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Tax Provisions in the CARES Act

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On March 27, 2020 President Trump signed the Coronavirus Aid, Relief, and Economic Security Act (HR 748) ("CARES Act") shortly after the bill cleared the House. The Senate had passed the measure the day before.

The CARES Act is the third phase of Congress's response to the coronavirus (COVID-19) emergency. The most significant business and individual tax provisions of the CARES Act are summarized below.

Previous Action

Phase One of the Congressional response was the Coronavirus Preparedness and Response Supplemental Appropriations Act (HR 6074), enacted on March 6, 2020, which provided $8.3 billion in additional spending on vaccine research and development.

Phase Two was the Families First Coronavirus Response Act (HR 6201), enacted on March 18, 2020. This legislation included new employer mandates for paid sick leave and paid family leave related to the pandemic and allowed employers to recover the cost of the mandates through refundable payroll tax credits. Phase Two included a total of $104 billion in new spending. For detailed information on the Phase Two legislation see **here**.

In addition to this legislative action, the IRS had previously issued a notice (Notice 2020-17) granting taxpayers with income tax payments (including estimated tax and self-employment tax payments) due April 15, 2020 the ability to defer up to $1 million (for individuals) or $10 million (for C corporations) of those payments until July 15, 2020. The IRS later removed these dollar limitations and delayed the filing date for income tax returns until July 15, 2020 (IR-2020-58).

The CARES Act

The CARES Act is a massive, 880-page, $2 trillion stimulus package. Unlike the earlier measures, the CARES Act includes numerous important tax relief provisions for individuals and businesses. Most of these provisions are temporary measures designed to quickly put money into the hands of taxpayers by delaying tax payment obligations, creating refund opportunities and using the tax system to make direct grants to individuals.

Business Tax Provisions

- Employment Tax Credit
- Deferral of Employer Payroll Tax Payments
- Net Operating Loss Changes
- Loss Limitations of Noncorporate Taxpayers
- Corporate Alternative Minimum Tax Credit
- Business Interest Deduction
- Qualified Improvement Property
- Aviation Excise Taxes
- Forgiveness of Small Business Loans

Employment Tax Credit

The CARES Act provides a refundable employment tax credit for employers to employees during shutdowns or periods of significant revenue loss as a result of COVID-19 from March 12, 2020 through year-end.

Calendar quarters for which credit is available. The credit is applied on a calendar quarter-by-calendar quarter basis. The credit is available for any quarter during which the employer's business was shut down, i.e., "fully or partially suspended," by a government order limiting commerce, travel or group meetings due to COVID-19.

An employer whose business was not shut down may qualify for the credit for any quarter the employer was suffering a significant revenue loss. This is defined as drop in gross receipts of more than 50% compared to the same quarter in the previous year. The credit also may be claimed in subsequent quarters ending with the quarter beginning after the quarter in which the employer's gross receipts return to more than 80% of the gross receipts for the same quarter in the previous year. The Secretary is instructed to issue guidance on the application of these rules to employers who were not carrying on business for all or part of the same quarter in the previous year.

Amount of the credit. For any quarter for which the credit is available, the employer is allowed a credit equal to 50% of "qualified wages" paid to each employee during the quarter. The maximum amount of qualified wages that can be taken into account for any employee for all quarters cannot exceed $10,000. The credit is limited to the employer's share of Social Security taxes for the quarter reduced by other credits for employing veterans, for qualified small business research and development expenditures and for the credits for paid sick leave and paid family leave under the Families First Coronavirus Response Act. However, credits in excess of this limit are refundable.

Qualified wages. The meaning of the term "qualified wages" differs depending on the size of the employer. For employers who had an average of more than 100 full-time employees in 2019, qualified wages means wages paid to an employee who was not providing services because of a shutdown or during a period of significant revenue loss. For these employers, creditable wages cannot be in excess of the amount the employee would have been paid for working the same amount of time during the preceding 30 days.

For employers at or below the 100-employee threshold, qualified wages means wages paid to any employee during the actual shutdown period and wages paid to any employee in a quarter during the revenue loss period, in either case whether or not the employee was working.

Qualified wages includes amounts the employer pays to provide and maintain a qualified group health plan that are allocable to the qualified wages. Unless the Secretary provides different rules, the allocation of health plan costs may be made pro rata among employees and, with respect to individual employees, pro rata among periods of coverage relative to the periods to which the wages relate.

Restrictions. The credit is subject to several restrictions:

- The credit is not available to governmental employers, including the states and their political subdivisions and the agencies and instrumentalities of either.
- Employers may not claim the credit with respect to any employee for any period if the employer is allowed a work opportunity credit under Code section 51 with respect to the employee for the same period.
- Wages taken into account for the purpose of the credit may not be taken into account for purposes of the paid family and medical leave credit under Code section 45S.
- The credit is not available to employers who receive a small business interruption loan under the CARES Act, and future guidance is expected to provide for the recapture of credits if the employer receives such a loan after claiming the credit.

Third party payors. Credits with respect to wages paid to employees employed by a professional employer organization belong to the customer. The Secretary is instructed to issue guidance concerning the application of the credit to other third party payors.

Penalty waivers. The Secretary must waive penalties for failures to deposit payroll taxes if the failure was due to the reasonable anticipation of the credit.

Deferral of Employer Payroll Tax Payments

The CARES Act permits employers to defer payment of the 6.2% employer portion of Social Security taxes otherwise due with respect to a “deferral period” that begins on the date of enactment and ends on January 1, 2021. One-half of the deferred taxes is due December 31, 2021, and the remaining half is due December 31, 2022. As long as the deferred taxes are paid by these dates, the employer is treated as having made timely deposits of the deferred taxes. Employers who have had a CARES Act small business interruption loan forgiven are not eligible for the deferral. If an employer uses a third party to pay wages (i.e., a professional employer organization or an authorized paying agent) and directs the third party to defer payment of the employment taxes, the employer and not the third party is liable to make the deferred payments on the deferred due date.

Self-employed individuals may defer payment of one-half of the 12.4% self-employment tax otherwise due with respect to the same deferral period. One-half of the deferred taxes is due December 31, 2021, and the remaining half is due December 31, 2022. Deferred taxes are not taken into account in computing the individual’s estimated tax penalties for any year that includes any part of the deferral period.

Net Operating Loss Changes

The 2017 Tax Cuts and Jobs Act (“TCJA”) made two important changes to the Code’s net operating loss (“NOL”) rules. First, for losses arising after 2017, the TCJA limited the NOL deduction to 80% of taxable income (with an exception for insurance companies other than life insurers). Second, the TCJA provided for the unlimited carryforward of NOLs but eliminated the taxpayer’s right to carry the loss back to earlier years. A limited two-year carryback was preserved for farming businesses and insurance companies.

The CARES Act temporarily eliminates both the prohibition on carrybacks and the 80% taxable income limitation to permit taxpayers to claim refunds to boost liquidity.

Specifically, the Act permits taxpayers (including insurers and farming businesses) to carry back losses arising in 2018, 2019 and 2020 to the five preceding years. Special rules apply to REITs and life insurance companies.

The 80% taxable income limitation does not apply for years before 2021. Beginning in 2021, the limitation is restored in a modified form. Specifically, income must first be offset by NOL carryovers from pre-2018 years. Post-2017 loss carryovers can then offset up to 80% of remaining taxable income computed before the Section 199A qualified business income deduction and the deductions under Section 250 with respect to foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI").

The Act prevents the use of NOL carrybacks to offset income inclusions attributable to the TCJA's deemed repatriation of foreign earnings.

Loss Limitations of Noncorporate Taxpayers

The TCJA added a limitation on noncorporate taxpayer's deduction for business losses in excess of an inflation-adjusted $250,000 ceiling ($500,000 for joint filers). A disallowed excess business loss could be carried over as a net operating loss to future years. This limitation applied to years beginning in 2018 through 2025. The CARES Act delays the application of this limitation until tax years beginning after 2020, creating refund opportunities for taxpayers who had been subject to the limitation in prior years.

Under current law, non-corporate farmers receiving certain government subsidies generally may not use farm losses to offset more than $150,000 ($300,000 for joint filers) of non-farm income. Under the CARES Act, this rule does not apply for the 2018 through 2025 tax years.

Corporate Alternative Minimum Tax Credit

A taxpayer is allowed a credit against its regular income tax liability equal to all or part of its alternative minimum tax ("AMT") liability paid in previous years, with unused credits being carried forward indefinitely. The AMT was repealed for corporate taxpayers by the TCJA for years beginning after 2017. Any AMT credit carried forward to years after 2017 is generally limited to the taxpayer's regular tax liability. However, half of any excess credit carried to 2018, 2019 and 2020 is refundable, and 100% of any remaining excess credit is refundable in 2021.

The CARES Act accelerates refunds of excess AMT credits by making 100% of the excess AMT credit refundable for 2019. However, the Act also permits taxpayers to elect to make the credit 100% refundable for 2018 by filing a tentative refund application by the end of this year.

Business Interest Deduction

The TCJA limited the deduction for net business interest to 30% of adjusted taxable income. The CARES Act increases this limit to 50% for taxable years beginning in 2019 or 2020. Recognizing that many taxpayers will have lower taxable income in 2020, the Act permits taxpayers to elect to apply the limit for 2020 by using 2019 adjusted taxable income.

For partnerships, the Act preserves the 30% limitation for 2019, but a partner receiving an allocation of suspended interest in 2019 is permitted to deduct half of such interest in 2020.

Qualified Improvement Property

The CARES Act corrects a glitch in the TCJA relating to the depreciation of qualified improvement property ("QIP"). QIP generally is defined as an improvement made to the interior of nonresidential real property after the building was placed in service. The TCJA failed to designate a depreciation recovery period for QIP. As a result, by default QIP was subject to a 39-year recovery period like other nonresidential real property. Furthermore, while QIP was entitled to immediate expensing under section 179 (subject to that section's dollar limitations), it was not eligible for bonus depreciation because bonus depreciation is only available for property with a recovery period of 20 years or less. The CARES Act provides that QIP has a recovery period of 15 years, thus making it eligible for bonus depreciation. This technical correction is effective retroactively to taxable years beginning in or after 2018.

Aviation Excise Taxes

The Code imposes a 7.5% excise tax on amounts paid for domestic passenger air transportation and a 6.25% excise tax on domestic cargo air transportation. The CARES Act provides a tax holiday for both excise taxes from the date of enactment until January 1, 2021. The holiday does not apply to air transportation paid for before the date of enactment.

Forgiveness of Small Business Loans

The CARES Act expands the Small Business Act to create a small business interruption loan program to make loans to a broad array of businesses as well as public and private nonprofits. Loan amounts are based on four months of payroll, mortgage, rent and debt payments, not to exceed $10,000,000. Taxpayers that receive loans before the end of June would be eligible to have the loan forgiven in an amount equal to the cost of maintaining payroll during the period from March through June. The Act provides that any debt forgiven under this provision is be excluded from gross income.

Individual Tax Provisions

- Individual Recovery Rebates
- Charitable Contribution Changes
- Employer Payment of Student Loans
- Modifications to Families First Coronavirus Response Act

Individual Recovery Rebates

The CARES Act provides "recovery rebates" for individuals (other than nonresident aliens and dependents claimed on another taxpayer's return) equal to $1,200 ($2,400 for joint filers) plus $500 for each of the taxpayer's dependents under the age of 17. For taxpayers with adjusted gross income ("AGI") in excess of $75,000 ($150,000 for joint filers), the rebate amount is reduced by 5% of the taxpayer's AGI in excess of the threshold amount. The basic rebate amount is thus phased out in full for taxpayers with AGI of $99,000 for single filers and $198,000 for joint filers.

The mechanism for issuing the rebates is to treat them as refunds for the 2020 taxable year. The taxpayer is treated as having made a tax payment equal to the rebate amount in 2019, thus creating an overpayment (without interest). The IRS is required to refund or credit this hypothetical overpayment to the taxpayer "as rapidly as possible." No refunds or credits are allowed after 2020. Rebate payments are not subject to reduction or offset for amounts the taxpayer owes to federal agencies, state income tax obligations or for unemployment compensation debts.

Charitable Contribution Changes

Modification of percentage limitations. Deductions for charitable contributions are limited to certain percentages of a taxpayer's modified AGI (in the case of individuals) or taxable income (in the case of corporations). Contributions in excess of these limits are carried over to succeeding years.

The CARES Act provides that, at the election of the taxpayer, cash contributions made in 2020 (other than to donor advised funds and section 509(a)(3) supporting organizations), will be disregarded in applying these percentage limitations. An individual's deduction for all charitable contributions for the year, however, may not exceed 100% of the individual's modified AGI, and a corporation's deduction for all charitable contributions for the year may not exceed 25% of the corporation's taxable income. Any amounts contributed in excess of these limits may be carried over to succeeding years. If the contribution is made by a partnership or S corporation, the election is made at the partner or shareholder level.

Deduction for non-itemizers. For the 2020 tax year, the CARES Act permits non-itemizers to deduct up to $300 from gross income for cash charitable contributions made during the year (and not as a carryover from an earlier year) to exempt organizations other than section 509(a)(3) supporting organizations and donor-advised funds.

Food inventory contributions. Under current law, deductions for food contributions from a taxpayer's trade or business may not exceed 15% of taxable income (for C corporations) or 15% of aggregate net income from all contributing trades or businesses (for other taxpayers). The CARES Act increases these limits to 25% for contributions of food made during 2020.

Employer Payment of Student Loans

Under current law, employees may exclude from gross income up to $5,250 in education assistance provided by their employers. The CARES Act expands the scope of education assistance to include payments by the employer of principal or interest on a student loan taken out by the employee for his own education. The exclusion is available if the employer pays the lender directly or pays the employee. The payment must be made before January 1, 2021. The overall $5,250 limit of current law continues to apply to all education assistance made during the year. An employee benefiting from an employer student loan payment loses the right to deduct interest on the loan.

Modifications to Families First Coronavirus Response Act

Phase Two of Congress's COVID-19 legislation, the Families First Coronavirus Response Act, imposed new employer mandates for paid sick leave and paid family leave due to the COVID-19 health emergency. The act also provided employer payroll tax credits (and equivalent income tax credits for self-employed taxpayers) to reimburse employers for the costs of the mandates. The act further instructed the IRS to issue regulations that, among other things, would waive penalties otherwise imposed on employers for failure to make payroll tax deposits in anticipation that the payroll tax credits would be enacted. The CARES Act codifies this penalty waiver provision. The CARES Act also provides that the IRS must issue forms and instructions for self-employed taxpayers to obtain advance payments of the refundable income tax credits with proper reconciliation when the taxpayer's income tax return is filed.

What Didn't Happen

No Delay in Estimated Tax Payments

As explained above, the IRS extended the deadline for filing 2019 income tax returns and making income tax payments, including first quarter estimated tax payments, from April 15 to July 15. The original version of the CARES Act included provisions delaying individual and corporate second and third quarter estimated tax payments until October 15, 2020. These provisions were not included in the final bill.

No Offset Relief for Repatriation Installments

The TCJA effected a deemed repatriation of deferred foreign earnings held by foreign corporations with United States shareholders. The United States shareholders were generally required to include the repatriated earnings in income in 2017, but could elect to pay the tax due on the income in eight annual installments.

Taxpayers owing tax installment payments are subject to certain offset obligations. For instance, a taxpayer may have to offset an unpaid tax installment against a refund otherwise due, and a taxpayer that overpays one tax installment may be required to apply the overpayment to future installments in lieu of a refund.

The original version of the CARES Act would have allowed a taxpayer to elect to disregard unpaid repatriation tax installments in applying these offset provisions, thus creating or accelerating refunds. The provision was not included in the final bill.

No Fix to Downward Stock Attribution

Under the Code's "Subpart F" regime, the "United States shareholders" of a "controlled foreign corporation" (or "CFC") must include in income certain foreign earnings of the CFC, including global intangible low-taxed income ("GILTI"), on a current basis, whether or not the income is distributed. Section 958 of the Code contains stock attribution rules that must be applied in determining whether a foreign corporation qualifies as a CFC and whether a US person qualifies as a United States shareholder of the CFC.

Section 958(b)(4) formerly prohibited the attribution of stock held by a non-US person to a US person. This prohibition on so-called "downward attribution" made it possible for a CFC owned by a US person that was in turn owned by a foreign person to shed CFC status by having the US person transfer its stock in the CFC to the foreign person. To prevent these "de-control transactions," the TCJA repealed section 958(b)(4). This made de-control transactions ineffective, because the foreign person's CFC stock could be attributed to the US person thus preserving CFC status.

While Congress's purpose in repealing 958(b)(4) was limited to preventing de-control transactions, the repeal produced a host of unintended consequences, causing many US persons to be classified as United States shareholders and many foreign corporations to be classified as CFCs with various Subpart F and GILTI consequences. In October of 2019, Treasury issued proposed regulations (REG-104223-18) and a Revenue Procedure (Rev. Proc. 2019-40) to provide relief from some of these consequences. The original version of the CARES Act would have retroactively restored Section 958(b)(4) and added a new provision narrowly tailored to address the de-control transaction situation. These provisions were not included in the final bill.

Conclusion

Smith Anderson will update this Alert as additional guidance is provided by the IRS. In the meantime, please contact a member of Smith Anderson's Tax Group if you have questions about the tax provisions of the CARES Act.