Key Considerations and Opportunities:

Cash and Liquidity Impacts of the TCJA on Losses

The Tax Cuts and Jobs Act ("TCJA") made significant changes to the tax code, a number of which can have unexpected effects when a company loses money in the United States or abroad. While the immediate concerns around the spread of COVID-19 are rightfully focused on public health and welfare, given the current economic fallout arising from COVID-19, companies should be aware of these rules and the steps that could be taken to mitigate their impact.

1 Summary Impacts of the TCJA on Companies with U.S. Losses

- The tax code has long sought to ameliorate the negative effects of the annual accounting period by allowing certain attributes, including losses, to be carried between multiple years. This is intended to ensure that one-time economic occurrences do not have an outsized impact on a taxpayer's tax liability solely because of timing.
- The TCJA changed rules around the use of net operating losses ("NOLs") and the taxation of foreign operations that increase the significance of the annual accounting period and make it more difficult for taxpayers to smooth out the effects of one-time losses over multiple years. These and other changes decrease the ability to secure needed cash-flow through tax refunds, and actually increase the likelihood that a taxpayer may owe U.S. tax despite being in an overall loss position in a given year. These changes can affect the taxpayer both in the year of the loss and in subsequent years after the taxpayer earns taxable income.
- Additionally, with respect to banking organizations, the changes made by the TCJA have additional effects on regulatory capital when the organization has an unprofitable year, compared to the prior tax code.
- These impacts may be mitigated through appropriate planning, and should in all events be considered by Congress and the Executive Branch as it evaluates stimulus or corrections to TCJA.

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2 Discussion of Certain Rules

Changes to the NOL Rules

- Under pre-TCJA law, an NOL could be carried back to the 3 preceding taxable years, and carried forward to the succeeding 15 taxable years. The NOL could offset all of a taxpayer's taxable income in the year to which the loss was carried. In a loss situation, allowing a loss to be carried back allowed a taxpayer additional cash flow more quickly, by permitting the taxpayer to get a refund of previously paid tax.
- The TCJA amended the rules to eliminate the ability of a taxpayer to carry back an NOL to an earlier year, but allow the taxpayer to carry forward the loss to any future year. This means that a taxpayer gets no benefit from the NOL rules immediately, but rather has to wait to a future year when the taxpayer has taxable income to use the loss.

- Additionally, the rules were amended to limit the use of the NOL in a future year to 80 percent of the taxable income in that year. Thus, a taxpayer can no longer use a loss to offset their entire taxable income in future year; instead they will owe tax on the remaining 20 percent of taxable income.

Changes to the International Rules

BEAT

- The base erosion and anti-abuse tax ("BEAT") enacted as part of TCJA is intended to subject taxpayers with a high amount of related party payments to a minimum tax in the United States. Because BEAT is a minimum tax that is assessed on a base other than taxable income, a taxpayer can owe tax under BEAT even if the taxpayer has no taxable income from a U.S. income tax perspective.
- Additionally, to the extent that a taxpayer has an NOL in a given year, the portion of that NOL that the BEAT rules consider related to these disallowed related party deductions can give rise to additional tax liability under the BEAT in years following the initial loss, because that portion of the NOL is added back for purposes of calculating the minimum tax due.

GILTI/FDII

- The global intangible low-taxed income ("GILTI") regime and foreign-derived intangible income ("FDII") regime were enacted as part of the TCJA. Under these regimes, the offshore earnings of a U.S. taxpayer earned directly (FDII) and indirectly through foreign entities (GILTI) are subject to current tax, but at reduced rates.
- GILTI operates on a wholly annual basis, with no carryback or carryforward of tax attributes that are not used in the current year. Thus, for example, if a taxpayer finds themselves with an overall loss in GILTI in a given year, that loss cannot be used to offset past or future GILTI. And any foreign income taxes associated with GILTI in a year cannot be carried back or carried forward if they are not used, which is likely to occur where a company is in a loss position in the United States or abroad. Losses in a single controlled foreign corporation can also eliminate certain tax attributes that increases a taxpayer's liability for GILTI.
- Moreover, losses in the United States can cause the U.S. tax rate on a taxpayer's foreign operations to increase. The deduction that reduces a taxpayer's tax on GILTI and FDII is subject to a taxable income limit. If a taxpayer has no taxable income in the United States, the effect can be to tax any GILTI and FDII at the standard corporate rate (21%) rather than their reduced rates.

Section 965 Transition Tax

- Tax payments due but deferred under the section 965 transition tax are to be paid in each of the 8 years following TCJA without regard to whether the taxpayer has income or loss in the year of payment.

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3 Bank Capital Levels and Requirements

The combination of the TCJA and current economic conditions may have certain effects on bank capital levels and requirements.

General Capital Requirements

For a banking organization subject to the U.S. bank regulatory capital rules, TCJA will have two negative effects on regulatory capital when the organization has an unprofitable year, compared to the prior tax code:

- First, TCJA eliminated a countercyclical effect of the prior tax code on regulatory capital in an unprofitable year that follows profitable years.
    - TCJA eliminated NOL carrybacks, which were deferred tax assets ("DTAs") that were not deducted from regulatory capital. NOL carrybacks had a countercyclical effect on regulatory capital, because they produced tax refund income (which increases regulatory capital) in unprofitable years that follow profitable ones. As a result, TCJA may have a net negative impact on regulatory capital in 2020.
    - For similar reasons, TCJA has resulted in larger peak-to-trough declines in capital ratios in stress tests for banking organizations that were profitable in years leading up to the tests.
- Second, TCJA dampened a pro-cyclical effect of the prior tax code that had boosted regulatory capital in profitable years that follow an unprofitable year.

- TCJA limited the amount of NOL carryforwards, which are DTAs that are deducted from regulatory capital, that a company can recognize. NOL carryforwards have a pro-cyclical impact on regulatory capital because they reduce tax liabilities (and therefore increase retained earnings, which increases regulatory capital) in profitable years that follow an unprofitable year. As a result, TCJA may have a net negative impact on regulatory capital in future years, assuming economic recovery.
- For this reason, TCJA has slowed the projected recovery of firms' regulatory capital ratios over the horizons used in stress tests, as NOL carryforwards no longer boost regulatory capital in profitable years following an unprofitable year to the extent that they once did.

Stress Capital Buffer

The Federal Reserve last week finalized a new rule establishing a stress capital buffer ("SCB") that will function as an important component of the largest banking organizations' regulatory capital requirements. The new SCB will effectively convert the results of the Federal Reserve's annual Comprehensive Capital Analysis and Review ("CCAR") stress test exercise – which previously has been used to determine how much capital a bank could return in the following year – into a capital buffer requirement that a bank must maintain on an ongoing basis to avoid any restrictions on its ability to pay dividends or repurchase shares.

- Under the final rule, the Federal Reserve will use the results of its supervisory stress test of a banking organization to determine the organization's SCB (depending on the organization's common equity tier 1 capital ratio projections during the stress test and assumptions regarding common stock dividends), subject to a floor equal to 2.5% of risk-weighted assets.

The TCJA's elimination of NOL carrybacks and limitation on NOL carryforwards may cause, for certain banking organizations, projected common equity tier 1 (CET1) capital ratios to decline more substantially under the stress test than they otherwise would have without the TCJA's provisions, thus leading to greater capital requirements via the SCB, and making it more likely that a bank's SCB exceeds the 2.5% floor. Either of these impacts would make it more likely that the results of each year's CCAR exercise would, via the SCB, act as the binding requirement that determines how much capital large banking organizations must hold.

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4 Mitigation through Planning

Companies should consider what actions they may be able to take in the absence of action by Congress or the Executive to respond to the changes that were made by TCJA and the current economic situation.

Acceleration of Income/Deceleration of Deductions or Losses

- One potential opportunity to mitigate the negative effects of losses is to accelerate income that a taxpayer would otherwise recognize in a future year to the current year to lessen or eliminate the loss.
- This could be helpful in order to preserve the use of current year tax attributes that will otherwise be eliminated as a result of the annual accounting system. For example, if a taxpayer has losses in the United States, but earns GILTI offshore and incurs foreign taxes on that income, insuring that there is taxable income in the U.S. preserves the reduced rate on the taxpayer's GILTI and the creditability of the foreign taxes.

Location of Loss

- Similarly, because of the operation of the taxable income limitation on the deduction for GILTI and FDII, as well as certain foreign tax credit rules, incurring losses on U.S. operations can have more significant negative effects than if those losses are incurred offshore for many taxpayers.
- Accordingly, reassessing the source of income including between foreign operations and U.S. operations can mitigate some of these negative effects, and preserve attributes that might otherwise go to waste.

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5 Mitigation through Policy Changes

In 2008, both Congress and the Executive Branch took a number of actions to mitigate the effects of the fiscal crisis. Here, there are number of places where Congress or the Executive Branch could similarly act to mitigate the current economic situation, and work on a stimulus package to address the economic fallout arising from COVID-19 is actively underway. Accordingly, companies should consider identifying measures that would be most helpful in addressing the anticipated consequences of the pandemic, which differ from other economic crises in the past, and consider mechanism for providing industry input into the legislative process that is gearing up.

Deferral of Current Payments

- Deferring the obligation for certain current year tax payments could lessen the burden on companies from one-time losses associated with current economic events.
- Potential payments that could be deferred include 2019 tax payments, 2020 estimated tax payments, and, to the extent applicable, any deferred payment due related to section 965.

Limiting Negative Effects of Current Year Losses

- Changes could be made to increase the use of current year losses, both in the current and future years. The NOL rules could be altered for 2020 to permit carrybacks for one or more years, and the 80% limit on the use of NOLs could be removed or suspended.
- Temporary changes to the BEAT could be made to mitigate its effect in the current year where losses might be more likely. For example, the applicability of the BEAT could be limited to taxpayers making income in 2020, or the internal thresholds for when BEAT applies could be temporarily increased to reduce the likelihood that it would apply to a taxpayer in 2020.

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