LOEB & LOEB LLP

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# The CARES Act and M&A Transactions: Net Operating Losses

The recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act includes several provisions that are intended to create much-needed cash flow in the form of tax refunds. (Read our alert on the tax-related provisions of the CARES Act here.) In particular, temporary changes in the CARES Act pertaining to the net operating loss (NOL) rules will have potential impact on merger and acquisition (M&A) transactions. These changes provide an opportunity for both buyers and sellers in stock acquisitions completed in recent years to work together to take advantage of the potential benefits. In a nutshell, the strategy involves carrying back post-closing NOLs of the target company generated in 2018, 2019 and 2020 to offset taxable income in any of its five preceding tax years, starting with the earliest. This offset would lead to a cash refund of taxes previously paid with respect to this income. IRS has accelerated the process for obtaining a portion of these refunds.

## Here's how this could work for buyers and sellers.

Prior to 2018, the federal income tax rules allowed NOLs to be carried back two years. The rules were changed in 2017 to eliminate any carryback of NOLs generated after 2017. The CARES Act suspended the application of this carryback denial until 2021. As a result, losses generated in 2018, 2019 and 2020 now can be carried back for up to five years. In the context of M&A transactions, the suspension may allow NOLs generated after closing by the target company to be carried back to its preclosing years. A buyer may waive the right to carry back post-closing NOLs of the target company and elect to carry these losses into the future indefinitely. The target company would have to generate taxable income in future years to be able to utilize the carryforward, however. Because these NOLs can offset only 80% of the taxable income in future years, the company must generate greater income to fully utilize the NOLs. Even if the target company eventually will generate sufficient income to utilize the NOLs, it will take longer to receive the benefit of the NOLs carrying them forward. Finally, beginning in 2018, the federal corporate income tax rate was reduced from a top rate of 35% to 21%. Carrying back post-closing NOLs could significantly benefit the target company and the buyer by eliminating the 80% limitation, offsetting higher tax income and resulting in a faster refund.

In many M&A transactions, the buyer likely will not be able to do this alone. Most stock purchase agreements prevent the buyer from amending the target company's preclosing-period tax returns (including filing preclosing-period tax refund claims) without the seller's consent. Given the benefits of the NOL carryback, both parties should be incentivized to come together and work out a deal that allows the carryback of the NOLs for a higher refund.

Another opportunity may exist where the target company generated preclosing-period NOLs in 2018 through 2020 and the stock purchase agreement requires the buyer to pay the seller for using these NOLs in the post-closing period. Although this situation is less common, both parties could benefit from agreeing to carry back the NOLs.

In any case, the carryback of NOLs should be carefully analyzed to confirm that it does not otherwise negatively impact a client's overall tax position. This is particularly true for buyers with international operations and target companies that are part of an affiliated group of corporations filing a consolidated federal income tax return.

For information on the business impacts of COVID-19, please visit our COVID-19 Resource Center, which we continue to update as the situation evolves. If you have questions about COVID-19's impact on your business, please reach out to your Loeb relationship partner or email us directly at COVID19@loeb.com.

## Related Professionals

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