MENKE & ASSOCIATES, INC.
ESOP ADVISORS AND INVESTMENT BANKERS

MEMORANDUM

To: Menke Clients
From: Menke Legal Department
Date: April 23, 2020
Re: Strategies for Both C Corps and S Corps to Minimize Taxes and Maximize Cash Preservation During the COVID-19 Crisis
Re: Extension of Certain IRS Filing Deadlines

Strategies to Minimize Taxes and Maximize Cash Preservation

Prior to the 2017 Tax Cuts and Jobs Act ("TCJA"), C corporations that generated a net operating loss ("NOL") could carry that loss back to the preceding two years and could carry forward any excess to the next 20 years.

TCJA changed the NOL carryback and carryforward rules for years after 2017 in two respects. First, TCJA eliminated the ability to carry back NOLs to prior taxable years. Second, for years after 2017, TCJA provided that NOLs could only offset up to 80% of taxable income in carryover years.

The CARES Act, however, provides a temporary suspension of the TCJA rules. Under the CARES Act, C corporations now have the following options:

- NOLs generated in taxable years beginning after December 31, 2017 - i.e., taxable years beginning in 2018, 2019, and 2020 - may now be carried back for up to five years, and such carrybacks may be used to offset up to 100% of prior taxable income.
- NOLs generated in taxable years beginning in 2018, 2019, and 2020 may also be carried forward indefinitely. Such carryforwards can be used to offset up to 100% of taxable income in 2019 and 2020, but they can only offset up to 80% of taxable income after 2020.

- NOLs generated after 2020 will again be governed by TCJA, i.e., such NOLs cannot be carried back, and any carryforwards can only offset up to 80% of taxable income in carryforward years.

Taxpayers who are eligible for the temporary suspension of the TCJA rules should take note of the following tax principles:

- NOL carrybacks are automatic. The taxpayer does not need to elect the carryback of an NOL to a prior year.
- Taxpayers, however, can elect to “waive” the carryback of an NOL if the taxpayer believes that using an NOL as a carryforward will be more beneficial than using an NOL as a carryback.
- NOLs are first carried back to the earliest tax year of the five-year carryback period, and then to the next succeeding tax year. For example, an NOL generated in 2020 will first be carried back to the 2015 tax year.
- The federal tax rate for C corporations prior to 2018 was 35%. Accordingly, any NOLs that can be carried back to years prior to 2018 will generate much larger savings than will NOLs that are carried forward against the current 21% C corporation tax rate.

Given these tax principles, the following describes several tax strategies that can be used by C corporations and by S corporations, as appropriate, to minimize taxes and maximize cash conservation for 2019 and 2020.

For Both C Corps and S Corps: **Contribute Newly-Issued Shares of Company Stock to Your ESOP for 2019 Instead of Making a Cash Contribution**

Most companies have not yet filed their corporate tax return for 2019 and have not yet made their retroactive contribution to their ESOP for 2019. Under these circumstances, one strategy companies might consider is to make their 2019 contribution to their ESOP in the form of newly-issued shares of company stock rather than in cash. The company will obtain the same tax-deduction for this contribution as for a cash contribution, but this contribution will not involve any cash outlay and thus will help to conserve cash. It will, however, result in some dilution of the percentage of ownership owned by existing shareholders.

***For Both C Corps and S Corps:* Contribute Newly-Issued Shares of Company Stock to Your ESOP for 2019 in a Much Larger Amount than Planned**

Most companies had a very profitable year in 2019 and probably cannot generate a 2019 NOL that can be carried back to secure a tax refund. However, most companies have made estimated tax payments based upon paying at least 80% of their projected 2019 tax liability. Accordingly, any steps you can take to reduce your 2019 tax liability can help you secure a refund of excess estimated tax payments. One way you can still reduce your 2019 pre-tax profits is to make a retroactive contribution of newly-issued shares of company stock to your ESOP in an amount that is over and above the amount you previously estimated, thus reducing your taxable income by that amount.

A collateral consequence of using this strategy is that it is also one way of reducing your 2019 repurchase obligation, even if you are not able to utilize an interim valuation date. For example, if you make a retroactive contribution of 100,000 shares of company stock and there are 1,000,000 shares currently outstanding, the per share value of your company stock as of 12/31/2019 will be reduced by 10%. Note, however, that newly-issued shares will need to appraised as of the actual date of contribution, not as of the prior year end date. In addition, it should be noted that the approach of issuing newly-issued stock in amounts over and above planned cash contributions will result both in a reduction of ownership equity and a reduction of voting control held by existing shareholders.

***For C Corps:* Accelerate the Loan Forgiveness of the Internal Loan Between Your ESOP and Your Company**

If you are a C corporation and your ESOP is leveraged and there is an internal loan between your ESOP and your company in which the annual loan “forgiveness” contribution is less than the maximum of 25% of eligible payroll, you can accelerate the loan forgiveness amount up to the maximum of 25% of eligible payroll in order to create a larger non-cash tax deduction, which will reduce your taxable income and enable you to secure a larger refund of excess estimated tax payments. (Please note, however, that the term “loan forgiveness” is a shorthand way of describing the process of contributing cash to your ESOP and then simultaneously using this cash to make a payment on the internal company loan.

The IRS requires a simultaneous exchange of cash; it does not accept a cashless loan forgiveness as being a valid ESOP contribution.)

I**n addition**, you should note that under Section 404(a)(3) of the IRC, if you also contribute newly-issued shares of company stock to your ESOP over and above the amount of your loan forgiveness contribution, you may also deduct the value of this contribution in an amount up to an additional 25% of eligible payroll. (Note, however, that any matching contributions or discretionary contributions to your 401(k) plan, if any, will count against the additional 25% limit.) **Thus, by combining a loan forgiveness contribution with a contribution of newly-issued shares of company stock, you can obtain a total deduction of up to 50% of eligible payroll, and the entire amount of this deduction will be a non-cash expense.** As mentioned above, however, contributions of newly-issued stock will result both in a reduction of ownership equity and a reduction of voting control held by existing shareholders.

For C Corps and S Corps: **Contribute Newly-Issued Shares of Company Stock to Your ESOP for 2020 Instead of Making a Cash Contribution and/or Accelerate the Loan Forgiveness of the Internal Loan Between Your ESOP and Your Company**

Although it is too early to tell, some of our clients anticipate having a break-even or a loss year in 2020 despite being very profitable in 2019. Under these circumstances, one strategy to minimize taxes might be to contribute newly-issued shares of company stock to your ESOP for 2020 and/or accelerate the loan forgiveness of the internal loan between your ESOP and your company so as to create larger tax deductions, resulting in a 2020 NOL (or in an increase in the amount of your 2020 NOL). This NOL can then be carried back to 2015 and used to generate a tax refund of taxes previously paid at the 35% tax rate. Note that this refund will not be received until 2021. In the meantime, however, your company can also use this approach to reduce its 2020 estimated tax payments if the company would otherwise be profitable in 2020.

Corporate Procedures for Claiming a Tax Refund

- **2019 NOL.** File your 2019 tax return and concurrently, or within 12 months of the end of the 2019 tax year, file Form 1139 by mail or by fax to make a claim for a tentative refund. You should receive your refund within 90 days, but it is tentative and subject to IRS review and possible review by the Joint Committee on Internal Revenue Taxation.
- **2020 NOL.** Follow the same approach as for 2019. In addition, if you wish to receive a refund of 2020 estimated taxes, you should file Form 4466 by mail after year end and prior to filing your 2020 tax return. You should receive this refund in the first quarter of 2021.
- **Faxing of Form 1139.** Since the IRS is not currently processing incoming mail, the IRS will temporarily accept the submission of Form 1139 via fax at (844) 249-6236.
- **State NOL Procedures.** Some states automatically incorporate federal tax law changes by reference. Others, such as California, do not. As of this date, California has not passed legislation adopting the CARES Act provisions. Under current California law, NOLs cannot be carried back for taxable years beginning after December 31, 2018.

Extension of Certain IRS Filing Deadlines

IRS Notice 2020-23 automatically extends until **July 15, 2020** the deadline for taking the following actions that would otherwise have a deadline falling on or after April 1, 2020 through July 14, 2020 (the "Delay Period"):

- **Form 5500**. ESOPs and other qualified plans with plan years ending on or after June 30, 2019, through November 30, 2019, now have until July 15, 2020, to file their Form 5500.
- **Purchase of QRP**. If a company owner has sold company stock to their ESOP and has elected tax-deferral under Sec. 1042, qualified replacement property ("QRP") must be purchased within 12 months of the date of sale. If this 12-month period falls within the Delay Period, the extended deadline for purchasing QRP is now July 15, 2020.
- **ESOP Put Options**. If distributions have been made from your ESOP in shares of company stock, participants must be given a "put" option to sell these shares back to the ESOP or to the company within 60 days. If

the end of this 60-day period falls within the Delay Period, the 60-day period is automatically extended to July 15, 2020.

- **Sixty-Day Indirect Rollover Period.** If a participant receives an eligible rollover distribution from your ESOP as an indirect rollover, such participant has 60 days from the date of distribution to roll over such distribution tax-free into another qualified plan or IRA. If the end of this 60-day period falls within the Delay Period, the 60-day period is automatically extended to July 15, 2020.
- **Refunding Excess Deferrals**. If you have a 401(k) plan, ERISA limits elective deferrals for 2019 to $19,000 (plus an additional $6,000 for participants who are age 50 or older) and limits total "annual additions" from 401(k) allocations and ESOP allocations to $56,000. To the extent either of these limits is exceeded, elective deferrals must be refunded to participants by April 15, 2020. This deadline has now been extended to July 15, 2020.

Conclusion

Menke & Associates, Inc. is not in the business of rendering tax advice. However, we do want to call to your attention the above described strategies and tax filing deadlines that may or may not be beneficial in your circumstances. If any of these strategies or filing extensions do appear to have merit, we suggest that you discuss them with your outside CPA firm and/or other tax advisors.