Continuing COVID-19 Impacts on Federal Taxation - The CARES Act

After some tense negotiations, near-misses, and threatened hold-outs, President Trump signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) H.R. 748, into law on March 27, 2020. This third stimulus bill aims to provide relief and boost the economy via $2 trillion in aid and stimulus money via tax breaks, rebates, small business loans, industry specific aid, and unemployment benefits. Here, we focus on the tax provisions of the CARES Act, which the Joint Committee on Taxation has already scored here, indicating the tax-related provisions will cost in excess of $591 billion over the next 10 years. On top of direct payments to many individuals in the form of recovery rebates, the CARES Act temporarily suspends or adjusts the three largest revenue raisers (allowing NOL carrybacks with no income limitation, suspending the excess business loss rules of IRC § 461(l), and relaxing the business interest limitation of IRC § 163(j)) from the Tax Cuts and Jobs Act – P.L. 115-97 (TCJA) enacted in December 2017, along with making several other technical corrections. This article summarizes the new tax provisions and provides our perceived impact of these new provisions.

Individual Provisions

Direct Payments (Recovery Rebates) for Individuals – Sec. 2201

Perhaps the most discussed provision of the CARES Act concerns the direct individual stimulus payments, officially dubbed "recovery rebates," which involves the IRS sending over $500 billion via check or direct deposit to most American adults. The new statute provides $1,200 for single-filers and heads of household and $2,400 for joint filers, along with $500 per qualifying child (using the Child Tax Credit provisions). Thus, a jointly-filing family of four would get $3,400 before the application of any phase out rules.

The direct payments start to phase out at a 5% rate above adjusted gross incomes (AGI) of $75,000 for single-filers, $122,500 for heads of households, and $150,000 for joint-filers. The point at which a taxpayer no longer will receive any direct payment depends on filing status and qualifying children. For example:

- Single-filer with no children is completely phased out if AGI exceeds $99,000 | (1,200 / 5%) = 75,000 = 99,000).
- Head of Household with one child completely phased out if AGI exceeds $156,500 | ((1,200 + 500) /5%) + 122,500 = $156,500.
- Joint-filer with no children is completely phased out if AGI exceeds $198,000 | (2,400 / 5%) + 150,000 = 198,000.
- Joint-filer with two children is completely phased out if AGI exceeds $218,000 | ((2,400 + 1,000) / 5%) + $150,000 = $218,000.

Generally, taxpayers must submit the SSNs for each family member claiming the direct payments. But, since these direct payments are going to be advanced refunds for 2020 and the IRS is supposed to send these direct payments as soon as possible, a taxpayer's AGI will initially be determined by referencing the 2019 tax return. If a 2019 tax return has not been filed, the IRS will look at your 2018 return. Non-filers generally need to file a tax return to claim the rebate. However, if neither a 2019, nor a 2018 return was filed because the taxpayer did not have a filing obligation (too little taxable income), but third-party payor information is available to the IRS, like a 2019 Form SSA-1099, the IRS may determine eligibility based on the Social Security Benefits Statement. Note, the direct payment credit will be recomputed again on the filing of taxpayer's 2020 return in calendar year 2021 based on 2020 data.

Takeaways

1. For most taxpayers, no action will be required on their part to receive the direct payment. However, the credit payment amount must be recalculated on the filing of 2020 tax returns.
2. The recalculation of the direct payment amount on your 2020 tax return based on your 2020 data could lead to significant differences between the 2020 calculation and the direct payment you actually received based on a 2018 or 2019 tax return. If the advance payment was *less* than what you are owed in 2020, i.e., you were phased out in 2019 but not 2020 or you had another child or different filing status, the excess will be treated as a credit that reduces your 2020 tax liability.
3. If the advance payment received is *greater* than what you're owed on your 2020 tax return, or you're completely phased out per your 2020 tax return, you should not have to repay or return the excess. The CARES Act does not explicitly require any income recognition on the excess advanced payment received, and it says that the credit cannot be reduced below zero by the advanced payments. This could create some planning opportunities if you have not yet filed your 2019 return.
4. The expected expedited calculation and processing of this direct advanced payment/rebate is going to be an administrative nightmare for an already understaffed IRS. Even though the IRS has paused some compliance and collection efforts during the COVID-19 pandemic, it is still being asked to perform what seems to be an impossible task. Will the IRS stagger the issuance of the checks over several months like it did with the 2008 stimulus checks to prevent overwhelming its staff and technology? Treasury wants them issued in three weeks. We'll see what happens.
5. The nature of these payments, along with the expedited processing, could lead to an uptick in identity theft issues, scams, etc., that taxpayers, practitioners, and the IRS will have to deal with on the back-end. Low income taxpayers are likely to be impacted more severely.

Retirement Funds and Plans – Secs. 2202 and 2203

Generally, if you receive a distribution from a qualified retirement plan before the age of 59 ½, you pay income tax on the distribution and IRC § 72(t) imposes a 10% penalty (or additional tax) on the distribution unless an exception is applicable. The CARES Act adds a new exception by providing that the 10% penalty does not apply to any "coronavirus-related distribution" up to $100,000. A "coronavirus-related distribution" is a distribution made during 2020 to an individual:

- Who is diagnosed with COVID-19 with a test approved by the Center for Disease Control (CDC);
- Whose spouse or dependent (as defined by IRC § 152) is diagnosed with COVID-19; or
- Who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business because of COVID-19, or other factors determined by Treasury.

While a "coronavirus-related distribution" avoids the 10% penalty, it is still subject to income tax; however, the CARES Act allows you to spread the income tax burden over a three-year period starting with 2020. Income recognition can be avoided entirely by repaying the distribution to the retirement plan within three years of receipt. This repayment does not apply against contribution limitations. In addition, the loan amount an individual can borrow against his/her plan increases from $50,000 to $100,000 for the 180-day period starting after the CARES Act is enacted, while certain outstanding loans that were previously due on or before December 31, 2020, will be delayed for one year. Finally, for individuals 72 and older that are normally required to withdraw a "required minimum distribution" from the retirement plan, the CARES Act waives the minimum distribution rules for calendar year 2020.

Takeaways

1. While it's generally best to leave your retirement plan alone, the waiver of the 10% penalty and the spread of income recognition over three years will soften the impact of 2020 early withdrawals.
2. For more specifics on the employee/retirement related benefits read this.

Charitable Contributions – Secs. 2204 and 2205

The enactment of the TCJA in December of 2017 almost doubled the applicable standard deduction, but curtailed many itemized deductions, like the one for state and local taxes paid. This led to less than 10% of taxpayers itemizing their deductions in 2018. To account for this and provide some extra relief, the CARES Act provides a new "above the line" deduction of up to $300 to individual taxpayers who do not itemize their deductions.

For individual taxpayers that do itemize their deductions, the CARES Act temporarily raises the AGI limitations on charitable giving to public charities and donations from 60% to 100%. Excess contributions may be carried forward for five years. The limitation on corporation donors is increased from 10% of adjusted taxable income to 25%. In all cases the charitable contribution must be made in case to a public charity or foundation as defined in IRC § 170(b)(1)(A).

Takeaways

1. Taxpayers who itemized are not permitted to claim the $300 above the line deduction allowed to taxpayers who do not itemize. Taxpayers who itemize must still report on charitable contributions on Schedule A, but the AGI limitations were increased to 100%.
2. There is no requirement that the contribution be used in COVID-19 relief efforts in order to take advantage of the above the line deduction or higher percentage limitations as applicable.

<u>Exclusion for Employer Payments of Student Loans – Sec. 2206</u>

Generally, when someone, say an employer, pays a debt on your behalf, you have taxable income to the extent of the amount paid. However, the CARES Act provides an exclusion by permitting employers to pay up to $5,250 in 2020 of an employee's student loan obligations tax free. The $5,250 limitation is a combined limit that applies to both student loan payment and other educational assistance provided pursuant to an IRC § 127 plan.

For example, if an employer paid $3,500 of an employee's qualified educational expenses pursuit of a qualified degree program and another $5,000 of the same employee's student loan payments in 2020, only $5,250 of those combined payments will be tax free to the employee. In addition, the employee will not be able to deduct the applicable student loan interest.

Takeaway

1. Employers should update their education assistance plan documentation to make student loan payments part of the plan administration and recordkeeping.

Business Provisions

<u>Employee Retention Credit – Sec. 2301</u>

The CARES Act provides a refundable payroll tax credit for 50% of wages paid by eligible employers to certain employees during the COVID-19 pandemic. The employee retention credit is only available in 2020 and a business is considered an eligible employer if:

- Business operations were fully or partially suspended due to COVID-19; or

- Business operations continued, but during any quarter in 2020, gross receipts for that quarter were less than 50% of what they were for the same quarter in 2019. The business will remain eligible for the credit in 2020 until the business has a quarter where its gross receipts exceed 80% of what they were for the same quarter in the previous year.

An employer is not eligible for the employee retention credit if the employer receives a payroll protection loan under Section 7(a) of the Small Business Act (SBA).

The credit is for 50% of "qualified wages," the definition of which depends on the employer's size. For employers who had an average number of 100 or fewer full-time employees in 2019, all employee wages are eligible, regardless of whether the employee is furloughed. For employers who averaged more than 100 full-time employees in 2019, only the wages of employees who are furloughed or faced reduced hours as a result of their employers' closure or reduced gross receipts are eligible for the credit. The effective period for paying qualified wages runs from March 13, 2020 through December 31, 2020. The employee retention credit is capped at the first $10,000 of compensation, including health benefits, paid to an employee. It is refundable if it exceeds the business's liability for payroll taxes.

Takeaways

1. Given the credits provided for paid sick leave and family leave in the also recently enacted Family First Coronavirus Response Act (FFCRA) and the impact of the COVID-19 pandemic, the employee retention credit will be refundable to many employers.
2. The CARES Act appears to use the aggregation rules of IRC §§ 52 and 414 to determine which entities are treated as a single employer for determining the employee count.
3. For the employee retention credit in the CARES Act, the window qualified wages runs from March 13, 2020 through December 31, 2020. But, per Notice 2020-21 the IRS established that the effective date of the FFCRA for qualified sick leave and family leave starts on 4/1/2020 and continues through 12/31/2020. So, we have two different effective dates for three credits that impact payroll taxes for 2020.
4. Employers need to understand that this retention credit cannot be claimed if they took out a 7(a) loan under the SBA, and accountants will need to ask this question during 2020 return preparation.

<u>Delay of Payment/Deposit of Employer Payroll Taxes and Self-Employment Taxes – Sec. 2302</u>

On top of the credits in the FFCRA and the employee retention credit noted above, the CARES Act allows for the deferral of the employer's share of the 6.2% Social Security tax that would otherwise be due in 2020 from the date of enactment through December 31, 2020, to be paid on December 31, 2021 (50%) and December 31, 2022 (50%).

Similarly, a self-employed taxpayer can defer paying 50% of his or her self-employment tax that would be due from the date of enactment through the end of 2020 until the end of 2021 (25%) and 2022 (25%).

Takeaways

1. Employers will be able to: (1) defer payment of its share of Social Security tax until 2021 and 2022, but (2) receive immediate credits against those to-be-paid later payroll taxes in through the sick leave and family leave credits in the FFCRA and the employee retention credit. Who knows how this will be administered on income and payroll tax filings for 2020? Good luck IRS.
2. Social Security Trust Funds will be held harmless under this provision.
3. The CARES Act includes special rules for third-party payroll providers and professional employer organizations.
4. The deferral does not apply to employers who took out a loan under section 7(a) of the SBA.

<u>Technical Correction for Qualified Improvement Property – Sec. 2307</u>

The TCJA amended IRC § 168(k) to allow for 100% bonus depreciation for certain qualified property. Then the TCJA eliminated pre-existing definitions for several categories of property generally eligible for bonus depreciation and replaced them with one category called qualified improvement property (QIP). It was intended by the drafters that QIP have a 15-year recovery period and be eligible for bonus depreciation, but a specific recovery period was not reflected in the TCJA. Thus, under the TCJA, QIP technically had a 39-year recovery period and was ineligible for 100% bonus depreciation.

The CARES Act provides a needed and much anticipated technical correction concerning QIP. It specifically and retroactively designates QIP as 15-year property (20-year for ADS) for depreciation purposes; thus, QIP is eligible for 100% bonus depreciation if placed in service after December 31, 2017.

Takeaways:

1. Automatic accounting method changes will likely need to be filed to comply with this technical correction and obtain the benefit through an IRC § 481(a) adjustment. Taxpayers are generally required to file a change of accounting method when the depreciation method changes. Here, QIP placed in service after 2017 that has initially been depreciated as 39-year building property, will need to be changed to 15-year property that is eligible for 100% bonus depreciation.

2. However, if a QIP asset was only depreciated on a single tax return, it was placed in service in 2018, and the 2019 return has not yet been filed, the depreciation method may be corrected with an amended 2018 return.
3. Hopefully the IRS will issue some procedural guidance concerning the filing of automatic accounting method changes or amended returns under these circumstances. Particularly concerning partnerships subject to the centralized audit regime of the Bipartisan Budget Act of 2015, as many partnerships will likely need to file Administrative Adjustment Requests with the benefit accounted for in 2020.
4. The CARES Act does not permit the ability to change prior-year elections concerning the depreciation of QIP. Nothing in the CARES Act allows for a taxpayer to go back and elect out of bonus depreciation for property placed in service in 2018 or election to use ADS.
5. This technical correction will create a multimillion swing in depreciation deductions available for many taxpayers, particularly those in the commercial real estate and hospitality industries, who have been lobbying for this correction since December of 2017.

Modification of Net Operating Losses – Temporary Carryback Allowance – Sec. 2303

The CARES Act provides for a temporary five-year carryback period for net operating losses (NOLs) arising in calendar years 2018, 2019, and 2020 and allows NOLs for those calendar years to offset 100% of taxable income until the 2021 tax year. Taxpayers may elect out of this five-year carryback regime, but that election is irrevocable. The creation of this temporary five-year carryback regime will require some taxpayers to track three different groupings of federal NOLs:

- Incurred prior to 2018 (pre-TCJA) – 2-year carryback, 20-year carryforward, and eligible to offset 100% of taxable income.
- Incurred after 12/31/2017 and before 1/1/2021 (CARES Act) – 5-year carryback, indefinite carryforward, eligible to offset 100% of taxable income when carried forward to 2019 and 2020, but only eligible to offset 80% of taxable income when carried forward to 2021 and subsequent years.
- Incurred after 12/31/2020 (TCJA adjusted by CARES Act) – no carryback, indefinite carryforward, and eligible to offset 80% of taxable income.

Real Estate Investment Trusts (REITs) are carved-out of the CARES Act carryback rules.

Takeaways

1. A corporation can carryback 2018, 2019, and 2020 NOLs to offset pre-2018 ordinary income or capital gains that were taxed at a rate up to 35%, which generates a current refund and a significant favorable rate differential. In other words, to the extent NOLs can be increased in 2020 via accelerated deductions, deferred revenue, or the impacts of COVID-19, permanent cash tax savings could

be generated if those NOLs can be carried back to profitable, higher tax rate years. In addition, if NOLs were already on the books in 2018 and 2019, prior income tax liabilities could be offset as far back as 2013 or 2014.
2. Basically, this provision aims to provide cash flow and liquidity during the COVID-19 pandemic.
3. The CARES Act does not modify the rules related to capital losses.

Temporary Reversal of the Limitation of Excess Business Losses – Sec. 2304

The CARES Act removes the excess business loss limitation (the fourth limitation on an individual's ability to use losses from a business added via the TCJA) under IRC § 461(l) for the calendar years 2018, 2019, and 2020, by changing the effective date of the excess business loss limitation rule to apply for any tax year beginning after 12/31/2020, and before 1/1/2026. This modification is retroactive back to December 31, 2017. Further, the CARES Act includes some technical corrections to IRC § 461(l), namely that wages will not be considered business income, which should result in more losses being limited in most cases when it becomes effective again in 2021.

Takeaways

1. Amended returns will need to be filed for 2018 (and 2019 if already filed) to account of the retroactive nature of the removal of IRC § 461(l).
2. These amended returns will likely report larger losses given the removal of the limitation leading to potential refunds for the individual owners of the pass-through entities.
3. Given the delay of the effective date of IRC § 461(l) until after 2020, pass-through entities may not even need to report IRC § 461(l) information on Schedules K-1 until the 2021 tax year.

Temporary Relaxation of the Limitation on Business Interest – Sec. 2306

The TCJA added IRC § 163(j), which limits the ability of a business to deduct its interest expense to 30% of its adjusted taxable income (ATI) while any excess interest is carried forward. ATI equals a taxpayer's taxable income computed without regard to: (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any NOL deduction; (4) the 20% deduction for certain pass-through income; and (5) for tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

The CARES Act increases the ATI limit from 30% to 50% for 2019 and 2020, and allows a business to elect to use its 2019 ATI when computing its 2020 limitation (since many businesses in 2020 will likely not have taxable income in 2020). Taxpayers are allowed to elect-out of the application to the temporary new rule.

For partnerships, the 50% ATI limitation does not apply to 2019. Instead, interest disallowed at the partnership level is allocated to the partners and suspended at the partner-level under the normal rules. However, in 2020 there is a bifurcation, 50% of the suspended interest becomes available and deductible, while the other 50% will remain suspended until the partnership allocates excess taxable income or excess interest income to the partner (or the partnership is no longer subject to IRC § 163(j).

Takeaways

1. The ability of a business to elect to use its 2019 ATI limitation in 2020 could generate some significant tax savings. For example, if a business had ATI of $8 million in 2019 but a negative ATI in 2020, it could elect to deduct $4 million of interest expense in 2020 (50% of $8 million), generate a bigger loss, and then use the favorable new NOL provisions to carryback the loss to 2019 (or prior years) and recover taxes paid in that year (or prior years).
2. If NOLs arise in 2019 or 2020 on account of either the increased IRC § 163(j) limitation or the treatment of excess business interest expense allocated to a partner for a taxable year beginning in 2019, those NOLs are now available for carryback and is not subject to the 80 percent limitation pursuant the CARES Act changes to the NOLs rules discussed above.

<u>Acceleration of the Ability to Use Corporate Minimum Tax Credits – Sec. 2305</u>

The CARES Act allows corporations to accelerate the utilization of their remaining minimum tax credits (MTCs) from the pre-TCJA alternative minimum tax (AMT) regime. The TCJA repealed corporate AMT and allowed corporations to claim outstanding AMT credits or MTCs subject to certain limits for tax years prior to 2021, at which time any remaining AMT credit may be claimed as fully-refundable. The CARES Act allows corporations to claim 100% of MTCs in 2019 as fully refundable and provides an election to accelerate claims to 2018, with eligibility for accelerated refunds.

Takeaways

1. Taxpayers that used MTCs to offset regular tax liabilities in 2018 may be able to use the new NOL carryback rules to get a refund.
2. The accelerated refund claims for 2018 will be treated as tentative carryback refund claims under IRC § 6411. The application must be filed before 12/31/2020. An amended return is not required.
3. It appears that these CARES Act amendments are intended to provide a cash refund for carryforward MTCs following the TCJA's elimination of corporate AMT.

<u>Temporary Suspension of Alcohol Taxes on Spirits Used in Emergency Production of Hand Sanitizer – Sec. 2308</u>

Distilled spirits are generally subject to an excise tax upon removal from the distillery; however, denatured spirits for non-beverage use may be removed free of tax. The Food and Drug Administration (FDA) has issued recent guidance on the emergency production of hand sanitizer in connection with the COVID-19 outbreak, which taken together, provides that undenatured spirits may be produced by a distillery for use in the production of hand sanitizer, provided such spirits are later denatured prior to use in such production. The CARES Act exempt from tax spirits removed during 2020 and used for the production of hand sanitizer in compliance with all FDA guidance.

Takeaways

1. This should further encourage an already significant number of distilleries to shift some of their resources to produce hand sanitizer to combat COVID-19.
2. In addition, the Alcohol and Tobacco Tax and Trade Bureau has waived certain permitting, bond, and formula requirements to expand the ability of distilleries to provide hand sanitizer in connection with COVID-19.

Temporary Suspension of Aviation Excise Taxes – Sec. 4007

There are several aviation-related taxes in IRC §§ 4261 and 4271, including a 7.5% ticket tax and domestic and international segment taxes paid by passengers (ticket taxes), as well as a 6.25% tax on the transportation of air cargo, and a per gallon aviation fuel excise taxes, which range from 4.3 to 21.8 cents per gallon. The CARES Act suspends the collection of these taxes from the date of enactment through 1/1/2021.

Takeaways

1. This will provide instant relief to the aviation industry and free up cash to cover other expenses.
2. The relief for transportation taxes seems to apply broadly to all payors of these taxes, including airlines, charter companies, and private and business aviation.

Conclusion

While the CARES Act provides approximate $2 trillion in stimulus money to combat COVID-19 and help people and businesses absorb the impact of COVID-19, many think additional relief is needed, particularly those in the hospitality and construction industries. The House is already discussing another package. It remains unclear how many of the Federal agencies, including the IRS, will be able to implement some of these sweeping changes in an expedited manner while their own employees are impacted by COVID-19 just like everyone else. Time will tell.

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