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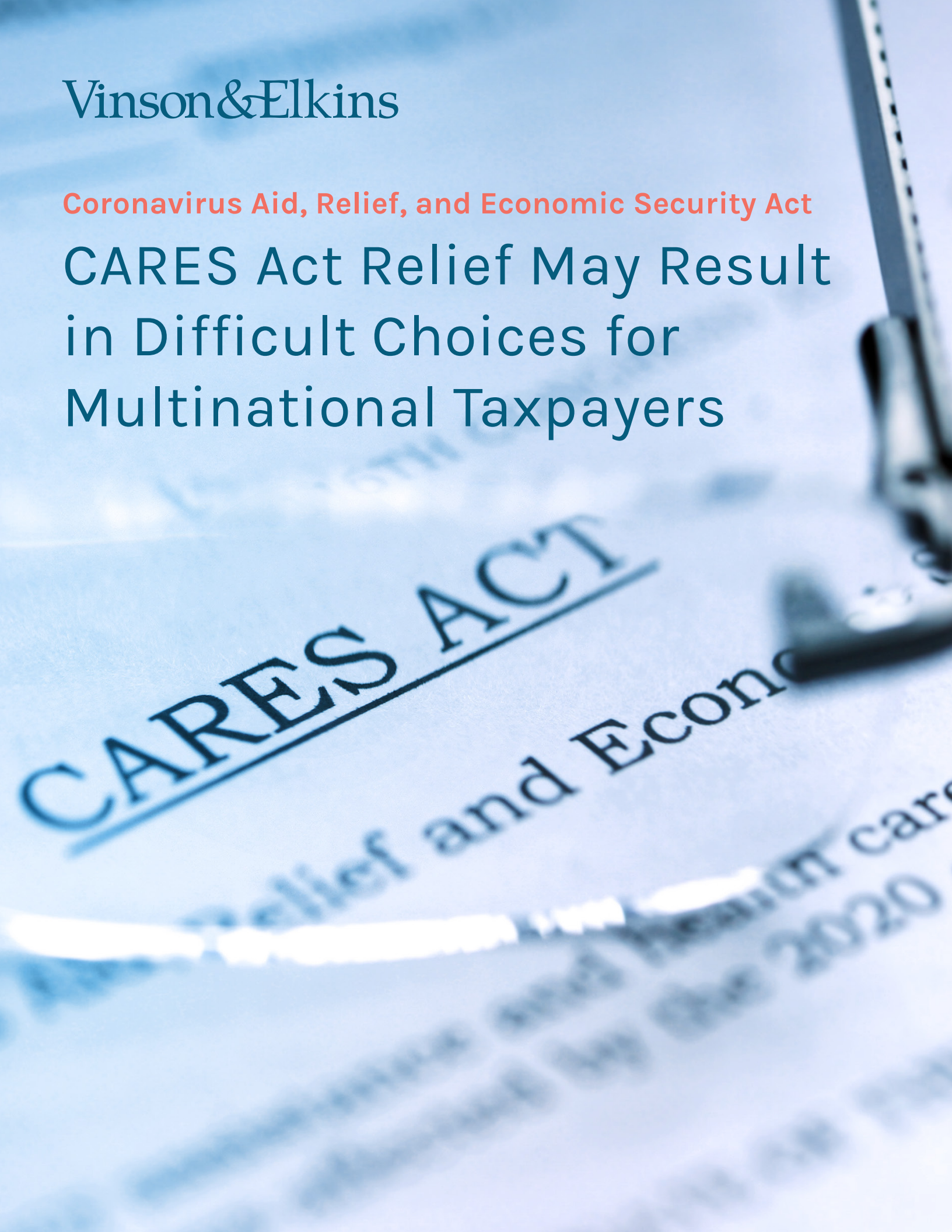
Coronavirus Aid, Relief, and Economic Security Act

CARES Act Relief May Result in Difficult Choices for Multinational Taxpayers



CARES Act Relief May Result in Difficult Choices for Multinational Taxpayers

The roughly $2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES Act) passed on March 27, 2020 includes temporary modifications to the Internal Revenue Code intended to provide economic relief and increased liquidity to those affected by the COVID-19 pandemic. The most important of these for businesses include (i) an expanded ability to use as well as carry back net operating losses (NOLs) and (ii) an increase in the deductibility of business interest expense. For multinational taxpayers, however, the potential benefit of these provisions requires an analysis of their interaction with certain international tax provisions. There are many specialized rules applicable to investments in foreign operations and cross-border transactions that interact with a taxpayer's NOLs and interest deductions, potentially limiting or negating the intended benefits of the CARES Act tax provisions. Careful tax planning can ensure that taxpayers maximize the utilization of NOLs, interest deductions, foreign tax credits, and other tax attributes. Further, current lower asset values present opportunities for taxpayers to put in place tax-efficient business structures for the future.

Set forth below is a discussion of the key business income tax provisions in the CARES Act and their interactions with certain international provisions, along with examples. The benefits and drawbacks to specific taxpayers will vary depending on their circumstances, including their tax attributes. The V&E Tax group can help you analyze all of the relevant factors and settle on a strategy that works best for your particular situation.

Background – CARES Act Tax Provisions

Expanded Ability to Use and Carry Back NOLs

- Temporary Lifting of 80% Limitation: The Tax Cuts and Jobs Act of 2017 (TCJA) limited NOL deductions for taxable years beginning after December 31, 2017, to 80% of taxable income in the year of the deduction. The CARES Act lifts the 80% taxable income limitation on the use of NOLs for taxable years beginning before January 1, 2021. However, NOLs carried forward from tax years beginning in 2018, 2019, or 2020 to taxable years beginning after December 31, 2020, remain subject to the 80% limitation.
- Expansion of NOL Carrybacks: The TCJA generally disallowed the use of NOLs against the income of prior tax years. The CARES Act allows an NOL incurred by a corporation in tax years beginning after December 31, 2017, and before January 1, 2021, to be carried back to each of the five tax years preceding the tax year of the NOL.[1] An NOL arising during this period that a taxpayer elects to carry back must be carried back to the earliest year within the five-year period in which the taxpayer has taxable income. A taxpayer may elect to waive the carryback period. An NOL carried back to a section 965 transition tax year will not be applied to reduce a section 965 inclusion. In addition, taxpayers may elect to fully exclude the section 965 transition tax year from the five-year NOL carryback period.[2]

[1] Rev. Proc. 2020-24 and Notice 2020-26 provide guidance on the procedures and requirements relating to the carryback of NOLs pursuant to the CARES Act.

[2] Taxpayers should be aware that carrybacks of consolidated NOLs (*i.e.*, CNOLs), including to a tax year in which a member was not part of the consolidated group, introduce additional complexities that should be considered. Such considerations are beyond the scope of this discussion.

Corporate NOLs carried back to pre-TCJA tax years will offset income taxed at a **35%** rate, potentially yielding a **greater overall benefit** than NOLs carrybacks to TCJA years (2018 and 2019 for calendar year taxpayers) taxed at a **21%** rate.

Temporary Increase in Business Interest Deduction

- The CARES Act increases the business interest expense limitation of section 163(j) (as amended by the TCJA) from 30% to 50% of adjusted taxable income (effectively EBITDA) for tax years beginning in 2019 and 2020. For these tax years, taxpayers subject to the interest expense limitation (generally, taxpayers with average annual gross receipts for the prior three tax years in excess of $25 million, inflation adjusted) may elect to deduct business interest expense of up to 50% of their adjustable taxable income. In the case of a partnership, the election must be made at the partnership level.
- The increased limitation applies to partnerships only for tax years beginning in 2020. Partners that were allocated excess business interest in a tax year beginning in 2019 however, will be able to deduct without limitation 50% of that excess business interest in the partner's first tax year beginning in 2020, with the remainder subject to the usual limitations for carried over excess business interest.

For tax years beginning in 2020, taxpayers may elect to use their 2019 adjusted taxable income to determine the limitation amount. This election could benefit taxpayers whose 2020 adjusted taxable income is lower than in 2019. For partnerships, the election must be made by the partnership.

Significantly, if the additional deduction yields negative tax consequences for another tax provision, for example, because of an increased BEAT liability (see discussion below), a taxpayer may elect out of the increased section 163(j) limitation.

CARES Act Interaction with International Tax Provisions

Increased interest deductions and NOL carrybacks and carryforwards may affect a multinational taxpayer's (1) base erosion anti-abuse tax (BEAT) liability, (2) section 965 transition tax installment obligations, (3) allowable foreign tax credits (FTCs), and (4) section 250 deduction for both foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI), among other consequences.

(1) BEAT

BEAT, added by the TCJA, is essentially a minimum tax on multinational corporations calculated by (1) increasing taxable income (modified taxable income) by backing out certain deductions

from payments to related foreign persons (*i.e.*, base erosion tax benefits or BEAT addbacks), and (2) multiplying that amount by a 10% tax rate (5% for tax years beginning in 2018). The BEAT liability, if any, is equal to the excess of this amount over the regular tax liability. BEAT applies only to corporations (other than RICs, REITs, and S corporations) with average annual gross receipts for the prior three years of at least $500 million and a base erosion percentage (discussed below) of at least 3% (2% for banks and securities dealers).

Decreases in taxable income resulting from the current market turmoil, coupled with increased interest deductions and NOL carrybacks under the CARES Act, may result in an increased BEAT liability in certain circumstances. This may come as an unwelcome surprise to multinational corporations.

For example, a taxpayer that takes advantage of the increased 50% business interest expense deduction limitation in 2020 may get the benefit of a decrease in its 2020 regular tax liability generally equal to 21% of the additional interest expense deductions (*i.e.*, the 21% corporate tax rate multiplied by the amount of the additional deductions). On the other hand, the taxpayer's BEAT liability may increase as a result of the reduction in regular tax liability at a rate of up to 10% for each dollar of reduction in regular taxable income. Accordingly, the benefit of the additional interest deductions might be almost cut in half, from 21% to 11%, after taking into account the increased BEAT liability.

Further, if the taxpayer takes advantage of the 5-year NOL carryback provision by carrying back an NOL from 2020 or 2019, it may increase its BEAT liability in prior years. This increase in BEAT liability may arise both from the reduction in regular tax liability in the prior year, as well as an increase in prior year BEAT addbacks as a result of base erosion tax benefits embedded in the carried back NOL. The following example illustrates how this could occur.

EXAMPLE: Increased BEAT Liability

Assume that in tax year 2020 a domestic corporate taxpayer has $100 of NOL carrybacks in 2020, and its ratio of base erosion tax benefits to all deductible payments in 2020 is 20% (*i.e.*, a base erosion percentage of 20%).

In tax year 2019, assume the taxpayer has taxable income of $100, with $100 of base erosion tax benefits. The U.S. regular tax liability in 2019 is $21 ($100 x 21%). The BEAT addback is $100. The BEAT tax is 10% of $200 or $20, which is still less than the regular tax liability of $21, so there is no BEAT liability.

But when the taxpayer carries back the 2020 NOL, taxable income is reduced to zero (assuming the NOL does not reduce taxable income in the 2015 through 2018 tax years). For the BEAT calculation of modified taxable income, the taxpayer adds back $100 in base erosion tax benefits accrued in 2019 plus the base erosion tax benefits embedded in the 2020 NOL, which is the 2020 base erosion percentage (20%) multiplied by $100 of NOLs applied to 2019, or $20. Its modified taxable income is therefore $120, reflecting both the existing 2019 BEAT addbacks and the BEAT addbacks embedded in the NOL, giving rise to a total BEAT liability of $12.

2019 Before NOL Carryback

Regular Taxable Income (a)	$100
Regular Tax Liability (21%)	**$21**
BEAT Addback (b)	$100
BEAT Modified Taxable Income (a+b)	$200
BEAT 10% of Modified Taxable Income	**$20**
NO BEAT (Regular Tax > BEAT)	

2020

NOL	($100)
Deductible Related Foreign Party Payments (x)	$20
Total Deductions (y)	$100
BEAT Base Erosion Percentage (x/y)	**20%**

NOL Carryback

2019 After NOL Carryback

Regular Taxable Income	$0
Regular Tax Liability (21% rate)	**$0**
BEAT Addback (2019)	$100
BEAT NOL Addback (2020)	$20
BEAT Modified Taxable Income	$120
BEAT Liability (10% rate)	**$12**

What are a taxpayer's options for minimizing BEAT when carrying back NOLs?

First, this issue is not a concern for pre-BEAT tax years (for calendar year taxpayers, 2017 and before). The benefit of soaking up NOLs in pre-BEAT tax years may exceed the BEAT offset in later years. Even for NOLs carried to BEAT tax years, there is still an overall reduction of tax liability (in the example above, almost half), just not as much of a reduction as would be available in pre-BEAT years. Note that a five-year NOL carryback from tax year 2018 might avoid BEAT liability altogether, as it would apply to 2013-2017 tax years for calendar year taxpayers. Finally, a taxpayer may elect to waive the carryback of NOLs for any specific year, carrying them forward instead. Accordingly, a taxpayer could carry back an NOL for 2018 while waiving the carryback for tax years 2019 and 2020, for example. Additionally, a taxpayer incurring an NOL in 2020 could take steps to restructure transactions with foreign affiliates in 2020 in order to reduce its base erosion percentage for 2020 and, accordingly, reduce the BEAT addbacks that would be embedded in any 2020 NOL. Taxpayers should weigh the costs and benefits from carrying back NOLs versus solely carrying them forward.

(2) Section 965 Transition Tax

The section 965 transition tax was imposed on the retained earnings of foreign corporations attributable to U.S. shareholders during the tax years 1987 through 2017. This tax essentially represents a repatriation of up to 31 years of accumulated foreign earnings in a single year—generally the 2018 taxable year—at a discounted rate. Taxpayers were allowed to pay the transition tax in eight annual installments, without interest, pursuant to section 965(h).

When considering whether to carry back NOLs to a period that includes the transition tax year, the taxpayer may elect to exclude the transition tax year from the carryback period. Although the CARES Act excludes application of the carried back NOL to the section 965 transition tax inclusion income, the application of the carried back NOL to other income in that transition tax year could be harmful to taxpayers that elected to pay the transition tax in installments. Those taxpayers should consider making the election to skip the transition tax year in applying the carryback. Otherwise, an NOL carryback to the transition tax year might not give rise to a cash refund, but instead would be applied to reduce the amount of any section 965(h) installment payments, pursuant to the IRS's interpretation of section 965(h). Accordingly, taxpayers should consider whether to make the election to exclude the transition tax year from the carryback period in order to ensure that NOLs are applied to tax years in which a reduction of tax liability can give rise to a current refund (rather than merely a reduction of future installment payment obligations). Alternatively, a taxpayer could decide not to carry back the NOL and instead carry it forward to future years.

(3) Foreign Tax Credits

An NOL carryback (foreign or domestic) decreases overall taxable income for the carryback year, which will reduce foreign tax credit (FTC) capacity in each separate FTC limitation category. The carryback may also have transition tax consequences, even if the taxpayer elects not to carry back the NOL to the transition tax year. In such case, while an NOL carryback to a pre-transition tax year would not directly impact the amount of a taxpayer's transition tax inclusion, the decreased income from applying the NOL to that carryback year could increase the taxpayer's foreign tax credit (FTC) carryover from that year. The carryover FTCs could be taken into account in each succeeding tax year, and a greater FTC carryover could be available in the section 965 transition tax year, thus reducing the taxpayer's transition tax liability.

Note, however, that excess FTCs in the GILTI category (*i.e.*, deemed paid foreign taxes arising from a GILTI inclusion) cannot be carried over to a later tax year. Accordingly, if GILTI is displaced by carryback or carryforward NOLs, GILTI deemed paid foreign taxes that are consequently unused in the year that they arise cannot be applied as credits in a future tax year. If such potentially lost foreign tax credits are substantial, taxpayers should consider deducting rather than crediting foreign taxes for the year. Electing to deduct rather than credit foreign taxes for the year provides for a deduction of foreign taxes directly incurred by the domestic corporation and, with respect to a GILTI inclusion, eliminates the gross-up for deemed paid foreign taxes, limiting the overall inclusion to the after-tax GILTI amount (effectively providing a deduction for foreign taxes paid by the CFC on its GILTI). Further, while GILTI gives rise to potentially creditable foreign taxes equal to only 80% of actual foreign taxes paid on such GILTI, 100% of such taxes are effectively deductible if the taxpayer elects not to credit foreign taxes. Note, however, that the election to deduct rather than credit foreign taxes for the tax year will apply to all foreign taxes, including non-GILTI foreign taxes, such as foreign taxes imposed on foreign branch income and subpart F income.

Further, taxpayers should consider whether pre-TCJA FTCs may be fully utilized in TCJA tax years, given that new FTC categories were added under the TCJA. Income that under prior law might have been categorized as general limitation category income may be placed under a different category (such as the branch income category or section 951A category) under TCJA law.

(4) Section 250 Deduction (GILTI and FDII)

Global intangible low-taxed income (GILTI) is a new category of controlled foreign corporation (CFC) income added by the TCJA as part of an effort to prevent U.S. taxpayers from migrating intangible property, and the income it produces, to offshore tax havens. Although broader in its application, the tax is designed to reach a CFC's earnings from intangible, highly mobile assets, such as patents, trademarks, and copyrights, by taxing the CFC's U.S. shareholders on earnings that exceed a 10% return on the tax basis of the CFC's depreciable tangible property.

To offset the impact of the tax on domestic corporations, section 250 provides U.S. corporate shareholders a deduction generally equal to 50% of their GILTI inclusion, making the effective tax rate on GILTI 10.5% instead of 21%.[3] To level the playing field and neutralize the incentives for companies to send technology offshore, Congress provided a new deduction for U.S. corporations, allowing them to deduct 37.5% of their foreign derived intangible income (FDII) which, like GILTI, is computed by reference to certain foreign income of a corporation that exceeds a 10% return on the tax basis of the domestic corporation's depreciable tangible property.

Significantly, the income with respect to which the section 250 deduction applies may not exceed the total taxable income of the U.S. corporate shareholder for that year. Accordingly, when a domestic corporation uses an NOL carryforward or carryback to offset taxable income, it can result in a reduction in the section 250 deduction to the extent that taxable income is reduced below the aggregate GILTI and FDII amounts for that year.[4] In such case, the NOL ends up displacing income subject to the effective lower rate applicable to GILTI and FDII (*i.e.*, the NOL effectively soaks up income that otherwise would be taxed at a maximum tax rate of 13.125% and 10.5% respectively). Further, if the GILTI income brings with it deemed paid foreign taxes that are otherwise creditable, the effective rate of such GILTI income being displaced with carried back NOLs may be even lower (and, as discussed above, the FTCs on GILTI cannot be carried over to a future tax year). However, if taxable income prior to application of the NOL exceeds the available section 250 deductions, the NOL will effectively operate to offset that excess income, taxed at 21%, prior to limiting the section 250 deductions.

Depending on the circumstances, it might make sense to carry the NOL forward instead of back, if in future years more U.S. income is expected, which will be taxed at 21%. Alternatively, now may be the time to look forward and undertake taxable transactions in the current tax year, the taxable income of which can be offset by current losses. These transactions could provide a future benefit in the form of additional depreciation deductions over the succeeding years, offsetting future taxable income, or reduced U.S. taxation in the case of outbound asset transfers.

EXAMPLE: Decreased Utilization of Section 250 Deductions

Assume a domestic corporation has $100 of GILTI, $100 of FDII, and $100 of other income in 2019. Its total taxable income is, therefore, $300. Because it has taxable income of $300, it can take full section 250 deductions with respect to the $200 of GILTI and FDII income.

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[3] Individuals are not entitled to the section 250 deduction unless they elect to be taxed as a corporation under section 962. See our discussion: Not GILTI – The Multiple Personality Defense.

[4] The section 245A deduction available to domestic corporations, generally equal to 100 percent of the foreign-source portion of dividends from specified foreign corporations, does not have a taxable income limitation and should not present the same issues discussed herein with respect to the section 250 deduction.

Assume, however, that the corporation has an NOL in 2020 that it elects to carry back. After that NOL is applied to earlier years, $200 remains to apply in 2019. The application of that NOL reduces 2019 taxable income to $100.

Accordingly, the available section 250 deductions are limited and computed solely with respect to $100 of remaining GILTI and FDII income, prorated between GILTI and FDII. Effectively, the section 250 deductions are cut in half because they are computed with respect to only $50 of GILTI and $50 of FDII rather than $100 of each such category of income. The forgone section 250 deductions are permanently lost. As can be seen in the computations below, the section 250 deductions are reduced from $87.50 to $43.75. Although total tax for the 2019 tax year was reduced from $44.63 to $11.81, the forgone section 250 deductions have a potential value of $9.19 (*i.e.*, $43.75 x 21%), which could have been realized had the NOL been carried forward and applied to a tax year in which overall taxable income exceeds aggregate GILTI and FDII by at least the amount of the NOL.

2019 Before NOL Carryback

GILTI Income	$100
FDII Income	$100
Other Income	$100
GILTI § 250 DRD (=50%)	($50)
FDII § 250 DRD (=37.5%)	($37.50)
Net Taxable Income	**$212.50**
Total Tax @ 21%	$44.63

2019 After NOL Carryback

2020 NOL	($200)
Taxable Income after NOL	$100
GILTI § 250 DRD (=50% of $50)	($25)
FDII § 250 DRD (=37.5% of $50)	($18.75)
Net Taxable Income	**$56.25**
Total Tax @ 21%	$11.81

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