What's News in Tax

Analysis that matters from Washington National Tax

How to Apply the 80 Percent of Income Limitation on the Use of NOLs in Light of the Brady Draft

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The Tax Cuts and Jobs Act created new restrictions on the use of net operating losses ("NOLs"). Application of the new 80 percent limitation is unclear when losses generated both before and after the effective date of the new law are available in a single tax year. Provisions included in former Ways and Means Chairman Brady's discussion draft for possible technical corrections legislation would resolve this uncertainty, but what are taxpayers to do until those corrections are finalized (if ever)?

The tax legislation enacted at the end of 2017, commonly called the Tax Cuts and Jobs Act ("TCJA"),[1] modified the NOL rules in section 172.[2] One of the modifications was the imposition of an 80 percent of taxable income limitation on the use of NOLs arising in tax years beginning after December 31, 2017. However, the TCJA failed to address how this rule would apply in a subsequent tax year in which a taxpayer sought to use both pre-effective date NOLs and post-effective date NOLs.

On January 2, 2019, the outgoing Chairman of the House Ways and Means Committee, Kevin Brady (R-TX), released a Discussion Draft of the "Tax Technical and Clerical Corrections Act" that includes

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[1] P.L. 115-97, 131 Stat. 2054 (2017).

[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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technical and clerical amendments to the TCJA (the "Brady Draft"). Then-Chairman Brady indicated that he was releasing the draft "to inform stakeholders" and "provide an opportunity to submit feedback on draft provisions.[3] The Brady Draft includes significant clarifications of the TCJA's amendments of the NOL provisions of section 172, and a few additional modifications to the TCJA amendments.

The Section 172 "Corrections" in the Brady Draft

80 Percent of Taxable Income Limitation

Section 172(a), as amended by the TCJA, allows a taxpayer to claim an NOL deduction ("NOLD") for a tax year in an amount equal to the lesser of (1) the taxpayer's NOL carryovers to the year, or (2) 80 percent of the taxpayer's taxable income for the year, computed without regard to the NOLD. This provision is effective with respect to NOLs arising in tax years beginning after December 31, 2017. Prior to amendment by the TCJA, section 172(a) allowed taxpayers to claim a NOLD in an amount equal to the aggregate of the NOL carryovers to the year, plus the NOL carrybacks to the year. The net effect of the amendments to section 172 is that NOLs that arose in pre-effective date tax years are not subject to the 80 percent of income limitation, while NOLs that arose in post-effective date tax years are subject to the 80 percent of income limitation.

We expect that over the next two decades, many corporate taxpayers will seek to use a combination of pre-effective date and post-effective date NOLs, at least until the pre-effective date NOLs are fully absorbed or expire. This is due, in large part, to the effect of the section 382 and consolidated separate return limitation year ("SRLY") limitations, which can have the effect of significantly slowing or reducing the absorption of acquired NOLs, the general ordering rule that prioritizes the use of the oldest available NOLs,[4] and the 20-year carryforward period under prior law.[5]

Previously, we analyzed[6] three potential ways in which the new statutory language implementing the 80 percent of income limitation might be interpreted with respect to a taxpayer with taxable income in 2019, and NOL carryovers from both pre-2018 (i.e., pre-effective date NOLs that *are not subject* to the 80 percent limitation) and post-2017 (i.e., post-effective date NOLs that *are subject* to the 80 percent limitation). We concluded that the 80 percent of income limitation is applied with reference to the taxpayer's taxable income for the tax year, determined without giving effect to any portion of the NOL carryover, and without any intermediate reduction for the use of pre-2018 NOLs (Interpretation 3). In the

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[3] *See* Brady statement on the House Ways and Means Minority web site. The day after the Brady Draft was released, a new Congress began, and Richard Neal (D-MA) became the new chairman of the House Ways and Means Committee. Former chairman Brady is now the ranking Republican on the Committee. Although there is a chance that some technical corrections to the TCJA might be enacted in the 116*th* Congress, this is by no means a certainty. *See* KPMG report: Tax policy and the 116*th* Congress.

[4] Section 172(b)(2).

[5] In general, the carryforward period is 20 years for NOLs arising in tax years beginning after August 5, 1997, and on or before December 31, 2017, under section 172(b)(1)(A) as in effect prior to its amendment by TCJA.

[6] *See* Becky Sager and Maury Passman, *Does NOL Stand for Net Operating Loss or Non Obstante Lamentum? A Discussion of Amendments to Section 172 by H.R.1*, 45 Corp. Tax'n, No. 4 (July/August 2018).

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core example, we demonstrated that this could allow taxpayers to use a combination of pre- and post-effective date NOLs to "zero-out" taxable income in a post-effective date tax year.

The staff of the Joint Tax Committee's general explanation of the TCJA (the Bluebook) explains the 80 percent of income limitation as follows:

> A taxpayer with NOL carryovers to a taxable year from both taxable years beginning before 2018 ("pre-2018 NOL carryovers") and taxable years beginning after 2017 ("post-2017 NOL carryovers") computes its tax liability as follows. First, the taxpayer is entitled to an NOL deduction in the amount of its pre-2018 NOL carryovers without limitation. Second, the taxpayer is entitled to an additional NOL deduction equal to the lesser of (1) its post-2017 NOL carryovers, or (2) 80 percent of the excess (if any) of the taxpayer's taxable income (before any NOL deduction attributable to post-2017 NOL carryovers) over the NOL deduction attributable to pre-2018 NOL carryovers.[7]

However, in a footnote to the passage above, the Bluebook acknowledges that "a technical correction may be necessary to reflect this intent."[8]

The Brady Draft would "correct" the statutory language in section 172(a)(2) to provide that the 80 percent of income limitation for post-2017 NOLs is determined *after* use of any pre-2018 NOLs.[9] We rejected this approach as an interpretation of current-law section 172 (Interpretation 2), in part because it would require a bifurcation of a NOLD, create an extra-statutory, interim measure of taxable income that would exist after deducting the first part of the NOLD (the pre-2018 NOLD) and before deducting the second part of the NOLD (the post-2017 NOLD), and impose the 80 percent of income limitation with reference to this interim taxable income number that is notably absent from section 172 as enacted by the TCJA.

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[7] Staff of the Joint Committee on Taxation, General Explanation of Public Law 115-17, JCS-1-18, at 181 (Dec. 20, 2018) ("Bluebook").

[8] Bluebook, at 181, n.899.

[9] Brady Draft, section 4(p)(3)(A), proposes to add a new subsection 172(g) to read as follows:

In the case of a taxable year (hereinafter in this subsection referred to as the 'current year') to which is carried a net operating loss arising in a taxable year beginning before January 1, 2018, the amount determined under [section 172(a)] for the current taxable year shall be an amount equal to the sum of—

(1) the aggregate amount of such net operating losses carried to the current taxable year, and

(2) the lesser of –

(A) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, which are carried to the current taxable year, or

(B) 80 percent of the excess (if any) of –

(i) taxable income computed without regard to the deductions allowable under [sections 172, 199A, and 250], over

(ii) the amount determined under paragraph (1).

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Effective Date for Repeal of NOL Carrybacks

Section 172(b)(1)(A)(i), as amended by the TCJA, generally and unambiguously provides that a corporation is not allowed to carry back an NOL arising in a tax year *ending* after December 31, 2017.[10] In contrast, the legislative history describes this rule as applying with respect to tax years *beginning* after December 31, 2017.[11] This apparent statutory drafting error affects taxpayers that generated losses in a straddle year that began in 2017 and that will end (or ended) in 2018. The Brady Draft[12] would correct this error by substituting the word "beginning" in place of the word "ending" in the effective date provision.[13]

Other Technical "Corrections"

The Brady Draft would also clarify that the 80 percent of taxable income limitation would be calculated without regard to the deductions allowable under sections 199A (qualified nonbusiness income of noncorporate taxpayers) and 250 (GILTI and FDII). Other technical corrections would be made, as well, to various aspects of the TCJA amendments to the section 172 NOL rules.

KPMG's Reaction and Other Considerations

First, it must be emphasized that the Brady Draft simply is a discussion draft and, thus, the provisions in it are not law unless and until they go through the legislative process and are enacted. As of the date of this article, prospects for enactment of technical corrections to the TCJA in the current Congress remain uncertain. We continue to believe that, unless and until section 172 is amended, our discussion of the 80 percent of income limitation in the earlier article represents the better interpretation of current law. In addition, we believe that the general prohibition of NOL carrybacks applies with respect to NOLs arising in tax years *ending* after December 31, 2017, notwithstanding that Congress appears to have intended a different date. However, we anticipate that if the technical corrections relating to section 172 contained in the Brady Draft go through the legislative process and become law, they likely would apply with retroactive effect, as if they had been a part of the TCJA as originally enacted.[14]

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[10] Prior to enactment of the TCJA, corporations generally were permitted to carry back NOLs for two tax years, although carrybacks potentially were subject to the corporate equity reduction transaction (or CERT) rules and to other limitations. The two-year carryback provision is retained with respect to certain farming losses and for certain insurance companies (other than life insurance companies), under section 172(b)(1)(B) and (C) as amended by the TCJA.

[11] H.R. Conf. Rep. No. 115-466, at 394 (2018).

[12] Brady Draft, section 4(p)(5)(B).

[13] The relevant effective date provision is contained in section 13302e)(2) of the TCJA.

[14] Because technical corrections generally are supposed to reflect the intent of Congress at the time the provision being corrected was enacted, they often are retroactive. Congress generally has authority to enact retroactive tax legislation. United States v. Carlton, 512 U.S. 26 (1994).

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Affected taxpayers face a difficult choice, either: (1) apply the law as it is currently in effect, and accept the risk that the law might be amended with retroactive effect, or (2) apply the NOL provisions in a manner consistent with the apparent legislative intent, and accept the risk that current law might be inconsistent with the apparent legislative intent and that the technical corrections might not be enacted (or if enacted, might be enacted in the distant future or with prospective effect).

The issue is expected to arise, at the earliest, on the due date for the return for the second tax year that begins on or after January 1, 2018. For taxpayers on a calendar year, this generally means that the first U.S. federal income tax return that could be affected is the calendar 2019 return.[15] However, the issue may arise sooner for taxpayers modeling loss absorption for purposes of discounted cash flow valuation, section 382 or SRLY utilization, or other purposes.

80 Percent of Taxable Income Limitation

Based on the language of section 172, as amended by the TCJA and as currently in effect, we believe that the 80 percent of income limitation applies with reference to taxable income of a corporation determined before any deduction for NOLs (i.e., Interpretation 3 from our prior discussion). At this time, we are not at (and do not anticipate getting to) a more likely than not level of comfort with respect to the alternative interpretations of section 172 (i.e., Interpretations 1 or 2 from our prior discussion).[16]

If the technical correction to the 80 percent of income limitation in the Brady Draft subsequently is enacted with retroactive effect, we would expect that affected taxpayers that have had to take a return position will have to evaluate whether any prior return should be amended; these taxpayers should correct any NOL statements on future returns to reflect the legislative change.

Where Does the Rubber Meet the Road?

We are aware that some taxpayers may have already taken a position consistent with the Brady Draft's proposed technical correction for purposes of estimating the usage of NOLs. These taxpayers should consider whether it may be appropriate to revisit the issue and the potential materiality of the issue. To demonstrate how taking a position inconsistent with current law could have an adverse impact to clients, assume the same facts from our earlier article: Corporation X has 2019 taxable income of $100, NOLs from 2017 of $90, and NOLs from 2018 of $30. If Corporation X takes a tax return position consistent with Interpretation 2 (i.e., the Bluebook/Brady Draft), Corporation X would be claiming a $98 NOLD to offset its 2019 taxable income, by utilizing $90 of its 2017 NOLs and $8 of its 2018 NOLs. Alternatively, if Corporation X applies our Interpretation 3, it would claim a $100 NOLD to offset its 2019 taxable income, by utilizing $90 of its 2017 NOLs and $10 of its 2018 NOLs (i.e., the full amount that was available and allowable to offset its 2019 taxable income). Under Interpretation 3, the additional $2

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[15] It is possible for the issue to affect 2018 returns, if there are losses from a short year that began after December 31, 2017, and ended before December 31, 2018.

[16] While Interpretation 3 appears to be the consensus view, at least one practitioner is reported to have taken the position that Interpretation 2 (i.e., the Bluebook and the Brady Draft) represents the better view. Emily L. Foster, *New Explanation on Computing NOLs for Carryovers Finally Adds Up*, 162 Tax Notes 319 (January 21, 2019).

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of 2018 NOLs can be utilized in 2019, and thus are not available for use thereafter regardless of whether the taxpayer included that amount in its NOLD for 2019. Sections 172(b)(2) and 1.172-4(b) require an NOL carryover to be carried to the earliest tax year to which it may be carried, and only permit the portion of the NOL that cannot be used in that year to be carried to a later year. Accordingly, continuing with our example, because the additional $2 of the 2018 NOL is available to be used in the NOLD for 2019, the additional $2 is not available for use in a later tax year. In other words, the 2018 NOL carried forward into 2020 is reduced by the full $10 that could have been utilized to offset 2019 taxable income, rather than the $8 that is utilized. We anticipate that this issue will arise during the preparation of future-year tax returns (e.g., when Corporation X seeks to utilize the $2 of its 2018 NOL in 2020 or later years), as well as during the tax due diligence and modeling phases for both our buy-side and sell-side engagements.[17] Importantly, we acknowledge, that once this pattern extends beyond the time period to amend the 2019 return to utilize the $2 difference, the risk of loss may be permanent. We anticipate and hope that clarification will be provided before such time. Of course, if the provision in the Brady Draft ultimately is enacted into law with retroactive effect, taxpayers should review their NOL utilization and carryforwards to determine the effect, if any, of such a change.

Effective Date for Repeal of NOL Carrybacks

We generally would advise taxpayers that there is no current statutory basis to carry back an NOL arising in a straddle year (a tax year that begins before December 31, 2017, and ends after that date), other than for excepted farming and certain insurance company losses, unless and until the statute is modified. While the legislative intent seems reasonably clear, the statute is to the contrary and it is unambiguous.

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[17] Financial reporting considerations are beyond the scope of this article; contact Ashby Corum or Jenna Summers of WNT's Accounting for Income Tax practice for guidance.

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