A Silver Linings Guidebook: Corporate Planning for Coronavirus Losses

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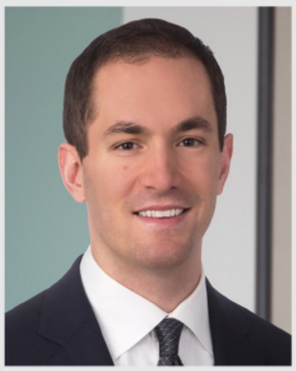

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In this article, the authors provide a practical guide for maximizing the value of corporate tax attributes in light of the COVID-19 crisis. They explain factors relevant to optimizing 2020 U.S. losses — focusing primarily on interactions between the Coronavirus Aid, Relief, and Economic Security Act net operating loss carryback and various Tax Cuts and Jobs Act provisions — and they identify transactions and other steps that companies can take to manage the size of their 2020 NOLs and controlled foreign corporation losses.

The recent Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) provides an elective five-year net operating loss carryback for losses incurred in 2020. This intended boon to corporate taxpayers has unexpectedly generated potential pitfalls. Some corporations may be able to monetize U.S. tax losses at up to 35 cents on the dollar, but others may be subject to limitations in the Tax Cuts and Jobs Act that reduce the value of 2020 losses to zero, regardless of whether they are carried back. Corporate taxpayers facing losses from the coronavirus crisis — both in the United States and in controlled foreign corporations — must therefore carefully consider how to optimize the benefit of those losses and other favorable tax attributes they expect to generate this year. In fact, because of the potential value of the carryback, even corporations that expect to be profitable for 2020 may benefit from planning into a 2020 NOL.

For all corporations, optimizing the use of the CARES Act's five-year NOL carryback election and/or 2020 CFC losses will require informed modeling and careful assumptions. Investing in tax planning now may have high after-tax returns; conversely, failure to manage tax losses may have stark opportunity costs. Key decisions will include:

- whether to accelerate deductions or defer income;
- whether to make expenditures eligible for bonus depreciation;
- whether to sell assets, either at a gain or at a loss;
- whether to modify debt, potentially generating cancellation of indebtedness (COD) income and original issue discount;
- whether to rethink a transfer pricing functional analysis in light of virus-driven changes in functions, assets, and risks;
- whether to adjust transfer prices in real time based on anticipated 2020 results;
- whether to change the analytical approach in a transfer pricing study (for example, by focusing solely on current-year 2020 data rather than multiyear data); and
- how to optimize the use of CFC losses treated as global intangible low-taxed income or subpart F income.

In the discussion that follows, we offer a conceptual framework and practical guidance on.

The election permits post-2017 NOLs to offset pre-TCJA income taxed at a 35 percent federal rate. If a corporation's 2015-2017 income exceeds a 2020 NOL, the corporation likely should make the election because the alternative would be to use the NOL against future income, producing a benefit at the currently applicable 21 percent rate. But if, for example, the NOL exceeds 2015-2017 income and is applied in years when a U.S. corporation earned foreign-derived intangible income or GILTI, or was subject to the base erosion and antiabuse tax, its value could be reduced or eliminated. We illustrate some of these interactions through concrete examples. We then identify planning options that a corporation seeking to enhance the benefit of an NOL carryback election may consider.

The coronavirus crisis is a worldwide phenomenon, but Congress has not yet enacted relief for U.S. shareholders that incur losses through CFCs. A CFC's losses generally cannot be carried back or forward to offset past or future income taxable under the GILTI or subpart F rules. We outline below considerations and options for making efficient use of these "now or never" losses.

Proactive planning may enable corporate taxpayers to derive maximum benefit from U.S. NOLs and CFC losses, whether by offsetting other income or gain or using CARES Act relief measures. This will principally involve accelerating income or deductions and restructuring financial arrangements with affiliates. Transfer pricing policies — which should in all events be reexamined in light of changes wrought by the pandemic — can support these planning efforts, when appropriate.

Our insights focus on alternatives available to corporations that have been profitable in recent years but expect losses because of the coronavirus in 2020. Parts of the discussion also may be helpful for corporations that incurred NOLs in 2018 or 2019 and are considering carrying back those losses to prior years. We caution readers that actionable planning requires individualized advice based on each taxpayer's particular facts.

I. Monetizing 2020 U.S. Losses

Corporations that had significant taxable income in the 2015-2019 period (other than under section 965) should consider whether additional planning for 2020 may be desirable to maximize the benefit of a five-year NOL carryback. For some corporations, there may be an inflection point for NOL size, below which making the election is beneficial (because it would be carried back against income taxed at a 35 percent rate) but above which making the election could be disadvantageous (for example, because it would be wasted on low-taxed FDII or GILTI, or effectively denied under the BEAT). Although NOL size will primarily be driven by business outcomes, in some cases additional tax planning may enable a corporation to optimize its favorable attributes.

A corporation should first determine its projected tax loss for 2020. This determination may be more difficult for calendar-year taxpayers than for fiscal-year taxpayers approaching year-end, but no taxpayer should defer this exercise for too long. The discussion and examples that follow generally assume a calendar-year tax year, unless otherwise indicated.

Once a projected 2020 loss has been quantified, a corporation should ask three questions:

1. What 2020 NOL amount would maximize the benefits of electing the five-year carryback? As noted earlier, answering this question entails careful analysis of interactions among CARES Act provisions, the TCJA rules, the TCJA reduction in the headline corporate tax rate (from 35 percent to 21 percent), and taxpayer-specific facts.
2. What benefit does the corporation expect to derive if an NOL of that size were retained and carried forward against post-2020 income, rather than carried back five years? Answering this question will undoubtedly prove a more daunting exercise than projecting current-year losses, but it is an important step for companies considering the election. Evaluating the opportunity cost of the election will entail developing projections for future years, making reasonable assumptions about future tax rates, and determining appropriate discount rates to reflect the time value of deferring use of the NOL.
3. What planning steps can the corporation take to manage the size of its NOL if it concludes that the carryback election could be beneficial? For corporations that expect to be profitable for 2020, answering this question will entail determining the extent to which planning could generate a 2020 NOL.

Below, we first discuss considerations for determining optimal NOL size and for evaluating opportunity costs, and then outline planning alternatives for influencing NOL size.

A. Determining Optimal U.S. NOL Size

Because of limitations in the TCJA, corporations may face special issues in determining the optimal amount of a 2020 U.S. NOL to carry back against 2015-2019 income. As noted earlier, carrybacks may be worth as much as 35 cents on the dollar, and as little as zero, depending on the year to which the NOL is carried (back or forward) and the corporation's other U.S. tax attributes for that year.

More specifically, carrybacks to 2015-2017 may be significantly more valuable than carrybacks to 2018-2019. The most obvious reason for that is that the TCJA lowered the headline corporate rate from 35 percent to 21 percent. Less intuitively, the operation of some TCJA rules, including for FDII, GILTI, and the BEAT, can reduce or eliminate the value of NOL carrybacks. Factors relevant to the value of an NOL carryback thus include:

- whether the NOL can be used to offset income taxed at a 35 percent rate for the 2015-2017 period;
- whether the NOL can be used to offset income taxed at a 21 percent rate for the 2018-2019 period;
- whether the value of the NOL is reduced because, in the year(s) to which it is carried back:
  - it offsets foreign-source income already covered by foreign tax credits that will now expire unused;
  - it offsets low-taxed FDII and GILTI;
  - it reduces taxable income below a corporation's total FDII and GILTI inclusions, triggering a limitation on the section 250 deduction; or
  - the corporation was an applicable taxpayer under the BEAT rules in the carryback year, and the NOL:
    - merely reduces the BEAT tax base, resulting in a refund at the lower BEAT rates (5 percent for 2018 or 10 percent for 2019);
    - reduces regular taxable income enough that the BEAT minimum tax threshold becomes relevant; or
    - fails to offset prior-year income even at the lower BEAT rate because a portion of

the NOL is added back to the BEAT base; and

- whether the election to "skip over" tax years in which the corporation had a section 965 inclusion (which inclusions generally cannot be offset by NOL carrybacks) would increase or reduce the value of the NOL.

We discuss these considerations in more detail below. Our examples are intended to aid taxpayers in developing intuitions and rules of thumb when navigating a complex modeling exercise.

1. Limited benefit from carrying back NOLs to years with significant FTCs.

Corporations may not derive full benefits from carrying 2020 NOLs back against taxable income to years in which their U.S. tax liability was offset by FTCs, unless the freed-up FTCs would carry forward and be usable in future years, or foreign countries enact legislation similar to the CARES Act that has the effect of reducing prior-year FTCs.

This is particularly true for carrybacks to post-TCJA years in which a taxpayer had GILTI inclusions because GILTI basket FTCs cannot be carried forward. Uncertainty regarding whether and when Treasury will finalize a proposed elective GILTI high-tax exclusion (the GILTI HTE election), and whether the election will be available for pre-finalization tax years, complicates this aspect of the analysis. We expect that this election will be finalized, with retroactive effect to 2018, in final regulations to be issued this year.

a. Interactions between NOL carrybacks and FTCs.

NOL carrybacks generally reduce taxable income before FTCs are applied to offset the taxpayer's U.S. tax liability. For example, a corporation that in 2015 had no U.S.-source income, 100x of general basket foreign-source income, and 35x of general basket FTCs would have a pre-credit tax liability of 35x, offset in full by the 35x of FTCs. If instead the corporation carried a 100x NOL from 2020 back to 2015, the corporation would have no income, resulting in no allowable credits and 35x of excess FTCs. Typically, unused FTCs are subject to a mandatory one-year carryback and 10-year carryforward against U.S. tax on general basket foreign-source income in other years.

Unlike deductions, FTCs may be monetized without loss of value despite the change in corporate tax rates. Building on the previous example, if in 2021 the corporation earns 167x of general basket foreign-source income that bears no foreign tax, the corporation could offset its 35x of U.S. tax liability on that income (21 percent * 167x) with the FTCs carried forward from 2015, assuming they have not already been used in an intervening year. (Note that some TCJA transition rules may reassign FTC carryforwards to a different basket.)

In practice, however, full use of excess FTCs is likely to be difficult because the TCJA lowered the U.S. corporate rate to 21 percent, fragmented the FTC limitation baskets, and — importantly, as discussed later — did not provide for carryovers of GILTI basket FTCs. To the extent an NOL carryback results in excess FTCs that cannot be used to reduce U.S. tax liability in a prior or later year, the carryback effectively renders the NOL valueless.

Tax planning to manage the value of NOL carrybacks claimed under the CARES Act thus should be coordinated with planning to manage the source, basket, and timing of foreign-source income under the FTC regulations. Further, taxpayers claiming carrybacks should take into account the consequences of other potentially relevant interactions under the FTC rules, such as the effect of the overall foreign loss, overall domestic loss, and separate limitation loss rules on the source or basket of their income in future years.

b. Special FTC interactions related to GILTI.

The inability to carry over GILTI basket FTCs effectively ensures that 2020 NOL carrybacks will be lost to the extent the deduction offsets a taxpayer's GILTI inclusion for 2018 or 2019. For example, suppose a corporation had a 100x GILTI inclusion for 2018, on which it owed 10.5x of U.S. tax, and its tax liability was fully offset by a 20x GILTI basket FTC (after accounting for the section 250 deduction and applying relevant limitations under sections 904 and 960). If the corporation carries back a 100x NOL to 2018, the loss could thus offset income on which no U.S. tax had been paid, without freeing up FTCs for use against other income. The corporation would thus realize no tax benefit from its economic loss.

That adverse consequence would be mitigated, however, if Treasury finalizes the GILTI HTE election — whereby U.S. shareholders would be permitted to exclude from GILTI all foreign-source income of a CFC taxed by a foreign country at a rate exceeding 90 percent of the U.S. corporate rate — and makes the election retroactive for all post-TCJA years. If, in the above example, the taxpayer could make such a GILTI HTE election for 2018, the 100x would not enter the taxpayer's GILTI base, and the NOL would not be consumed by it. Certainty regarding the availability of this election for 2018 and 2019 would greatly assist taxpayers that are considering whether to make an NOL carryback election under the CARES Act.

Corporations managing the value of their losses should carefully consider related planning to preserve the value of their FTCs, especially in connection with a CARES Act carryback election.

2. Limited benefit from carrying back NOLs to post-TCJA years.

a. Effect of FDII and GILTI.

Under section 250, corporations are entitled to deduct 37.5 percent of their FDII and 50 percent of their GILTI. The aggregate section 250 deduction is limited to the corporation's taxable income for the year, determined after reduction by any NOL carryovers. Because of this limitation, the value of NOLs carried back to post-TCJA years will be cut down in any case in which (1) the carryback is allocable to the corporation's FDII or GILTI inclusion, or (2) the carryback reduces the corporation's taxable income below its total FDII and GILTI for the year. These effects are separate but may both arise in a given year. When applying this rule of thumb, all relevant amounts should be determined before computing the corporation's section 250 deduction for the year.

To illustrate the first effect — the reduced value of an NOL carryback that reduces FDII or GILTI — consider a U.S. corporation that earned only 100x of GILTI in 2019 and therefore was eligible for a 50x section 250 deduction. Assuming no foreign tax, the corporation had 50x of taxable income and paid 10.5x of U.S. tax. If the corporation carries a 100x NOL back to 2019, it can zero out its U.S. taxable income for that year and save 10.5x of tax — but the carryback will have an opportunity cost if carrying the NOL forward would have allowed the corporation to offset future income taxed at 21 percent. Similar consequences would arise if the corporation's only income had been FDII, although they would be slightly less severe because FDII is taxed at a higher effective rate than GILTI.

To illustrate the second effect — the adverse result arising when an NOL carryback reduces taxable income below its total FDII and GILTI — suppose that in 2019 a corporation had 200x of FDII, 200x of GILTI, and 200x of income from a U.S.-only widget business. The corporation has a 37.5 percent FDII deduction of 75x and a 50 percent GILTI deduction of 100x, reducing total taxable income to 425x (that is, 600x of total taxable income less the 175x section 250 deduction). In 2020 the U.S. widget business generates a significant NOL, of which 400x is carried back to 2019. The corporation now has post-NOL carryback taxable income for 2019 of only 200x. Although the corporation has the same FDII and GILTI inclusions for 2019, because of the taxable income limitation, the FDII and GILTI deductions are each reduced pro rata (here, halved) to 37.5x and 50x.

Thus, the corporation has a total section 250 deduction of 87.5x and total taxable income of 112.5x for 2019. But the corporation carried a 400x NOL back to a year in which it started with only 425x of taxable income. If the NOL carryback had reduced taxable income dollar for dollar, the corporation would have only 25x of taxable income for 2019 and would bear 5.25x of U.S. tax. Because of the limitation on the section 250 deduction, the corporation winds up with taxable income of 112.5x and bears 23.625x of tax. The taxable income limitation on the section 250 deduction has a tax cost of 18.375x — the tax on the lost deduction of 87.5x.

These adverse effects arise separately from, and in addition to, the adverse interaction with GILTI basket FTCs discussed earlier. The adverse FTC consequences will be more important for many taxpayers that have no significant FDII and only limited U.S. tax on GILTI because they operate in high-tax foreign jurisdictions.

However, the section 250 consequences generally remain relevant to a residual GILTI inclusion even if Congress or Treasury provides a retroactive GILTI HTE election. Corporations considering carrybacks to GILTI years should weigh planning options to mitigate these adverse consequences.

b. Effect of the BEAT.

The benefit of carrying back a 2020 NOL to a year in which a corporation was subject to the BEAT (which, if relevant at all, would be 2018 or 2019) may be reduced because (1) it will be monetized at the lower BEAT rate rather than at the headline corporate tax rate, (2) the reduction in the taxpayer's regular tax liability may bring the BEAT minimum tax into play, or (3) a percentage of the NOL may be added back in computing the BEAT taxable income base.

A corporation to which the BEAT applies generally must pay a minimum tax equal to the greater of 21 percent of its regular taxable income, reduced by most tax credits (including FTCs), or a specified percentage (5 percent for 2018 and 10 percent for 2019) of its modified taxable income. Modified taxable income consists of regular taxable income with addbacks for specific categories of deductions referred to as "base erosion tax benefits" as well as the "base erosion percentage" of an NOL for the year in which the loss was incurred — in this case, 2020. Thus, an NOL carryback to a BEAT year generally will reduce regular taxable income dollar for dollar but will reduce modified taxable income by only (1 - *X percent*) of the NOL carryback, where *X percent* is the corporation's base erosion percentage for 2020. Unlike regular income tax, BEAT liability cannot be offset by FTCs.

If a corporation was liable for BEAT in a prior year, carrying back a 2020 NOL to that year will allow the NOL to be recovered at most against income taxed at the applicable BEAT rate (5 percent or 10 percent) rather than against income taxed at the regular 21 percent corporate rate.

First, assume a BEAT taxpayer with no FTCs or other credits. For the corporation to have been liable for the BEAT, 5 percent or 10 percent of its modified taxable income must have exceeded 21 percent of its regular taxable income — meaning that modified taxable income was at least twice regular taxable income. Even if an NOL carryback is fully available to offset both modified and regular taxable income, the BEAT minimum tax will continue to apply because reducing both figures by the same amount will only increase the ratio of modified taxable income to regular taxable income. The result is that the NOL carryback would be recovered at the 5 percent or 10 percent BEAT rate, rather than at the 21 percent corporate rate.

For example, a taxpayer with no FTCs or other credits would be liable for the BEAT in 2019 if it had 100x of regular taxable income, resulting in 21x of regular tax, but a dollar more than 210x of modified taxable income, resulting in more than 21x of BEAT minimum tax. If a 100x NOL carryback from 2020 is fully available to reduce both modified taxable income and regular taxable income (discussed later), the taxpayer would have no regular taxable income but would have modified taxable income of 110x. Thus, the taxpayer would have BEAT liability of 11x, and the NOL carryback would yield a tax benefit of only 10x (reflecting the 10 percent rate under the BEAT).

Alternatively, a corporation may have been liable for the BEAT in 2019 if its modified taxable income was only fractionally greater than its regular taxable income, but it used significant FTCs. Building on the previous example, assume a taxpayer with 100x of regular taxable income and only 110x of modified taxable income, and assume that its 21x of tentative regular tax was entirely offset by FTCs. The taxpayer will have no regular tax liability as defined under the BEAT rules and thus will have BEAT minimum tax liability of 11x. If an NOL carryback of 100x from 2020 is fully available to reduce both regular taxable income and modified taxable income, it would eliminate the taxpayer's regular taxable income and reduce modified taxable income to 10x, leaving the taxpayer with 1x of BEAT liability. The NOL carryback would again yield a tax benefit of 10x, reflecting the 10 percent BEAT rate.

If an applicable taxpayer was not liable for the BEAT minimum tax in a prior year, it may become liable for the BEAT as a result of an NOL carryback, which will also reduce the value of the NOL. In the first example above, the applicable taxpayer would have no BEAT tax liability in 2019 if it had regular taxable income of 100x but its modified taxable income were just slightly less than 210x. Yet the same relative reduction in its regular and modified taxable income would bring the BEAT into play to approximately the same extent. The precise detriment would depend on the amount by which the corporation's modified taxable income exceeded its regular taxable income (that is, the amount of its base erosion tax benefits in 2019) and its allowable FTCs.

Realistically, the adverse effects of the BEAT are likely to be worse than illustrated in these examples because, as noted earlier, BEAT modified taxable income will not be reduced by an NOL carryback to the extent it is attributable to base erosion tax benefits for 2020. To modify the first above example, if the corporation's base erosion percentage for 2020 is 100 percent, its 100x of regular taxable income will still be zeroed out, but its 210x of modified taxable income will not change. It will still be liable for tax of 21x, and the NOL carried back will be valueless.

The addback of the NOL may be a matter of indifference to a corporation that expects the NOL to be eliminated in the same way if it is instead carried to a future year. But it may entail an opportunity cost if the taxpayer expects the NOL to be usable in a future year when the corporation has ceased to be subject to the BEAT (for example, because fallout from the pandemic has reduced gross receipts below the $500 million threshold) or when its regular and modified taxable income will be more closely aligned (so that the NOL carryforward reduces the tax on regular taxable income before the BEAT threshold is triggered).

Because of these effects, the BEAT rules can significantly reduce or eliminate the value of NOL carrybacks if a taxpayer has material base erosion tax benefits in the carryback year or 2020, or used material FTCs in the carryback year. A corporation that intends to carry back NOLs to a BEAT year may wish to consider whether additional planning is possible to reduce its base erosion percentage for 2020 to mitigate adverse effects of a carryback to post-TCJA years.

3. Special election to skip over section 965 years.

The CARES Act NOL carryback election generally must be made on an all-or-nothing basis. An electing corporation thus must carry back an NOL to the earliest of the preceding five years in which it has taxable income, then apply any residual NOL against income in succeeding years until the NOL is exhausted. But under a special rule, a corporation that elects the carryback may make a separate election to skip over tax years for which it had a repatriation tax inclusion under section 965 (which would not, in any event, be eligible for offset by an NOL) from earnings of its specified foreign corporations (SFCs).

Section 965 inclusions arise in each year of a U.S. shareholder with or within which a relevant SFC year ends. Repatriation tax attributable to an SFC arose based on the SFC's last tax year beginning before January 1, 2018. U.S. shareholders of SFCs thus had repatriation tax inclusions in either or both of their 2017 and 2018 tax years:

- For calendar-year corporations that own calendar-year SFCs, making the skip-over election typically would require skipping over the 2017 tax year, in which the corporation was generally liable for tax at a 35 percent rate. Skipping over this year generally will be disadvantageous if the taxpayer had significant U.S. tax liability, other than under section 965.
- But for some fiscal-year corporations and calendar-year corporations with fiscal-year SFCs, the 2018 tax year (that is, the first post-TCJA tax year) will be a section 965 inclusion year. Skipping over this year may be advantageous if the NOL would be recovered at less than a 21 percent rate because of FDII or GILTI inclusions or BEAT liability (as explained earlier).

A corporation with section 965 inclusions in both 2017 and 2018 must skip over both or neither of those years. If such a corporation has an NOL that would be carried back to both 2017 and 2018, it should weigh whether the blended rate at which the NOL will be recovered in those years exceeds the rate at which the NOL would be recovered if those years were skipped and the NOL were instead carried to 2019 and to post-2020 years.

4. Effect of prior-law corporate AMT.

The prior-law corporate alternative minimum tax remains in effect for carrybacks to pre-2018 tax years but in principle should not affect the determination of an optimal NOL size because corporate AMT payments give rise to refundable credits under the TCJA and the CARES Act. Absent further legislative or regulatory relief, however, the corporate AMT could affect the immediacy of refunds and increase tax compliance burdens because corporations will need to adhere to the rules for calculating minimum tax in the carryback year and claiming credits in later years.

B. Evaluating Opportunity Costs

Our earlier discussion is limited to determining the absolute dollar value of carrying back 2020 NOLs to 2015-2019, without regard to the value of using those NOLs after 2020. Evaluating the opportunity cost of carrying back an NOL against carrying it forward requires consideration of the NOL use rules (indefinite carryforward, but limited to 80 percent of taxable income), the likelihood of earning income in the near future, the time value of money, and potential variation in effective tax rates (including as a result of FDII, GILTI, and the BEAT).

Several factors are likely to favor use of NOL carrybacks when they are available. Projected income may be lower than usual in the near term if the coronavirus crisis develops into a prolonged downturn. Eliminating part of an NOL through a carryback may cost little if the corporation is unlikely to be able to use the NOL for many years because of a sustained period of losses. Uncertainty about the timing of a recovery may encourage reliance on carrybacks as a surer thing and a source of cash in a liquidity crunch. Moreover, losses used in the current year or through NOL carrybacks may give rise to immediate refunds or reductions in tax liability, while NOL carryovers should be discounted on time-value principles.

Future tax rates will be difficult to forecast with confidence in an election year with massive government spending. Before the coronavirus, corporate tax rates were trending downward (including in the United States) as a result of tax competition. The crisis has not yet provoked widespread political support for increasing corporate tax rates; rather, the CARES Act appears to reflect the opposite. Nonetheless, corporations may think twice about carrying back NOLs if they apply a low discount rate and expect rate hikes before they resume earning taxable income. The political and economic situation is likely to be clearer in late 2020, however, before an NOL crystallizes and filing season begins for calendar-year corporations.

C. Influencing NOL Size

Some corporations may benefit from considering whether they can undertake transactions consistent with other commercial objectives so as to manage the size of their NOLs and maximize the benefits of the five-year carryback. Further, we advise all multinational corporations to revisit existing transfer pricing policies in light of pandemic-related changes in economic conditions. Appropriate adjustments to transfer pricing policies identified through that process also may affect NOL size. Pricing in a time of decreasing sales likely will differ.

1. Accelerating losses.

If a corporation does not expect to have a 2020 NOL sufficient to offset its taxable income for 2015-2017 (or to have an NOL at all), it may benefit by accelerating ordinary deductions or losses to increase the amount available for carryback. These types of planning transactions were impractical for many taxpayers at the end of 2017 because of the TCJA's rapid enactment and uncertain consequences, but they may be practical for taxpayers that have time to plan in 2020. Caution is required, however. Accelerating deductions and losses to take advantage of the five-year carryback is a form of tax arbitrage and may (and should) attract heightened scrutiny from the IRS.

Additionally, policymakers may provide further guidance limiting arbitrage in some cases. Congress's reasons for providing economic relief in the form of the CARES Act carryback provisions are not entirely clear, but Congress may not have intended the rule to operate as a de facto subsidy to previously profitable corporations that are able to generate 2020 tax losses that do not correspond to 2020 economic losses using other timing rules and tax preferences in the code.

a. Bonus depreciation.

The purest form of tax arbitrage that appears to have been enabled by the five-year carryback election relates to the TCJA rule allowing taxpayers to expense purchases of depreciable property.

In principle, a corporation could expense a 100x purchase of depreciable property in 2020, carry the 100x loss back against income from 2015 taxable at a 35 percent rate, dispose of the property for 100x in 2021, and include the ordinary income at a 21 percent rate for 2021. Recapture rules treat the 100x of gain corresponding to the 100x of accelerated depreciation as ordinary income but do not require the gain to be included at the statutory rate in effect for the year in which the depreciation deduction was used. If permitted, this transaction generates after-tax benefits of 14x with minimal risk (of course, it would need to have substance and otherwise satisfy general tax principles).

Before the CARES Act, this and similar tax arbitrage would have been impossible because of TCJA rules prohibiting NOL carrybacks. Moreover, using the expensing provision to incur losses was generally penalized because of the rule preventing an NOL from offsetting more than 80 percent of taxable income in succeeding years. The CARES Act does away with these protections for the fisc without including other special rules to mitigate the risk of exploitation. Rev. Proc. 2020-25, 2020-19 IRB 785, provided timing relief in making bonus depreciation elections for prior years, which may increase taxpayers' flexibility when planning into a carryback election but raises the same arbitrage concerns.

b. Ordinary losses.

Corporations also may have control over other transactions that could accelerate ordinary losses. For example, a corporation may incur an ordinary loss on the sale of foreign currency positions, claim an ordinary deduction for the worthlessness or abandonment of a partnership interest, or trigger ordinary losses that are suspended under other tax rules (such as the outside basis limitation on losses incurred by partnerships). Expensing depreciable property arguably presents an opportunity for abuse, but acceleration transactions of this kind only have the effect of crystallizing losses that arose before 2020 and that may even have arisen before the TCJA as an economic matter.

c. Interest expense.

Incurring interest expense on debt, which in many cases will have significant commercial implications, can also affect an NOL, and the CARES Act also relaxed limitations on the deductibility of that expense.

More specifically, the CARES Act increased the limitation on earnings stripping through interest expense to 50 percent of adjusted taxable income for 2019 and 2020 from its 30 percent level under the TCJA. The threshold is computed without reducing ATI by depreciation expense (and before reduction by any NOL carryovers). Thus, a corporation apparently can use business interest expense deductions to increase the size of an NOL even if it has no taxable income as a result of expensing purchases of depreciable property.

However, BEAT taxpayers considering additional borrowing in 2020 should be wary of the stacking rule that coordinates base erosion benefit calculations with the earnings-stripping limitation. The stacking rule provides that business interest expense disallowed by the limitation is allocable first to interest paid to unrelated parties, which generally increases modified taxable income and BEAT liability relative to alternative ordering rules.

2. Accelerating income.

a. Dispositions of assets.

Reducing the amount of an NOL may be straightforward in some cases because the code is biased toward accelerating gain, including in related-party sales. Excess NOLs that otherwise would be wasted on low-taxed income might be used to shelter ordinary income or capital gain on appreciated assets sold to an unrelated buyer, or to another group member that would take the property with a stepped-up basis. Corporations pursuing this type of transaction should be mindful of mandatory nonrecognition rules that could defer the income.

b. Distressed debt modifications.

Some loss corporations that are required to modify their debt because of liquidity or credit issues in 2020 may have COD income if the modification results in a deemed exchange and the issue price of the "new" debt instrument is less than the adjusted issue price of the "old" debt instrument. This may occur if the issuer's debt is trading at a discount, as was common during the subprime mortgage crisis.

If this occurs, the resulting COD income may be sheltered by losses, and effectively would be converted into OID giving rise to future interest expense deductions. The recognition of current income offset by a stream of future deductions is generally adverse but may be neutral or advantageous in some cases if it enables management of the size of an NOL carryback.

Corporations engaging in these transactions should be sensitive to possible limits on the deductibility of the resulting OID, such as the earnings-stripping limitation and the rules for applicable high-yield debt obligations (AHYDOs).

3. Transfer pricing.

Transfer pricing policies adopted in "normal" times may not be appropriate during the pandemic. The economic downturn, essential-worker rules, travel restrictions, and reduced consumer demand will likely produce substantive changes in a multinational corporation's business operations and the markets in which it operates. Those changes should be reflected in its tax positions. The pandemic will affect both the functional analysis of a multinational corporation's own transactions and the comparability analyses typically used to price those transactions:

- focusing on the corporation's own transactions, the arm's-length compensation due among U.S. and foreign members of a multinational group may change if value-adding and/or decision-making functions shift among jurisdictions as a result of labor availability or travel restrictions; and
- for purposes of pricing the corporation's transactions, one-sided transfer pricing methods that rely on data from transactions undertaken by, or on the financial results of, comparable uncontrolled taxpayers may require substantial adjustment to reflect changes in those transactions' prices or financial results.

Adjustments to transfer pricing policies in response to these drivers may reduce or increase the income of particular affiliates for 2020 and may thereby affect the sizes of their NOLs.

a. Revisiting functional analyses.

Transfer pricing policies and intercompany agreements are typically predicated on assumptions about where functions are performed, assets are used, and risks are borne within a multinational corporation. The coronavirus crisis may undermine some (or many) of those assumptions.

In general, functions are relatively immobile, but current conditions have forced many taxpayers to change the locations where activities are performed and decisions are made. Consider, for example, corporate managers working from home or salespeople concluding contracts in jurisdictions other than those in which they normally work as the result of border closures. Some companies may also affirmatively centralize — or decentralize — operational decision-making in response to the crisis. The arm's-length compensation to those functions should, in principle, follow them, which may mean moving profit from one jurisdiction to another.

Under U.S. transfer pricing rules and related federal income tax law, a taxpayer must generally respect ex ante risk allocations in its intercompany contracts, even if subsequent events make that allocation seem inappropriate. But contractual risk allocations should be consistent with substance — and if the facts have shifted, it may be appropriate to adjust the allocation of risks and the arm's-length return due for bearing them.

According to OECD base erosion and profit-shifting guidance, an affiliate to which risk is allocated by contract should earn the return to that risk only if it exercises control over the risk (through informed decision-making) and has the financial capacity to bear it. Suppose, for example, that a foreign manufacturing subsidiary bears volume risk by contract, but the U.S. parent's management decides to close the subsidiary's factories as a result of the coronavirus. The contractual risk allocation to the subsidiary, and whether and to what extent the subsidiary (and not the U.S. parent) should bear the losses resulting from the factory closures, may require reevaluation. Likewise, coronavirus-driven changes in where development, enhancement, maintenance, protection, and exploitation functions for intangible assets are controlled may require a reallocation of the nonroutine return to those intangibles.

More broadly, taxpayers should consider the extent to which their intercompany contracts address specific, low-incidence risks relevant to the coronavirus pandemic. Although the crisis is global, government responses have been far from uniform. The timing and stringency of measures implemented to protect public health — and their effect on local economies — have varied widely. The economic consequences of local government policies may constitute local risks that are properly borne by local affiliates. Even if an affiliate is ordinarily characterized as low-risk for transfer pricing purposes, it may be appropriate for that affiliate to earn lower returns, or losses, if the reduced returns or losses can be factually linked to local circumstances.

Taxpayers considering the jurisdictions in which they expect income or loss for 2020, and examining the use of their NOLs, should carefully consider whether and how functional changes may affect their preexisting transfer pricing policies.

b. Revisiting comparability analyses.

Many taxpayers use one-sided transfer pricing methods to set the arm's-length return to routine functions. Those methods rely on data from comparable transactions between unrelated companies and/or the financial results of comparable unrelated companies, typically for a multiyear period that lags the current year. These market data are used to benchmark a controlled taxpayer's transfer pricing and to demonstrate to tax authorities that it satisfies the arm's-length standard.

Unrelated companies in the same industry as a particular multinational company may suffer similar consequences as a result of the pandemic, and changes in their pricing and results have two related implications for the benchmarks used in the company's transfer pricing analyses.

First, transfer pricing can be adjusted in real time to anticipate changes in the uncontrolled comparables' results. Consider a U.S. manufacturer's foreign distribution subsidiary compensated with a guaranteed 3 percent operating margin established by reference to the results of uncontrolled comparables over the preceding three years. Those comparables' operating margins may likely decline in 2020. If so, a reduced return to the distribution subsidiary may be appropriate, even if it bears limited risk. Although 2020 financial data for uncontrolled companies may not be immediately available, real-time industry-level and regional economic indicators offer directional guidance and can be used to determine tentative pricing adjustments that can be trued up at year-end if required.

Second, tax authorities typically object if a multinational's benchmarking set includes comparables that have suffered persistent (or any) losses, but the inclusion of loss companies generally should be viewed as less aggressive in the current environment, in which loss-making companies can no longer be written off as outliers.

Benchmarking exercises are typically performed in conjunction with establishing a transfer pricing policy and, thereafter, on an annual basis after year-end. Some foreign jurisdictions require that this transfer pricing documentation be prepared and filed annually, and under U.S. transfer pricing regulations, having the documentation in place when the tax return is filed may provide penalty protection in the event of future transfer pricing adjustments. Typically, annual transfer pricing analyses draw on multiple years of comparables data. For 2020 tax years, however, taxpayers should consider whether using data for only a single (current) year would more reliably lead to an arm's-length result.

Further, U.S. transfer pricing regulations and OECD guidance recognize that an arm's-length result consists of a range rather than a single point. For U.S. purposes, the acceptable range is usually the interquartile range of the comparables included in the benchmarking set, although non-U.S. jurisdictions may apply a different standard. As an alternative (or in addition) to using fewer years of data to develop the interquartile range, it may be appropriate for a corporation to adjust its transfer pricing policy to target a different point within that range for 2020. For example, for the distribution subsidiary hypothesized earlier, the interquartile range of comparable operating margins may be 2 percent to 4 percent. The subsidiary's margin could in principle be reduced from 3 percent to 2 percent (by increasing the price paid to the U.S. manufacturer, and thereby U.S. income) or increased from 3 percent to 4 percent (by decreasing the price paid to the U.S. manufacturer, and thereby U.S. income), and either alternative result would be arm's length.

Revisiting benchmarking analyses and the data sets that flow into them, and making transfer pricing policy adjustments that are otherwise appropriate under applicable regulations, may have the effect of moving taxable income between the United States and foreign jurisdictions. This in turn may affect a group's ability to use an entity's tax losses in the current year, or at all.

Of course, transfer pricing policy changes often attract IRS scrutiny, and multinational corporations that adopt such changes for 2020 should be prepared to defend them on audit. Nevertheless, if the underlying functional, comparability, and economic analyses are robust and appropriately documented, their results will likely be sustainable.

II. Planning for 2020 Losses of CFCs

Because the coronavirus pandemic is a global crisis, CFCs with active businesses are as likely as their U.S. parents to incur losses. Yet under current law, a CFC's tested losses are ineligible for carryover under the GILTI rules (or for use against non-GILTI income), and its subpart F losses do not flow up to the U.S. parent at all. We advise U.S. shareholders to focus on managing their GILTI tested losses, but we discuss planning considerations for both categories of CFC losses.

A. Efficient Use of GILTI Tested Losses

Because GILTI tested losses are ineligible for carryover, U.S. shareholders of CFCs may benefit by giving advance consideration to transactions that would trigger off or accelerate any latent CFC income or gain that would be classified as tested income, and thereby maximize the use of 2020 tested losses. Absent such planning, the value of GILTI tested losses may be recoverable only through a loss or reduced gain incurred on a later disposition of the CFC.

A planning exercise of this kind has several potential pitfalls.

If a CFC triggers gain by selling assets, the sale generally will give rise to income under foreign tax law. Thus, acceleration transactions intended to manage GILTI liability may have the most value if undertaken by (1) CFCs that can use the income to offset their own losses under foreign tax law, (2) CFCs resident in zero-tax jurisdictions, or (3) CFCs able to execute hybrid transactions in which gain must be recognized currently for U.S. tax purposes but remains deferred for foreign tax purposes:

- Netting of tested income and loss occurs at the level of the U.S. shareholder across all its CFCs.
- If a CFC earns additional tested income but the U.S. shareholder's CFCs do not generate sufficient tested loss in the aggregate to zero out that income, the U.S. shareholder may have a GILTI inclusion. U.S. shareholders that also incur U.S. losses may have to use those losses against the GILTI inclusion, with the potential adverse consequences described earlier:
  - If CFC A has multiple U.S. shareholders, and one U.S. shareholder wants to trigger tested income in CFC A to offset its tested loss from CFC B that otherwise would expire unused, the other U.S. shareholders of CFC A may be disadvantaged unless they also have sufficient tested loss to offset the tested income from CFC A.
  - If a U.S. parent already had plans to onshore a CFC's business, it may be advantageous to accelerate the process, for example, to increase the NOLs eligible for the five-year carryback against 35-percent-rate income. But a U.S. parent typically will not benefit by liquidating a CFC solely to bring coronavirus losses onto its U.S. tax return. It is generally desirable to operate through a CFC rather than through a branch (for example, because of the section 250 deduction for GILTI), and loss recapture rules present hurdles to restoring a CFC structure.

Short of restructuring, the transfer pricing considerations discussed earlier are equally relevant in the context of CFC losses. Taxpayers revisiting their transfer pricing policies in light of the coronavirus crisis should carefully weigh the consequences of moving profit between the

United States and CFC jurisdictions through transfer pricing changes.

B. Efficient Use of Subpart F Losses

Although CFCs generally have greater control over the timing of subpart F losses (which are often incurred on the sale of subsidiaries or capital assets), loss sales may be necessary or desirable to generate liquidity during the coronavirus crisis.

With limited exceptions, subpart F losses (and related earnings and profits deficits) generally will not carry forward to reduce or offset gain from similar property in future years. These restrictions are particularly likely to apply to dispositions of investment assets such as stocks and debt, real property, or passive intellectual property in the subpart F category known as "foreign personal holding company income."

Corporate U.S. shareholders that expect their CFCs to realize significant losses in 2020 should consider whether the CFC can trigger income or gain to preserve the U.S. tax benefit of the loss, such as by appropriately documenting the fair market value of the asset and stepping up basis through a taxable sale to an affiliate. U.S. shareholder groups generally have limited ability to shift subpart F income from one CFC to another CFC so as to enable the losses of one CFC (in effect) to offset gains of another CFC, although this occurs with some deductible payments between related CFCs.

III. Silver Linings

The coronavirus crisis has already been terrible for business, and it is not yet over. Economic losses will be widespread. But once losses have been accepted as a reality, multinational corporations should turn their attention to maximizing the tax benefit of those losses. Even multinationals that generally expect to withstand the storm and do not project losses this year may wish to consider whether they can restructure their operations to benefit from loss-related relief measures like the CARES Act NOL carryback. For the reasons reviewed earlier, this endeavor will vary from taxpayer to taxpayer. To manage the value of its losses and FTCs, a corporation generally will need to examine its worldwide operations, possibly including entities and assets for which the corporation otherwise had no plans for this year. But through careful analysis and coordination with tax advisers, a corporation may be able to find a silver lining in today's economic clouds. ■