FEATURE

CARES ACT

PROVIDES TAX BENEFITS AND INCENTIVES TO BOTH BUSINESSES AND INDIVIDUALS TO EASE THE ECONOMIC IMPACT OF COVID-19

By Tim Thomasson, Don Carpenter, Jennie Beyer, Sarah Cornish and Katherine Gunter

In just a matter of weeks, U.S economic performance turned from a historic period of expansion to one of the sharpest declines since the Great Depression. But as Americans were becoming familiar with terms like "shelter-in-place" and "essential business services," the U.S. Congress moved at record speed to pass the Coronavirus Aid, Relief, and Economic Security (CARES) Act that President Trump signed into law on March 27, 2020.

This $2 trillion relief package contains an array of provisions such as small business loans and enhanced unemployment assistance. But the focus of this article is the tax provisions within the Act that provide financial assistance focused on liquidity to both businesses and individuals.

Corporations See 2017 Tax Changes Temporarily Altered

The Tax Cuts and Jobs Act of 2017 (TCJA) introduced sweeping changes to the corporate tax system. In exchange for a lower corporate tax rate, significant limitations were placed on the ability of corporations to utilize net operating losses (NOLs) and interest expense. And while the TCJA repealed the alternative minimum tax for corporations, any existing minimum tax credit carryforward was refundable over a four-year period from 2018 through 2021.

The CARES Act temporarily alters these limitations on NOLs and interest expense, and accelerates the recovery of any minimum tax credit carryforward. The provisions should provide additional liquidity to corporations that are struggling to retain employees, pay creditors and protect investors.

Additional Opportunities to Utilize NOLs

The TCJA eliminated any carryback of NOLs in exchange for allowing an indefinite carryforward period. In addition, under the carryforward provisions, the NOL could only offset 80% of taxable income in any future year. The CARES Act provides two opportunities for corporations (and other taxpayers) to utilize a NOL.

First, NOLs for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2021 (2018 – 2020 for calendar year corporations) can now be carried back five years. The indefinite carryforward period remains unchanged. This carryback period is considerably more generous than even the pre-TCJA two-year carryback provision. Although not widely applicable, the CARES Act prohibits NOL carryback to any tax year when the taxpayer was a real estate investment trust (REIT) and any losses from tax years when the taxpayer is a REIT are not eligible for carrybacks.

The carryback provision offers two obvious advantages:

1.) Acceleration of the tax refund for utilization of tax losses arising in 2018 through 2020.
2.) Increase in the amount of refund as the carryback will offset income taxed at prior corporate rates of 35% rather than future rates of 21%. This second advantage will likely have a financial statement benefit, as well.

Less obvious may be the implications of a carryback on the prior years' returns. For example, elimination or reduction of an earlier year's taxable income could reduce foreign tax credits that may otherwise expire or alter other tax benefits like the domestic production activities deduction.

Consideration should also be given to the limitations placed on carrybacks from merger and acquisition transactions. For these reasons, for each loss year, taxpayers are allowed to make an irrevocable election to forego the carryback and continue carrying forward the NOL indefinitely.

Special rules will apply to REITs, insurance companies and carrybacks to taxable years with Sec. 965 income inclusions from foreign subsidiaries.

The second additional opportunity to utilize a NOL under the CARES Act is a suspension of the 80% of taxable income limitation for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2021. This will allow corporations with enough NOLs to offset 100% of taxable income during this period. The 80% of taxable income limitation will continue to apply for post-2020 tax losses.

With regards to NOLs, the CARES Act introduced two technical amendments to the TCJA that will answer certain open questions of corporations and their tax advisors.

1. Pre-2018 NOLs were not subject to the 80% taxable income limitation under the TCJA. Uncertainty existed as to how to apply the 80% taxable income limitation in a year in which both pre-2018 and post-2017 NOLs are utilized. The CARES Act resolves this uncertainty by verifying the 80% taxable income limitation must be calculated after such income is reduced using pre-2018 NOLs.
2. For purposes of calculating the 80% limitation, the taxable income base will not consider the Sec. 199A qualified business income (QBI) deduction and the Sec. 250 FDII and GILTI deductions.

Both items above will be more relevant when the 80% limitation is reinstated for post-2020 years.

Interest Expense Limitations

Under the TCJA, the deductibility of interest expense is generally limited to 30 percent of adjusted taxable income (ATI) for a tax year. Adjusted taxable income is roughly equivalent to earnings before interest, taxes and (for taxable years beginning before Jan. 1, 2022) depreciation and amortization (EBITDA). The CARES Act provides relief to corporations (and certain other taxpayers) in deducting business interest expense in three ways.

First, the CARES Act temporarily increases the limitation to 50 percent of ATI for tax years 2019 and 2020. Second, when calculating the deductible interest expense for 2020, taxpayers may elect to use the 2019 tax year's ATI as the base since COVID-19 restrictions may reduce 2020 ATI dramatically. An election is permitted for taxpayers to forego the increased limitation.

Finally, the ability to use excess business interest expense from a partnership is enhanced. Although the 30% of ATI limitation for partnerships remains unchanged for 2019, it is increased to 50% of ATI in 2020. Additionally, 50% of excess business interest expense from a partnership in 2019 can be deducted in 2020 by the partner, without limitation. The remaining 50% of disallowed interest expense from a partnership remains subject to the limitations of TCJA.

For a taxpayer with a NOL in 2019 or 2020, the increased limitation may increase the NOL, allowing additional offset of higher taxed income in earlier years from the five-year carryback provisions discussed above.

Alternative Minimum Tax Credits

While the provisions impacting NOLs and interest expense are applicable to both corporate and non-corporate forms of business, one important aspect of the CARES Act specifically applies to corporations. The TCJA repealed the alternative minimum tax (AMT) for corporations for post-2017 tax years. In addition, any remaining AMT credits became refundable over the period from 2018 - 2021. The CARES Act accelerates the refund of these credits to either 2018 or 2019. The refund can be accelerated by claiming it in 2018 (via amended return or a tentative refund claim) or including it on the 2019 tax return.

In IRS Notice 2020-26, the IRS has extended the time for filing a Form 1139, Corporation Application for Tentative Refund, for the 2018 tax year until June 30, 2020. In addition, the IRS has indicated that refund of AMT credits can now be made using the Form 1139. In keeping with the current times, the IRS provided a toll-free fax number, recommending that all refund claims made on a Form 1139 related to these NOL carryback and AMT credit provisions be faxed versus paper filed.

Individual Taxpayers Are Not Overlooked

Individual taxpayers are provided several benefits under the CARES Act that are intended to provide liquidity, protect retirement savings and encourage philanthropy. The provisions include advanced refunds of a temporary tax credit, acceleration of excess business loss deductions, adjustments to the taxation of retirement distributions and a more generous limitation for charitable contributions.

Advanced Refunds Accelerate a Special 2020 Credit

Qualifying individual taxpayers will receive "recovery rebates" similar to the economic stimulus payments that followed the 2008 financial crisis. These rebates are immediate payments received by taxpayers as advanced refunds of a tax credit that will be granted on tax returns filed for 2020. The maximum amount of the tax credit is $1,200 for single filers and $2,400 for joint filers along with a $500 credit for each qualifying child.

The maximum tax credit is allowed for single filers with adjusted gross income (AGI) of not more than $75,000, head of household filers with AGI of not more than $112,500 and joint filers with AGI of not more than $150,000. The credit is reduced by $5 for every $100 of AGI that exceeds the above thresholds. Thus, the credit is entirely phased-out when the taxpayer's AGI is greater than $99,000 for individual taxpayers, $146,500 for heads of household and $198,000 for joint filers.

A $500 credit is also provided for each child under 17 years of age who is claimed as a dependent. To qualify, the child must have a Social Security number. The child tax credit is also subject to phase out based on the above schedule.

The amount of the advanced payment is based on a taxpayer's most recently filed tax return. With the extension of the 2019 due date to July 15, this may be the 2018 return in many cases. Because this is an advance of a 2020 credit, any correction of the payment amount will presumably be adjusted upon the filing of this year's tax return. For example, the advanced payment will not include any credit for children born or adopted since the filing of the last tax return. Also, AGI in 2018 or 2019 may be considerably different than 2020 AGI.

The recovery rebate credits are only allowed for qualifying individual taxpayers. Nonresident aliens, estates, trusts and individuals who are being claimed as dependents by another taxpayer are among those who do not qualify for this refund. The last category described (dependent taxpayers) will apply to college-age students claimed as dependents by their parents. However, no $500 child credit will be provided if the student is 17 years of age or older.

Limitations on Business Losses Are Removed

The TCJA limited post-2017 business losses for non-corporate taxpayers. Taxpayers were allowed a deduction of $250,000 for individuals and $500,000 for joint filers for any loss from an active trade or business to the extent that it exceeded the aggregate trade or business gross income from other business ventures of the taxpayer. The taxpayer could carryforward any NOL resulting from excess business losses indefinitely to offset 80% of future taxable income.

The CARES Act removes the limitation on business losses for tax years beginning prior to Jan. 1, 2021 (2018 – 2020 for calendar year taxpayers). This provision is extended to tax years beginning before Jan. 1, 2026 for any farm losses. An amended return may be necessary to adjust losses in 2018 or 2019 if returns were filed prior to enactment of the CARES Act. To the extent that business losses result in a NOL, that loss may be carried back to the five previous years and is not subject to the 80% limitation imposed by the TCJA, which is consistent with the corporate NOL provisions discussed earlier in this article.

The business loss provisions are effective for all losses occurring in the relevant years without respect to whether the losses were the result of the pandemic.

Retirement Distributions Provisions Are Liberalized

To provide financial assistance to eligible individuals, the CARES Act temporarily liberalized the restrictions placed on early withdrawals and loans from retirement plans such as 401(k) plans or individual retirement accounts.

Eligible individuals are defined as:

1) Someone who is diagnosed with SARS-CoV-2 virus or COVID-19 disease or whose spouse or dependent is so diagnosed.
2) Someone who experiences adverse financial consequences from being quarantined, furloughed, laid off. This includes individuals who have reduced work hours or are unable to work due to childcare.

For these individuals, the 10% early withdrawal penalty that applies to withdrawals from retirement plans prior to attaining 59 ½ years will not be assessed to the extent the withdrawal occurs in 2020 and does not exceed $100,000. Although not subject to the penalty, the withdrawal is still subject to income tax. The income tax can be avoided if the early withdrawal is repaid to the plan within three years. And to the extent an early withdrawal remains subject to income tax (is not repaid within three years), the resulting tax can be spread over three years.

Likewise, the CARES Act relaxes the restrictions on loans from retirement plans for eligible individuals. The Act doubled the amount a participant can borrow from a 401(k) plan to the lesser of $100,000 or the vested balance in the account. The loan must be made within 180 days of enactment of the CARES Act and must be repaid within five years to avoid income tax. Plan participants are also allowed to defer any payments on pre-existing loans that were due in 2020, although interest will continue to accrue.

It is important to note that these withdrawal and loan provisions are optional. Even plans that currently allow for hardship withdrawals or loans do not have to offer them.

The Act allows taxpayers to waive any minimum required distributions in 2020 from retirement plans. This would typically affect any plan participant who is at least 72 in 2020.

This provision applies to all plan participants and not just "eligible individuals" defined above. Participants have 60 days to return any distributions already received from a plan as a minimum required distribution if they so choose. Foregoing these distributions will allow the funds to remain in the plan and generate tax-deferred growth.

Charitable Contribution Limitations Adjusted to Encourage Giving

With the increase in the standard deduction as part of the TCJA, charitable donations have dropped. To encourage philanthropic response to the pandemic, the CARES Act has made temporary adjustments to the limitations affecting charitable contributions.

The Act allows individuals who do not itemize to deduct up to $300 of cash contributions to qualified organizations to arrive at adjusted gross income (above-the-line deduction). To be eligible, the contribution must be made in cash to a public charity or foundation. Contributions to supporting organizations or donor-advised funds do not qualify.

For those taxpayers who do itemize, charitable cash contributions are limited to 60% of adjusted gross income. The CARES Act removes this limitation, although the overall limit of 100% of adjusted gross income on total contributions (cash and in-kind) remains. To the extent contributions exceed adjusted gross income, the excess can be carried forward for five years.

The Act also increases the limit on charitable contributions for corporate taxpayers. The limitation has been increased to 25% of taxable income (before the charitable and other special deductions) from the previous limitation of 10% (15% for food inventory).

Increasing the income limitation for charitable contributions is not without precedent in times of natural disasters. To qualify for the increased limitation, taxpayers have historically been required to make contributions that directly benefit the relief effort. The CARES Act, however, has no such requirement. All cash contributions are included and not just those that benefit the relief effort for the COVID-19 virus.

Businesses Are Encouraged to Retain Employees Through Payroll Tax Incentives

As businesses have either been closed or experienced dramatic curtailment of trade, many are faced with the difficult decision of how to control costs. With payroll being a major cost category and employees being underutilized, furloughs or even terminations have become common as is evident by the swelling number of unemployment claims.

To reduce these impacts, the CARES Act included several major provisions affecting the payroll tax liability and payment obligations of businesses. These provisions apply regardless of whether the business is a corporation or individually owned.

Retention Credits

The Act provides retention credits to eligible employers (including nonprofit organizations) for 50% of "qualified" wages up to $10,000 per employee for wages paid between March 13 and Dec. 31, 2020.

An eligible employer must:

1) Have been carrying on a trade or business in 2020 and

2) During a payroll tax quarter within the year, either:

   a. Operations have been partially or fully suspended by government order as a result of COVID-19.

   b. Gross receipts for the calendar quarter are less than 50% of the gross receipts for the same calendar quarter in the previous year.

An employer remains eligible until gross receipts for a quarter equal at least 80% of gross receipts for the same quarter in the previous year.

The definition of qualified wages differs depending on whether the employer has more or less than 100 employees. For employers with more than 100 employees, only wages paid to employees who at the times the wages were earned are not providing services due to COVID-19 circumstances. For employers with less than 100 employees, all employee wages are qualified regardless of whether the employees are providing services. Determination of the number of employees is based on the 2019 calculation of full-time employees as required by IRC Sec. 4980H enacted as part of the Affordable Care Act.

Qualified wages are based on the definition of wages for FICA reporting purposes increased by any amounts paid by the employer for health plan costs. Any sick or child leave paid under the Families First Coronavirus Response Act (FFCRA) are specifically excluded from "qualified" wages for the retention credit since the employer is already receiving a dollar-for-dollar tax credit for these payments under that prior act.

Employers receiving Small Business Interruption Loans under Section 1102 of the CARES Act are not eligible to receive the payroll retention credits. In addition, the credit for wages paid to any employee during a period that an employer is allowed a Work Opportunity Credit with respect to that employee are not qualified.

Employers can claim the credit by reducing their federal tax deposit for wages paid to all employees, not just those employees for which the employer is claiming a retention credit. Specifically, the credit can offset the amount withheld from the employees' wages for federal income taxes, as well as both the employee and employer shares of Social Security and Medicare taxes. The credit will be reported as part of the reconciliation of the quarterly Form 941.

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