

# Alerts & Publications

## CARES Act NOL Rule Changes and Financially Troubled Companies

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As part of an effort to mitigate the economic impact of the COVID-19 crisis, the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) was enacted in March 2020. The CARES Act’s US\$2.2 trillion stimulus provides various forms of relief for businesses and individuals facing unprecedented challenges. Of particular note, the CARES Act includes a number of tax law changes that expand a taxpayer’s ability to utilize tax credits and net operating losses (“NOLs”), including by temporarily suspending certain significant limitations imposed by the Tax Cuts and Jobs Act (the “TCJA”).<sup>1</sup>

Subject to certain limitations, a taxpayer may be able to offset a significant portion of its past and/or future tax liability with NOLs. These NOLs can be a valuable tax asset and often affect the equity value of a corporation with such losses (a “Loss Corporation”). However, when a Loss Corporation undergoes an “ownership change” (as discussed below), section 382 of the Code<sup>2</sup> can significantly limit the value of its NOLs and therefore the Loss Corporation itself. Section 382 was enacted in order to limit a taxpayer’s ability to acquire a Loss Corporation in order to offset taxable income in periods subsequent to the acquisition. It does so by limiting the amount of pre-ownership change NOLs that can be utilized in post-ownership change tax years, thus potentially significantly reducing the value of the Loss Corporation’s NOLs, as well as the value of the Loss Corporation itself. The NOL rules enacted as a result of the CARES Act may make it possible for a Loss Corporation to maximize the value of certain NOLs when facing a potential ownership change.

### 1. Post-CARES Act NOL Rules

Prior to the TCJA, a taxpayer was able to carryback NOLs two years (i.e., reduce the amount of taxable income recognized in the two years prior to the year in which the NOLs were created) and then carryforward its remaining NOLs 20 years (i.e., reduce the amount of taxable income recognized in the 20 years subsequent to the year in which the NOLs were created) to offset up to 100% of its taxable income in each such year. As part of the TCJA, Congress enacted rules limiting the use of NOLs generated in taxable years ending after December 31, 2017. The TCJA provided that a taxpayer (a) was no longer allowed to carryback such NOLs to prior years and (b) could only carry them forward to offset up to 80% of the taxable income in each carryforward year.

The CARES Act temporarily suspends and modifies these TCJA limitations for losses arising in 2018, 2019 and 2020. A taxpayer may now (a) carryback such losses five years and (b) offset up to 100% of its taxable income in any such carryback year. A company may, instead, elect to waive the carryback and carry such losses forward.

	NOLs Generated Pre-TCJA	NOLs Generated Post-TCJA	CARES Act Changes
<b>Carryback</b>	Two taxable years	Disallowed	NOLs incurred in 2018, 2019 and 2020 may be carried back five taxable years
<b>Carryforward</b>	Twenty taxable years	No limitation	No limitation
<b>Taxable Income Limitation</b>	NOL deduction up to 100% of taxable income	NOL deduction limited to 80% of taxable income	In 2018-2020, deduction for NOLs generated in post-TCJA tax years may offset up to 100% of taxable income; after 2020, the deduction is again limited to 80% of taxable income

**Table 1: Changes in NOL Limitation Rules**

If a taxpayer carries back its NOLs generated during the 2018-2020 period, it may receive cash refunds for taxes paid during such prior years. For all tax periods for which returns have already been filed, the taxpayer will need to amend the relevant prior year tax return.<sup>3</sup>

## 2. The Section 382 Limitation

Generally, once a Loss Corporation undergoes an ownership change, the amount of NOLs and other tax attributes that it may use on an annual basis going forward is limited to an amount equal to the Loss Corporation's value immediately before the ownership change multiplied by the long-term tax-exempt rate published by the IRS for the month in which the ownership change occurs.<sup>4</sup> Any such limitation is (1) increased by the amount of any pre-ownership change built-in gain, including cancellation of debt ("COD") income, or (2) reduced by the amount of any pre-ownership change built-in loss that is recognized during the five-year period following the ownership change date. In order to calculate these adjustments to the section 382 limitation, a Loss Corporation must determine the amount of its net unrealized built-in gain ("NUBIG") (i.e., the amount by which the fair market value of the assets of a Loss Corporation exceeds the Loss Corporation's adjusted tax basis in such assets) or its net unrealized built-in loss ("NUBIL") (i.e., the amount by which the Loss Corporation's adjusted tax basis in its assets exceeds the fair market value of such assets) as of the date the ownership change occurs.<sup>5</sup> The recognition of any such NUBIL during the 5-year recognition period, along with any pre-change NOLs, in the aggregate, is subject to the section 382 limitation.<sup>6</sup> The recognition of any such NUBIG during the 5-year recognition period increases the section 382 limitation.

### *a. Ownership Change*

For purposes of section 382, an ownership change occurs when the cumulative percentage of Loss Corporation stock owned by shareholders who own more than 5% of the Loss Corporation's stock ("5% Shareholders") increases by more than 50% over the lowest percentage of stock owned by such 5% Shareholders any time during a "testing period" (generally, the prior three years).

### *Definition of Stock*

In determining ownership percentage, stock generally includes all stock, with the exception for stock that does not provide participation in corporate growth proportionate to its value and "straight preferred stock." Straight preferred stock is stock that (i) does not vote (or has limited voting rights that are accrued as a result of dividend arrearages), (ii) is limited and preferred as to dividends and does not participate in corporate growth, (iii) does not have redemption and liquidation rights that exceed the issue price of the stock (except for a reasonable redemption or liquidation premium) and (iv) is not convertible into common or other participating stock.

Options or similar interests may be treated as exercised and treated as stock for purposes of section 382 if they were issued, transferred or structured with the principal purpose of avoiding or ameliorating the consequences of a subsequent ownership change and have certain characteristics that confer rights related to the ownership of the underlying stock. Options issued in the course of the Loss Corporation's ordinary business are generally not treated as stock for this purpose.

## *Ownership Percentage*

The percentage of stock owned by a shareholder is equal to the value of the stock owned by the shareholder over the value of all outstanding stock. Shares of a single class are considered to have the same value. Shares with the same material terms are also considered part of a single class. Thus, stock in a class that may have been issued to various shareholders that have varying premiums or discounts are considered part of a single class for this purpose. Decreases in percentage ownership by 5% Shareholders are ignored when determining whether an ownership change has occurred; that is, only aggregate increases of stock held by 5% Shareholders during the 3-year testing period are counted.

The ownership change percentage is tested at the end of any testing date. Generally, a testing date is the last day of the 3-year period ending on the date that a 5% Shareholder's stock ownership has increased (i.e., the testing period). Any transactions that occur on such testing date are treated as simultaneously taking place at the end of the testing date, thus the order of the transaction steps will not affect the ownership change percentage.

### **b. Value of a Loss Corporation**

A Loss Corporation's value is the value of its stock immediately before the ownership change (including the value of straight preferred stock).

## **3. Bankruptcy Exception for Loss Corporations**

The section 382 limitation may significantly diminish the value of NOLs and thus the related equity value of a Loss Corporation. However, sections 382(l)(5) and 382(l)(6) provide exceptions from the limitation described above for a financially-troubled Loss Corporation that undergoes an ownership change in a Title 11 or similar proceeding. If the ownership change meets the requirements of section 382(l)(5), the section 382 limitation generally no longer applies. However, the corporation's pre-change NOLs may be reduced as discussed below. If the ownership change meets the requirements of section 382(l)(6), the base section 382 limitation is substantially increased because it is determined by reference to the value of the Loss Corporation's stock immediately after the ownership change transaction, which may include the forgiveness of debt as part of the transaction giving rise to such change in control.

If an ownership change meets the requirements of both sections 382(l)(5) and 382(l)(6), section 382(l)(5) applies unless the Loss Corporation makes an irrevocable election to apply the section 382(l)(6) exception instead.

### a. Section 382(l)(5)

If an ownership change transaction meets the requirements of section 382(l)(5), the section 382 limitation no longer applies to pre-ownership change NOLs. Section 382(l)(5) applies when (i) the Loss Corporation is under the jurisdiction of a court in a Title 11 or similar proceeding and the ownership change transaction is effectuated pursuant to a plan approved by such court, and (ii) the Loss Corporation's pre-ownership change shareholders and qualified creditors (the "old and cold creditors") own at least 50% of the vote and value of the Loss Corporation's outstanding stock immediately after the ownership change transaction.<sup>7</sup>

In a section 382(l)(5) transaction, instead of being subject to the section 382 limitation, the Loss Corporation reduces the amount of its NOLs by the amount of interest expense paid or accrued during the 3 prior taxable years and the pre-ownership change portion of the ownership change year on the allocable portion of any debt that converts into the Loss Corporation's stock pursuant to the ownership change transaction. The reduced NOLs can then be used to offset taxable income of the acquiring company or new Loss Corporation in post-change in control taxable years without regard to the section 382 limitation.

However, if a Loss Corporation undergoes a subsequent ownership change within 2 years, the NOLs will be lost entirely. Therefore, if another ownership change is likely to occur, an acquirer of a Loss Corporation may choose not to apply section 382(l)(5) in order to preserve the Loss Corporation's NOLs even if section 382(l)(5) exception would have otherwise preserved its ability to use all of its pre-change NOLs.

It is important to note (assuming a second ownership change is not likely to occur), that given historically low interest rates, section 382(l)(5) can be very valuable since the accrued interest during the prior 3-year period may result in a minimal reduction of a Loss Corporation's NOLs. Thus, the section 382(l)(5) exception may be preferable for certain Loss Corporations, even compared to the value of the increased section 382 limitation afforded under section 382(l)(6) (discussed below).

## b. Section 382(l)(6)

Section 382(l)(6) applies when a ownership change transaction is ordered or pursuant to a plan approved by a court in a Title 11 or similar proceeding to which section 382(l)(5) does not apply.<sup>8</sup> As noted above, generally, the section 382 limitation is calculated based on the Loss Corporation's equity value immediately before the ownership change. For an ownership change that meets the section 382(l)(6) requirements, the section 382 limitation is substantially increased because it is determined by reference to the lesser of (a) the fair market value of the Loss Corporation immediately after the ownership change or (b) the fair market value of the Loss Corporation's "gross assets" (i.e., without taking into account the corporation's liabilities) immediately prior to the ownership change. Because ownership change transactions involving troubled companies typically involve the surrender or cancellation of debt and/or involve the exchange of debt for stock, the fair market value of the Loss Corporation often increases after the ownership change, thereby increasing the section 382 limitation amount, allowing the Loss Corporation and the acquirer to access substantially more of the Loss Corporation's NOLs in post-change years.

It is important to note, however, that the fair market value of the Loss Corporation's gross assets immediately prior to the ownership change will be reduced by any capital contributions made (a) with the principal purpose of avoiding or increasing the section 382 limitation or (b) during the 2-year period ending on the ownership change date. Additionally, stock issued with a principal purpose of increasing the section 382 limitation is excluded from the value of the Loss Corporation after the ownership change to the extent such stock is not subject to "the entrepreneurial risks of the corporation's business operations."<sup>9</sup>

If a Loss Corporation applying section 382(l)(6) does not meet the "continuity of business enterprise" ("COBE") requirement continuously through a 2-year period from the ownership change date, the section 382 limitation is reduced to zero. To meet the COBE requirement, the Loss Corporation must either (a) continue the historic business of the pre-change Loss Corporation or (b) use a significant portion of the assets of the pre-change Loss Corporation in its business.

## c. Bankruptcy, Insolvency and COD Income

Generally, taxpayers recognize COD income for any discharged debt. However, the Code provides for an exception for insolvent taxpayers. An insolvent taxpayer does not recognize COD income to the extent it is insolvent. Debt discharged in excess of the taxpayer's insolvency amount will be recognized as COD income.

In a Title 11 proceeding, however, COD income is excluded from income without regard to a taxpayer's insolvency, but the taxpayer must, reduce its NOLs and other tax attributes (the "attribute reduction rule") by the amount of COD income excluded from income. The order in which tax attributes are reduced under this rule is as follows: (a) NOLs generated in the year COD income is excluded from income, (b) NOL carryforwards, beginning with the earliest NOLs generated, (c) general business credits, (d) alternative minimum tax credits, (e) capital loss carryover, (f) basis in company assets, (g) passive activity losses and credits,

and (h) foreign tax credits. The items described in (a), (b), (e) and (f) are reduced dollar for dollar up to the amount of the COD income not recognized, while the items described in (c), (d), (g) and (h) are reduced 33 1/3 cents for each dollar of COD income not recognized. In lieu of applying the attribute reduction rule, the Loss Corporation may elect to reduce its basis in depreciable property. However, this alternative may only be of value to the extent that a taxpayer has sufficient basis in depreciable property. A taxpayer with substantial depreciable property may also prefer not to make such election if it anticipates a subsequent ownership change or asset sale since such depreciable basis might be of significant value to a purchaser.

#### 4. Post-CARES Act Bankruptcies

As described above, a financially-troubled Loss Corporation's use of pre-ownership change NOLs may be substantially limited by section 382 and the exceptions afforded under sections 382(l)(5) and 382(l)(6) may subject the Loss Corporation to various conditions and requirements related to its operations before and after the ownership change. Furthermore, the Loss Corporation's NOLs may be significantly reduced by any COD income excluded from income as a result of the ownership change. For a Loss Corporation anticipating substantial losses in 2020 due to COVID-19 or that has significant unused NOLs that were generated in 2018 or 2019, the limitations under section 382 may create issues regarding the value associated with the use of those NOLs in future years when negotiating a potential restructuring.

Since section 382 does not limit a corporation's ability to utilize NOLs or credits carried back to pre-ownership change tax years, the recent changes in the NOL rules under the CARES Act may allow the Loss Corporation to preserve the value of its NOLs by carrying back such losses to years prior to any such ownership change arising from a sale or a restructuring. The Loss Corporation will be able to fully utilize such NOLs to the extent carried back and applied against taxes paid during the five-year period prior to the year such NOLs arose. Additionally, when NOLs are carried back to a pre-TCJA year, the 35% corporate income tax rate that was applicable before the TCJA may further enhance the value of the Loss Corporation's NOLs.<sup>10</sup>

As a result of the CARES Act's liberalized NOL carryback rules, with proper analysis and planning, a corporation with losses generated between 2018 and 2020 may be able to carry such losses back without being subject to the section 382 limitation that often significantly decreases the value of pre-ownership change losses. The interplay of section 382 and its limitations and the new carryback rules are very complex and many other factors will need to be considered, such as the impact that these rules will have on a company's ability to use credits, whether the right to carry back losses may be subject to contractual constraints (if, for example, such company was acquired from an unrelated party during the carryback period), and many others. Nevertheless, Loss Corporations undergoing an ownership change or reorganization should carefully consider whether the CARES Act NOL carryback rules provide significant value.



<sup>1</sup> We note that the House of Representatives passed the HEROES Act on May 15, 2020, which contains a provision that would retroactively amend the CARES Act NOL provision. If enacted, this particular amendment to the CARES Act NOL provision would prevent carrybacks from 2018, 2019 and 2020 to tax years prior to 2018. Many tax practitioners are of the view, however, that this provision of the HEROES ACT is unlikely to be enacted in its current form.

<sup>2</sup> All section references are to the Internal Revenue Code of 1986 (the “Code”), as amended time to time, and to the Treasury Regulations promulgated thereunder.

<sup>3</sup> We recommend that a taxpayer consult with its tax advisors when determining whether to amend prior year tax returns, as amending such tax returns will require recalculating various inputs and tax attributes that flow into the tax returns, such as alternative minimum tax credits, base erosion anti-abuse tax, and interest expense deductions.

The IRS has allowed taxpayers to access such refunds on an expedited basis by filing an application for a tentative carryback adjustment for prior year returns.

<sup>4</sup> The long-term tax-exempt rate for June 2020 is 1.09%.

<sup>5</sup> In calculating the extent of the potential adjustment that can be made to the base section 382 limitation, it is assumed that the acquiring company assumed the Loss Corporation’s indebtedness, including recourse indebtedness that was cancelled or discharged as part of the ownership change transaction.

<sup>6</sup> Recently proposed regulations affect the calculation of a Loss Corporation’s NUBIG and may often result in a lower valuation, although these regulations will not apply to transactions occurring pursuant to a binding agreement, a public announcement, an SEC filing, a court order or confirmed plan for sale in a Title 11 or similar case, or private letter ruling request, in each case, entered into within 30 days of the proposed regulations being finalized.

<sup>7</sup> Old and cold creditors are creditors (a) who continuously held their debt for at least 18 months before the filing of the Title 11 case or (b) who continuously held the beneficial interest in debt issued in the ordinary course of the Loss Corporation’s business. There are certain exceptions for holders of publicly traded debt with respect to the continuous holding requirement. Treasury Regulations Section 1.382-9(d)(5) provide additional exceptions to the 18-month continuous holding requirement by allowing certain transferees of debt to tack the transferors’ holding period to their own holding period.

For purposes of the 50% stock ownership test, a corporation that owns at least 80% of the combined voting power of both the voting stock and non-voting stock of the Loss Corporation will also meet the 50% ownership test to the extent it is also part of the Chapter 11 proceeding.

<sup>8</sup> Including transactions where a Loss Corporation elected not to apply section 382(l)(5).



<sup>9</sup> The increase of the section 382 limitation need not be the only principle purpose in order for the IRS to exclude the value of any such stock issued.

<sup>10</sup> As part of the TCJA, the corporate income tax rate was reduced from 35% to 21% for tax years beginning after 2017. As a result, when carrying back losses from 2018-2020 a taxpayer can take advantage of a tax rate arbitrage (NOLs are worth 66.66% more when offsetting a pre-2018 tax liability).

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If you have any questions regarding the aforementioned CARES Act-related net operating loss provisions, please contact [Alexander Anderson](#), [Robert Blashek](#), [Robert Fisher](#), [Arthur Hazlitt](#), [Luc Moritz](#), [Billy Abbott](#), [Alexander Roberts](#), or [Dawn Lim](#) from O'Melveny's Tax group.

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