case of corporate stock acquisitions, the buyer will generally acquire the target corporation along with its NOLs. The buyer's usage of target company-generated NOLs is often significantly limited by the ownership change rules in Section 382 of the Internal Revenue Code.

After the enactment of the TCJA and prior to the CARES Act, the parties to corporate M&A transactions typically negotiated an allocation of the tax benefits of any NOL generated by the transaction that would be carried forward to the buyer's tax returns. For example, the sellers may have negotiated a payment from the buyer to compensate the sellers for the tax benefit of the NOL generated by the transaction. This payment was often made either in the form of an up-front payment at closing or a series of payments made whenever the buyer realized tax savings from usage of the NOLs (and often limited to a specified number of years). M&A agreements entered into after the TCJA and prior to the CARES Act typically did not contemplate the ability of the seller to carry back NOLs generated by the transaction.

For corporate transactions that have already closed in 2018, 2019 or 2020, the parties should review their M&A agreements to determine which parties are entitled to the benefits of NOLs and to determine which party has the right to determine whether NOLs can be carried back under the modified rules. There may be opportunities for parties to enter into post-closing amendments to renegotiate the NOL provisions for closed transactions in light of the new CARES Act rules. While the original M&A agreement may have contemplated that the buyer would use the NOLs in future years, there may be more immediate economic benefits for transaction-generated NOLs to be carried back to prior years of the target entity, which can generate cash refunds that can be contractually allocated between the parties.

For corporate transactions that are set to close later in 2020, the parties should consider whether NOLs will be generated by the transaction and contractually negotiate the allocation of tax benefits if the NOL is carried back to the target company's prior tax years to generate cash refunds of taxes previously paid. In negotiating M&A agreements, parties should also take into consideration the impact of other CARES Act provisions, including those that relate to the ability of employers to defer payment of employment taxes or to receive employee retention tax credits.

In the case of transactions involving the sale of partnerships or S corporations, or transactions structured as asset sales for tax purposes, the benefit of transaction-generated NOLs will typically remain with the sellers or their beneficial owners and will not need to be renegotiated with the buyer in light of the CARES Act. In many of these instances, the tax deductions generated by the transaction will be fully absorbed by capital gains generated from the sale and will not generate an NOL. However, in the event sellers in these types of transactions generate an NOL, they may be able to more quickly monetize the NOLs by carrying them back to years prior to the transaction and obtain refunds of taxes previously paid.