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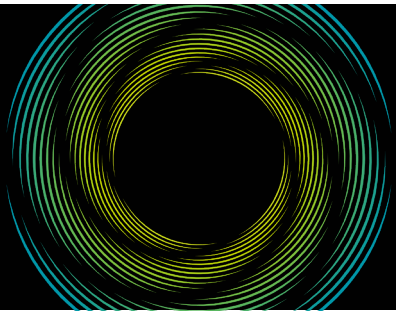

Tax sharing agreements help address tax refunds for consolidated groups

CARES Act expands possible opportunities to utilize losses and generate income tax refunds

Recent developments have highlighted the importance for consolidated groups to have a tax sharing agreement (TSA) in place that clearly and explicitly addresses the question of which member of the group is entitled to a refund of previously paid income taxes. One such development is the enactment of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), P.L. 116-136, which includes significant amendments to the net operating loss (NOL) rules, as amended by the 2017 Tax Act (P.L. 115-97, commonly known as the Tax Cuts and Jobs Act or TCJA). Pursuant to the amendments made by the CARES Act:

- A corporate taxpayer may carry back an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the loss.
- The 80 percent of taxable income limitation added to the NOL rules by the TCJA (the 80 percent limitation) has been temporarily repealed for taxable years beginning before January 1, 2021.
- A corporate taxpayer with a fiscal year-end that experienced an NOL in a taxable year beginning in 2017 and ending in 2018 may utilize the two-year carryback period of the former NOL rules, in effect prior to their amendment by the TCJA, with respect to such NOL. To obtain a tax refund, the corporate taxpayer must apply for a "tentative refund" with respect to the carryback of that NOL within 120 days after the enactment of the CARES Act.

Significantly, the temporary repeal of the 80 percent limitation, when coupled with the new five-year NOL carryback period, affords corporations the ability to **(i)** utilize NOLs in taxable years beginning as early as in 2013 (for an NOL experienced in a taxable year beginning in 2018), and **(ii)** offset taxable income in those prior years that had been subject to tax at a 35 percent rate. Overall, these changes are intended to allow corporations to utilize NOLs and amend prior year returns, which should provide additional cash flow and liquidity.

Another significant development is the recent US Supreme Court decision in *Rodriguez v. FDIC,*[1] which considered the question of entitlement to an income tax refund where a subsidiary member of a consolidated group experiences a loss that the group utilizes to generate the pertinent refund. The Court, in a unanimous decision, concluded that the resolution of this question is governed by state law, together with any applicable federal rules, and otherwise is not governed by "federal common law." Accordingly, consolidated groups are advised to have a well-crafted TSA in place that clearly and explicitly addresses which member of the group is entitled to an income tax refund, especially where different lenders have made loans to various members of the group and a particular member's assets may be looked to for purposes of satisfying one or more of those loans.

Pertinent consolidated return considerations

The consolidated return regulations generally provide that **(i)** the common parent of a consolidated group acts as the agent for the group with respect to all matters relating to the group's tax liabilities, and **(ii)** the members of a consolidated group are severally liable for the group's tax liabilities. Although these regulations generally direct that the common parent of the consolidated group is responsible for payment of the group's income taxes and is the recipient of any income tax refunds, they nevertheless do not address which group members are actually entitled to the refund.

Consolidated groups often enter into TSAs to explicitly acknowledge and agree upon the method(s) for determining which members are responsible for income taxes (and nonincome taxes) and are entitled to refunds of previously paid taxes. A TSA typically covers **(i)** the methodology for determining each member's share of the consolidated group's tax liabilities and **(ii)** whether and how to compensate a member where losses or other tax attributes of that member are used to offset income of another member of the group or the tax liability of the group. With respect to compensating a member for the use of its losses or other tax attributes, a TSA usually includes provisions addressing entitlement to an income tax refund resulting from that utilization. However, in the absence of a TSA that specifies which member of a consolidated group is entitled to a refund of income taxes, the members often turn to the courts to resolve disputes.

Bob Richards rule

Prior to the US Supreme Court decision in *Rodriguez*, the leading case was *Bob Richards Chrysler-Plymouth Corp.*[2] In *Bob Richards*, a subsidiary experienced a loss that the consolidated group utilized to generate an income tax refund that was received by the group's common parent when the subsidiary was in bankruptcy. Both the common parent and the bankruptcy trustee for the subsidiary claimed the refund, as the consolidated group did not have a TSA in place specifying which entity was entitled to the refund.

The US Court of Appeals for the Ninth Circuit held that the subsidiary was entitled to the income tax refund, reasoning that allowing the common parent to keep the refund amounted to unjust enrichment of the common parent. The court further reasoned that, in the absence of a TSA, an income tax refund belongs to the consolidated group member that experienced the loss that gives rise to the refund. This conclusion is referred to as the "*Bob Richards* rule."

The *Bob Richards* rule evolved over time and, in certain jurisdictions, was treated as "federal common law." Further, in some jurisdictions, the *Bob Richards* rule was applied in support of the conclusion that, even where a TSA existed and could be read to direct the allocation of an income tax refund to a particular member of the consolidated group, the member that experienced the loss nevertheless was entitled to the refund in the absence of clear and unambiguous language in the TSA.

Rodriguez v. FDIC

The facts in *Rodriguez v. FDIC* are similar to those in *Bob Richards*. Specifically, in Rodriguez, **(i)** a subsidiary experienced a loss that the consolidated group utilized to generate an income tax refund, **(ii)** both the subsidiary that experienced the loss and the common parent of the consolidated group were in bankruptcy when the income tax refund was received by the common parent, and **(iii)** both corporations claimed to be entitled to the refund even though there was a TSA in place. The US Court of Appeals for the Tenth Circuit concluded that the TSA was ambiguous and applied an expansive view of the *Bob Richards* rule in holding that the subsidiary was entitled to the income tax refund.[3]

On appeal, the US Supreme Court considered the validity of the *Bob Richards* rule and unanimously concluded that there is no unique federal interest in determining which member of a consolidated group is entitled to an income tax refund. Instead, that question must be resolved under state law, taking into account any applicable federal rules. In reaching this conclusion, the Court intimated that the right to a refund of income taxes constitutes a property right, entitlement to which historically has been governed by state law. Accordingly, the Supreme Court vacated the judgment of the Tenth Circuit and remanded the case for further proceedings.

Key takeaways

Many corporations expect to incur significant losses during 2020 due to the COVID-19 pandemic and other surrounding circumstances. In response, the CARES Act has expanded the possible opportunities for consolidated groups to utilize these losses and generate income tax refunds, subject to the resolution of various considerations. In view of this possibility, the *Rodriguez* case reinforces the need for a consolidated group to have a clear, unambiguous TSA in place to facilitate the allocation of these income tax refunds to the appropriate member(s) of the consolidated group.

Want to learn more?
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Endnote

1. *Rodriguez v. FDIC*, 140 S. Ct. 713 (2020).
2. *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262 (9th Cir. 1973).
3. *In re United Western Bancorp, Inc.*, 914 F.3d 1262 (10th Cir. 2019).