CARES Act – Tax Provisions for Businesses and Individuals

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On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law. The CARES Act was the third significant piece of legislation enacted during March 2020 in response to the COVID-19 pandemic; Congress has reportedly begun drafting a fourth legislative bill.

The CARES Act contains a number of provisions that modify federal tax rules for businesses including 1) allowing a 5-year carryback period for net operating losses (NOLs) for corporations and non-corporate taxpayers; 2) deferring the application of the excess business loss limitation rule of IRC Section 461(l) for non-corporate taxpayers; 3) modifying the business interest expense limitation calculation; 4) providing an immediate deduction for qualified improvement property (QIP) expenditures; 5) accelerating the time period in which minimum tax credits (MTC) are refunded; 6) deferring certain payroll tax payments; and 7) authorizing a new Employee Retention Tax Credit (ERTC). Each of these provisions generally is targeted at assisting businesses to address their cash flow requirements and incentivizing the continued employment of individuals.

The CARES Act also contains a number of provisions that modify federal tax rules for individuals including 1) direct cash payments structured as recovery rebates in the amount of up to $1,200 (individuals) and $2,400 (married filing jointly), plus $500 for each child under age 17, payable in the 2020 taxable year; 2) more generous charitable deduction provisions; 3) waiver of additional tax on up to $100,000 of early distributions from retirement plans for coronavirus-related distributions; and 4) waiver of the requirement to take the Required Minimum Distribution ("RMD") from certain retirement plans in 2020.

Note: not all states conform their state income tax laws to the federal income tax laws. Given the significant economic impact of the COVID-19 pandemic to each state, states will consider these federal tax law changes in the coming weeks to determine the extent to which modifications will be made for purposes of state taxable income for both current and prior years.

BUSINESS PROVISIONS

Modification of Business Loss Rules

1) Net Operating Losses (IRC Section 172)

For taxable years beginning after December 31, 2017, and before January 1, 2021, the CARES Act:

- Eliminates the 80% taxable income limitation on the use of NOLs that was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA); and
- Allows taxpayers to carryback NOLs to each of the five (5) taxable years preceding the year of the loss, beginning with the earliest taxable year in the carryback period.

For taxable years beginning after December 31, 2020, the 80% taxable income limitation is reinstated; however, taxable income for this purpose will be computed without taking any deductions allowed under IRC Section 199A (Qualified Business Income) or IRC Section 250 (FDII and GILTI).

The CARES Act also contains special NOL carryback rules applicable to REITs and life insurance companies. Moreover, taxpayers that carryback NOLs to a year in which they had an income inclusion under IRC Section 965 (i.e., the foreign repatriation tax provisions) are either required to modify their taxable income calculation for determining the amount of carryback NOLs utilized, or make an election to exclude a taxable year from the carryback period.

Observations

- U.S. federal income tax rates were lowered as part of the TCJA. Carrying back NOLs to pre-2018 tax periods can result in a higher tax refund for the same NOLs given the tax rate changes.
- M&A agreements need to be reviewed to determine which party is entitled to a tax refund attributable to an NOL carryback claim.

2) Excess Business Losses (IRC Section 461(l))

The CARES Act temporarily defers application of IRC Section 461(l) (enacted as part of TCJA), which limits a non-corporate taxpayer's (i.e., a pass-through entity, individual, trust or estate) excess business loss deductions, so that the limitation only applies to taxable years beginning after December 31, 2020. An "excess business loss" generally is equal to the excess of a taxpayer's aggregate trade or business-related deductions for a taxable year over its aggregate trade or business-related income for that year plus $250,000 (or $500,000 for a joint return), subject to adjustment for inflation. In addition to the temporary deferral, the CARES Act makes certain amendments relating to the computation of excess business loss for taxable years beginning after December 31, 2020, and before January 1, 2026, including specifying that items attributable to a trade or business of performing services as an employee and losses from the sale or exchange of capital

assets are not taken into account in determining the amount of excess business loss.

Observations

- 2018 and 2019 (if filed) tax returns should be reviewed to determine if a taxpayer had an excess business loss in either of these years and, if there was, consider filing an amended tax return (or take other steps) to claim a refund.

Business Interest Expense Limitation Modification (IRC Section 163(j))

The CARES Act increases a taxpayer's ability to deduct business interest expense under IRC Section 163(j), raising the 30% adjusted taxable income (ATI) threshold to 50% for taxable years beginning in 2019 and 2020. However, for partnerships, the 30% ATI threshold remains in effect for taxable years beginning in 2019 only. For those partnership tax years, 50% of any excess business interest expense allocated to a partner is allowed to be deducted by the partner without limitation in 2020, while the remaining 50% is subject to the general IRC Section 163(j) limitations. In addition, a taxpayer may elect to use its 2019 ATI for purposes of calculating the 50% threshold in 2020.

Observations

- For electing real property trades and businesses that depreciate their assets over longer recovery periods under the Alternative Depreciation System, the real property trades and businesses already are not subject to the interest expense limitation. Although such assets are generally not "qualifying property" eligible for bonus depreciation under IRC Section 168(k), the real property trade or business election was almost always advantageous for qualifying taxpayers due to a technical error in prior legislation which prohibited bonus depreciation on QIP. As discussed below, the CARES Act corrected the QIP depreciation error. Treasury then acknowledged this by issuing Revenue Procedure 2020-22 which provides guidance for withdrawing the real property trade or business election to enable taxpayers to claim bonus depreciation on QIP.
- The interest expense limitation and the election to avoid it are of particular importance in the real estate industry, especially for highly leveraged projects in the development stage. This would include projects financed in significant part by syndicated tax credits and other development incentives. Sponsors of such projects may now need to reexamine whether electing out of the business interest expense limitation is worthwhile in light of the temporary increase in interest deductibility and the resulting elimination of bonus depreciation.

QIP Expensing Correction

The CARES Act includes a technical correction to IRC Section 168(k) that makes QIP eligible for 100% bonus depreciation if placed in service before January 1, 2023. For QIP placed in service after December 31, 2022, the available bonus depreciation is reduced by 20% per year annually thereafter through 2026. QIP generally

includes any improvement to the interior portion of a building placed in service after the building was first placed in service but excludes enlargements, elevators, escalators, and improvements to the internal structural framework of the building. This correction is effective for assets placed in service after December 31, 2017.

Observations

- Given the immediate availability of a tax deduction for renovations or improvement projects, this correction is of significant importance to all taxpayers evaluating the overall cost of planned renovation projects.
- Consideration should be given to filing amended tax returns for prior tax years, given the retroactive effective date of this correction.

Refundable Minimum Tax Credits

The CARES Act allows a corporation to take its entire refundable minimum tax credits (MTCs) into account by the end of its taxable year beginning in 2019. The CARES Act also adds IRC Section 53(e)(5), which provides that a corporation may make an election to take its entire MTC refundable amount into account in its taxable year beginning in 2018.

Observation

- Taxpayers that have not been refunded MTCs for their taxable year beginning in 2019 should consider whether making the new election is helpful to their particular situation.

Payroll Tax Payment Deferrals

The Act defers payment of the employer share of Social Security taxes (i.e., 6.2%), both for employers and self-employed individuals, for payroll taxes attributable to the period beginning on March 27, 2020, through December 31, 2020. Fifty percent of the deferred amounts must be paid by December 31, 2021, and the balance must be paid by December 31, 2022. Taxpayers that have debt forgiven by a lender with respect to any amount borrowed under the new CARES Act Paycheck Protection Program are not eligible for this payroll tax deferral (a trade-off to be considered).

Employee Retention Tax Credit

In order to incentivize employers to keep employees on their payroll, the Act makes available a refundable payroll tax credit (i.e., the ERTC) to be used against an eligible employer's ("Eligible Employer") share of Social Security taxes. The ERTC is equal to 50% of "qualifying wages" paid from March 13, 2020, to December 31, 2020, up to a total of $10,000 per employee (i.e., a maximum credit of $5,000 per employee). For this purpose, "qualifying wages" generally includes both wages as well as certain qualified health plan expenses that are paid by businesses during a shutdown order or during a period of significant decline in gross

receipts. A period of significant decline in gross receipts generally begins with the first 2020 calendar quarter in which gross receipts are less than 50% of its gross receipts for the same calendar quarter in the prior year and ends with the calendar quarter immediately prior to the calendar quarter in which gross receipts exceed 80% of gross receipts of the same calendar quarter of the prior year. For employers with more than 100 full-time employees, the ERTC is available only for qualifying wages paid to employees who are not providing any services. Taxpayers that borrowed any amount under the new CARES Act Paycheck Protection Program are not eligible for this credit.

How do Eligible Employers Claim the Refundable Employee Retention Tax Credit

Since quarterly returns are not filed until after qualified wages are paid, some Eligible Employers may not have sufficient federal employment taxes set aside for deposit to the IRS to fund their qualified wages. Accordingly, the IRS has established a procedure for obtaining an advance of the ERTC. Generally, the IRS has provided a two-pronged approach for an Eligible Employer to claim the ERTC.

The Eligible Employer should first reduce its remaining federal employment tax deposits for wages paid in the same calendar quarter by the maximum allowable amount. If the anticipated credit for the qualified wages exceeds the remaining federal employment tax deposits for that quarter, the Eligible Employer can file Form 7200, Advance Payment of Employer Credits Due to COVID-19, to claim an advance refund for the full amount of the anticipated credit for which it did not have sufficient federal employment tax deposits.

If an Eligible Employer fully reduces its required deposits of federal employment taxes otherwise due on wages paid in the same calendar quarter to its employees in anticipation of receiving the credits, and it has not paid qualified wages in excess of this amount, it should not file Form 7200. If it files Form 7200, it will need to reconcile this advance credit and its deposits with the qualified wages on Form 941 (or other applicable federal employment tax return such as Form 944 or Form CT-1), and it may have an underpayment of federal employment taxes for the quarter.

Example: An Eligible Employer paid $20,000 in qualified wages, and is therefore entitled to a credit of $10,000, and is otherwise required to deposit $8,000 in federal employment taxes, including taxes withheld from all of its employees, on wage payments made during the same calendar quarter. The Eligible Employer has no paid sick or family leave credits under the FFCRA. The Eligible Employer can keep the entire $8,000 of taxes that the Eligible Employer was otherwise required to deposit without penalties as a portion of the credits it is otherwise entitled to claim on Form 941. The Eligible Employer may file a request for an advance credit for the remaining $2,000 by completing Form 7200.

Observations

- The calculation of the number of employees can be complex given the application of certain aggregation rules.

- The ERTC is structured similarly to the payroll credit for sick and family leave available under the Families First Coronavirus Response Act, although employers may not claim both credits on the same wages.
- Taxpayers should consider whether they achieve a greater benefit from the deferral of payroll taxes or the forgiveness of SBA loans under the Paycheck Protection Program.

INDIVIDUAL PROVISIONS

Recovery Rebate

The centerpiece of the CARES Act individual tax provisions is the recovery rebate for individuals. Eligible individuals are entitled to a refundable tax credit, the recovery rebate, in an amount up to $1,200 (individual) and $2,400 (married filing jointly). The recovery rebate increases by $500 for each qualifying child under the age of 17. Nonresident alien individuals are not eligible for a recovery rebate. The amount of the recovery rebate is reduced for higher-income taxpayers.

Charitable Contribution Provisions

1. Allowance of Partial Above the Line Deduction

The CARES Act permits individuals who did not itemize in 2020 to deduct up to $300 of cash charitable contributions on their 2020 federal income tax return. The deduction applies “above the line,” meaning that even though a taxpayer does not itemize their deductions, they will still be able to claim the deduction. The deduction, however, does not apply to donations to certain private foundations, supporting organizations, or donor advised funds.

2. Modifications to Charitable Contribution Limits

The CARES Act increases the deduction limitation for 2020 cash charitable contributions made by individuals who itemize their deductions. In general, these individual taxpayers may elect to deduct cash charitable contributions up to 100% of their adjusted gross income (without regard to any net operating loss carryback) remaining after factoring in other charitable contribution limitations. Any excess cash contributions that are not deducted in 2020 may be carried forward, subject to the 60% of adjusted gross income limitation, to the succeeding five years. This deduction, like the above the line deduction, does not apply to donations to certain private foundations, supporting organizations, or donor advised funds.

Observations

- Taxpayers looking to make a significant cash contribution to charities in 2020 and beyond should consider these rules and whether they have the ability to accelerate charitable contributions.

Retirement Plan Provisions

1) Temporary Rule for Early Retirement Plan Distributions

The CARES Act provides that any coronavirus-related distribution up to $100,000 on or after January 1, 2020, and before December 31, 2020, is not subject to the 10% additional tax under IRC Section 72(t). A coronavirus-related distribution is any distribution from a qualified retirement plan to an individual 1) who has been diagnosed with the virus; 2) whose spouse or dependent has been diagnosed with the virus; or 3) who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, or having work hours reduced due to the virus, or unable to work due to lack of child care because of the virus, or other factors determined by the Secretary of the Treasury.

Any individual who receives a coronavirus-related distribution may contribute it back to a qualified retirement plan, of which such individual is a beneficiary, at any time during the three-year period after the date such distribution is received. The distribution repaid will not be taxable or subject to the 10% additional tax. The CARES Act also provides that any coronavirus-related distribution is taxable ratably over a three-year period beginning with the 2020 tax year unless the taxpayer elects not to have the three-year spread apply.

2) Waiver of RMD

For the 2020 year, the CARES act waives the requirement for individuals to take RMDs from a defined contribution plan or an individual retirement plan. This includes distributions that would have been required to be taken by April 1, 2020, for taxpayers who turned 70 ½ in 2019.

Student Loan Repayment (IRC Section 127)

The CARES Act expands the existing exclusion for up to $5,250 of employer educational assistance, which currently applies to expenses such as tuition, fees, and books, to include employer repayments of student loans. Employees may exclude employer student loan repayments made between the date of enactment and December 31, 2020, but they are prohibited from deducting any employer-paid student loan interest expense excluded under this provision.

How HCVT Can Help

The CARES Act will provide relief to businesses and individuals, but it is complex. As always, please contact your HCVT tax professional with any questions you may have. Additional information about the CARES Act can be found in HCVT Tax Alerts and COVID-19 Resources.