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KPMG report: IRS FAQs on NOL carrybacks for taxpayers with section 965 inclusions (COVID-19)

The IRS on April 23, 2020, released a set of “frequently asked questions” (the Section 965 FAQs) that address the interaction of the new CARES Act net operating loss (NOL) carryback provisions with taxpayers’ section 965 “transition tax” liabilities and inclusion years.

Read the [Section 965 FAQs](#).

Background

The *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act) amended section 172(b)(1) to provide for a carryback of any net operating loss (NOL) arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year in which the loss arises (the carryback period).

Taxpayers may elect under section 172(b)(3) to waive the carryback period for NOLs arising in those years. Alternatively, taxpayers may make an election under section 172(b)(1)(D)(v)(I) for NOLs arising in those years to exclude tax years in which they have section 965(a) inclusions (965 inclusion years) from the carryback period.

Alternatively, if taxpayers do not elect the carryback waiver or 965 inclusion year exclusion, and instead do carry the NOLs to 965 inclusion years, the CARES Act provisions deem the taxpayer to have made a section 965(n) election with respect to the 965 inclusion year. The effect of the section 965(n) election is that the net section 965 income is “walled off” from being absorbed by the NOL, and the NOL is only available to offset the non-section 965 income in the taxpayer’s 965 inclusion year. This will often be a favorable result because the “wall off” result prevents the NOL from displacing the use of (presumably general “basket”) foreign tax credits to reduce the tax liability owed with respect to the section 965 income, especially given the challenges many taxpayers would have in absorbing such general basket credits as a carryforward attribute in post-965 inclusion years.

The Section 965 FAQs provide guidance and details about how taxpayers can make the waiver or exclusion elections and also address numerous other administrative aspects of carrying NOLs back to

section 965 inclusion years, including how to practically submit Forms 1139 and 1045 in light of the COVID-19-related IRS office staffing status.

KPMG observations on the Section 965 FAQs

The Section 965 FAQs largely follow the guidance previously announced in Rev. Proc. 2020-24 and Notice 2020-26 with respect to the procedural issues regarding the election to exclude section 965 years from the carryback period. Read [TaxNewsFlash](#) and [TaxNewsFlash](#). Nevertheless, there are several important points to note from the new release.

First, the Section 965 FAQs indicate (in FAQ#2) that the exclusion election to skip over section 965 inclusion years applies to “all” such years. Thus, for example, a calendar year taxpayer that had both 2017 and 2018 965 inclusion years—e.g. because of having some specified controlled foreign corporations with December 31, 2017 year-ends and also others ending on November 30, 2018—cannot choose to skip over one year but not the other, it must exclude both years from the carryback. Next, the Section 965 FAQs re-affirm (in FAQ#4) the IRS’s longstanding position that a taxpayer may not receive a refund or credit with respect to regular tax overpayment in a section 965 inclusion year until the amount of overall payments for such year exceeds the entire section 965 liability, including any future installments outstanding under section 965(h). This remains a critical point for taxpayers evaluating whether to make the exclusion election to skip over 965 inclusion years, as any potential refund of an overpayment attributable to non-965 income in a 965 inclusion year will be automatically withheld to apply against the taxpayer’s remaining section 965(h) liability for that year.

In cases when taxpayers’ payments for the 965 inclusion year are more than sufficient to fully satisfy future 965 installments—and thus, the taxpayer would be entitled for a refund for overpayments in excess of regular tax and tax with respect to the 965 inclusion—the Section 965 FAQs (in FAQ#3) helpfully provide that taxpayers may claim that refund by filing a Form 1139, *Corporation Application for Tentative Refund*, and Form 1045, *Application for Tentative Refund*. The Form 1139 instructions currently state that taxpayers may not file a Form 1139 for a tentative refund for a 965 inclusion year and instead must file a full-blown amended return (Form 1120X) for such year. However, the new FAQs instruct taxpayers to ignore these instructions, thereby streamlining the process for taxpayers in this category.

The Section 965 FAQs also address (in FAQ#10) whether taxpayers must file amended returns for their 965 inclusion years to account for the carryover of non-NOL attributes into the 965 inclusion year, e.g. foreign tax credits and charitable contributions that are released as a result of carrying back NOLs to years preceding the 965 inclusion year. FAQ#10 does not explicitly say that taxpayers **must** file an amended return for their 965 inclusion year, but encourages taxpayers to do so and in order for proper accounting for any corresponding reduction to the taxpayers’ remaining section 965(h) tax liability. The implication is that a failure to do so could result in future problems relating to the assessment of a taxpayer’s remaining section 965(h) liability—e.g., if the taxpayer believes its liability has been reduced by reason of these other attributes, but does not adjust the source-year section 965(h) liability through an amended return, the IRS may treat as an acceleration event, a failure to pay in full a future installment that the IRS systems still believe to be owed at the pre-adjustment amount.

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