Tax Savings Opportunities from the CARES Act

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On March 27, President Trump signed the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, the third phase of legislation aimed at fighting the COVID-19 pandemic and mitigating the related economic harm for families, workers, and businesses. It's the largest stimulus package in history with an estimated cost of $2.2 trillion. The CARES Act, among other things, provides "recovery rebates" to individuals, expands and enhances unemployment benefits, extends loans and loan guarantees to eligible businesses, offers funding for the healthcare and education systems, and provides tax relief for businesses and individuals. This article discusses the business and individual tax provisions of the CARES Act.

Business Provisions

Deferral of employer Social Security tax

The employer share of the 6.2% Social Security tax on wages paid from March 27, 2020 through December 31, 2020 is deferred, with 50% due on December 31, 2021, and 50% due on December 31, 2022. A similar rule applies to 50% of self-employment tax liability of partners and sole proprietors. The deferral is not available to taxpayers that take advantage of loan forgiveness under the paycheck protection program under the CARES Act (i.e., certain new SBA loans for payroll and specified other expenses).

Employee retention credit

The CARES Act added a refundable payroll tax credit equal to 50% of certain compensation (including health benefits) paid by eligible employers from March 13, 2020 to December 31, 2020. An eligible employer is one whose:

- Operations were fully or partially suspended due to a COVID-19 related shut-down order, or
- Gross receipts declined by more than 50% when compared to the same quarter in the prior year. The employer remains an eligible employer in subsequent quarters until the gross receipts exceed 80% of gross receipts compared to the same quarter for the prior year.

If the employer has more than 100 employees, the credit is available only for compensation paid to employees who are not working as a result of a COVID-19 related shut-down order or the significant decline in gross receipts. For employers with 100 or fewer employees, any compensation paid during the period when the operations were fully or partially suspended or during a quarter in which gross receipts have significantly declined are eligible for the credit, even if paid to an employee who is still working.

The credit is limited to the first $10,000 of compensation paid to a particular worker. The credit is not available for compensation taken into account in computing the sick leave or family medical leave credits under the Families First Coronavirus Response Act (FFCRA). Similarly, the credit is not available to employers who take advantage of a small business interruption loan under the paycheck protection program.

Example: Apex Electrical, Inc. is an electrical contractor whose operations are suspended from March 20 through April 14 as a result of a COVID-19 related shut-down order. A few of Apex Electrical's employees are able to work from home during the shut-down but most are not. Apex Electrical continues to pay all of its employees, regardless of whether they are able to work. The sick leave credit under the FFCRA covers all of the wages paid from April 1 through April 14 to employees unable to work. Apex Electrical's second quarter gross receipts decline by 25% relative to the same quarter in the previous year and then pick back up in the third quarter.

If Apex Electrical has more than 100 employees, it can claim the retention credit with respect to compensation paid from March 20 to March 31 to employees unable to work. The credit is not available for compensation paid to employees who work from home. Similarly, the credit is not available for compensation paid from April 1 to April 14 as those amounts qualified for the sick leave credit.

If Apex Electrical has 100 or fewer employees, it can claim the retention credit with respect to all compensation paid from March 20 to March 31 — regardless of whether the employees are working. In addition, the credit is available for compensation paid to the employees who are actually working from April 1 to April 14 (wages paid to employees who are working during the period April 1 to April 14 do not qualify for the sick leave credit and thus are eligible for the employee retention credit).

Reinstatement of NOL carrybacks

Following tax reform, NOLs generated in tax years beginning in 2018 and later years cannot be carried back and can only offset up to 80% of taxable income in carryover years. The CARES Act permits NOLs from the 2018, 2019, and 2020 tax years to be carried back to the previous five tax years (beginning with the earliest year first) and suspends the 80% of taxable income limitation through the 2020 tax year.

Taxpayers can elect to waive the loss carryback. For losses generated during the 2018 and 2019 tax years, the waiver needs to be made by the extended due date for the tax return for the first year ending after the CARES Act is enacted. For example, a calendar year corporation with an NOL in 2018 but income in 2019 and 2020 would need to waive the carryback for the 2018 year by the due date of the 2020 tax return. Taxpayers cannot elect a reduced carryback period (e.g., there is no election to use a two-year carryback in lieu of the five-year carryback).

Aside from the cash flow benefits, NOL carrybacks present an opportunity to secure permanent tax savings by using losses to offset income generated prior to tax reform when the tax rates were higher. For example, a corporate NOL from 2020 can be carried back to offset income from 2015 which may have been subject to a 35% tax rate rather than carried over to 2021 when income is subject to a 21% tax rate. In some cases, however, income in future years will be subject to higher tax rates than income in the carryback period and the client may prefer to waive the carryback.

Depending on the client's situation, you should consider planning measures — such as accounting method changes — to accelerate deductions and defer income to maximize the amount of the NOL that can be carried back. If 2019 was profitable but the taxpayer anticipates a loss for 2020, the planning may focus on accelerating income into the 2019 year and deferring deductions to 2020 to maximize the NOL for 2020.

Example: Auburn, Inc., an accrual-method C corporation, anticipates having $2 million of taxable income in 2019 and $0 taxable income in 2020. Auburn's projections assume it will defer recognizing income associated with a one-time prepayment of $1 million received in 2019 for services to be performed in 2020 under the deferral method of section 451(c). If Auburn uses the full inclusion method instead, Auburn will have $3 million of taxable income in 2019 (subject to tax at a 21% rate) and a $1 million net operating loss in 2020 which can be carried back to offset income in 2015 (subject to tax at a 35% rate). While it's counterintuitive to accelerate income, doing so creates an NOL in 2020 which can be carried back to offset income subject to higher rates in earlier years, resulting in permanent tax savings of $140,000.

The CARES Act also made a few technical corrections to the tax reform NOL rules. For example, NOLs generated in a year beginning in 2017 and ending in 2018 can now be carried back two years. As another example, for tax years after 2020, the 80% of taxable income limitation is computed by increasing taxable income for deductions under sections 199A and 250 and is reduced for NOL carryovers from pre-2018 tax years.

Temporary suspension of excess business loss rules

Tax reform limited individuals from using more than $250,000 ($500,000 MFJ) of business losses to offset non-business income. The CARES Act repeals the limitation for years beginning before 1/1/21. The repeal is non-elective, so it appears that any taxpayer with an excess business loss in 2018 or 2019 will need to amend their return to claim that loss, regardless of whether doing so is favorable.

> *Example:* Adam is a single individual whose only items of income and loss for 2018 were a $3 million business loss from his S corporation construction business and a $4 million long-term capital gain from the sale of marketable securities. Adam used only $250,000 of the business loss against the long-term capital gain in 2018 due to the excess business loss rules. He was planning to carry over the $2,750,000 excess loss to 2019 to offset ordinary income from the business.
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> Adam appears to be required to amend his 2018 tax return to use the ordinary loss to offset the long-term capital gain income otherwise taxed at preferential capital gains rates. Adam cannot use the 2018 loss to offset any of his 2019 ordinary income. The repeal of the excess business loss rules increased Adam's total 2018 and 2019 tax liability.

The CARES Act also made several adjustments to the computation of the excess business loss which will apply beginning in 2021, such as treating wage income as non-business income.

Corporate credit for prior year AMT

Tax reform repealed the corporate alternative minimum tax (AMT) and provided an opportunity for corporations to claim a refund of minimum tax credit carryovers during 2018 through 2021. The CARES Act makes any remaining minimum tax credit carryovers fully refundable in 2019. Alternatively, corporations can elect to claim a refund for the unused carryovers in 2018.

Modification of business interest limitation

The business interest limitation was added as part of tax reform and generally limits the deduction for business interest expense to the sum of (i) business interest income, (ii) 30% of adjusted taxable income (ATI), and (iii) floor plan financing interest. Certain small taxpayers are exempt from the limit.

The CARES Act increases the limit to 50% of ATI for 2019 and 2020, potentially increasing interest expense deductions and reducing taxable income (or creating a net operating loss which can be carried back). Taxpayers can elect to use their 2019 ATI in computing the 2020 limit, providing relief to those whose income declines in 2020. Taxpayers can elect to apply the more restrictive 30% of ATI limit if desired.

A special rule applies to partnerships in 2019. Instead of increasing the limit from 30% of ATI to 50% of ATI, half of the excess business interest of a partnership is treated as business interest of the partner in 2020 and is not subject to the business interest limit at the partner level. The other half of the excess business interest expense is subject to the normal rules for excess business interest. Partners can elect out of this relief provision if desired. The 50% of ATI limit applies to partnerships in 2020.

> *Example:* Pacific Partnership incurred $50 of business interest expense and has adjusted taxable income of $100 in 2019. Pacific Partnership does not have any business interest income or floor plan financing interest. Pacific Partnership's business interest limitation is $30 (30% x $100 adjusted taxable income), so $30 of its interest is currently deductible and $20 is allocated to the partners as excess business interest. Abby is a 50% partner and is allocated $10 of the excess business interest.
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> In 2020, Abby will be able to deduct half of the 2019 excess business interest expense from Pacific Partnership (50% x $10 excess business interest from 2019 = $5). The other half of Abby's excess business interest expense is subject to the normal business interest rules. Specifically, the excess business interest is treated as business interest paid by Abby (and then subjected to Abby's personal business interest limit) to the extent Abby is allocated excess taxable income from Pacific Partnership in a subsequent year.

The change presents an amended return opportunity for taxpayers who have already filed their 2019 tax returns. The special rule for partnership eliminates the burdens of filing an administrative adjustment request for those partnerships that have already filed their 2019 tax returns.

Bonus depreciation for qualified improvement property

Under tax reform, qualified improvement property (QIP) was supposed to have a 15 year cost recovery period and be eligible for 100% bonus depreciation. A drafting error, however, caused QIP to have a 39 year cost recovery period, and be ineligible for bonus depreciation. The CARES Act retroactively corrects the drafting error for QIP acquired and placed in service on or after 1/1/18.

The retroactive fix presents an opportunity for many taxpayers to accelerate depreciation, either by filing a Form 3115 or, in some cases, by filing an amended tax return. Taxpayers who use the alternative depreciation system — including those who elected out of the business interest limitations — are ineligible for bonus depreciation on QIP.

In some cases a taxpayer may wish to change a depreciation election for a previously filed return (e.g., to elect not to claim the 100% bonus depreciation). While the CARES Act does not allow taxpayers to make or revoke a depreciation election, it is possible the IRS will issue a notice or revenue procedure granting relief.

Individual Provisions

Recovery rebate

U.S. resident individuals who are not dependents of another taxpayer will receive a "recovery rebate" of $1,200 ($2,400 MFJ) plus an additional $500 per qualifying child. The rebate begins phasing out for incomes over $75,000 ($112,500 HOH; $150,000 MFJ) and is reduced by $5 for every $100 that the taxpayer's income exceeds the threshold. The rebate is available only for individuals and qualifying children who have a social security number.

The IRS will begin direct depositing the rebate or mailing checks in short order to individuals who are eligible based on the income reported on their 2018 tax return (or 2019 return if they've already filed). If a taxpayer receives a rebate but their 2020 income makes them ineligible for the rebate, there is no requirement for the taxpayer to repay the rebate. On the other hand, if an individual was not eligible for the rebate based on their 2018 or 2019 income but they would be eligible based on their 2020 income, they can claim the rebate as a credit on their 2020 tax return.

Waiver of early withdrawal penalty

The 10% penalty on an early withdrawal from a retirement account is waived for up to $100,000 of distributions for coronavirus-related purposes made on or after 1/1/20. A distribution is coronavirus related if made to an individual:

- Who is diagnosed with SARS-CoV-2 or with COVID-19 by a test approved by the CDC;
- Whose spouse or dependent is diagnosed with SARS-CoV-2 or COVID-19; or
- Who experiences adverse financial consequences because of quarantine, furlough, lay off, work hour reduction, or inability to work due to lack of child care.

A taxpayer who takes a coronavirus-related distribution can either report the distribution as ordinary income ratably over a three-year period beginning in 2020 or can recontribute the funds to a retirement plan within three years to avoid tax on the withdrawal altogether.

Waiver of Required Minimum Distributions (RMDs) for 2020

The CARES Act waives the required minimum distribution rules for certain defined contribution plans and IRAs during 2020.

> *Example:* Beth has an individual retirement account. Beth turns 70 on May 1, 2019. Beth did not receive her RMD on or before January 1, 2020. Beth does not have to take a RMD in 2020.

Charitable contribution provisions

Cash contributions made during 2020 to certain charities are eligible for special tax treatment. Specifically:

- Individuals who do not itemize can claim an above-the-line deduction of up to $300 for such contributions;
- Individuals who itemize can deduct such contributions up to 100% of AGI;
- C corporations can deduct such contributions up to 25% of taxable income; and
- Business deduction limits for contributions of food inventory is increased from 15% to 25% of the business taxable income.

Note that contributions made to donor advised funds are not eligible for the incentives.

Exclusion for student loan repayment

Employees can exclude up to $5,250 from income for student loan repayments made by an employer between March 27, 2020 and December 31, 2020. The exclusion appears to be available regardless of whether the student loan repayment has any connection to COVID-19.

Conclusion

The CARES Act provides timely cash tax savings and presents an opportunity for us to know and help our clients. Amended return opportunities are available for the following changes brought by the CARES Act, among others:

- 5-year NOL carryback for losses generated in the 2018 and 2019 tax years.
- 2-year NOL carryback for losses generated in a year beginning in 2017 and ending in 2018.
- Repeal of the excess business loss rules for 2018 or 2019.
- Apply 50% of ATI limit instead of 30% of ATI in computing business interest limitation for 2019.
- Apply 100% bonus depreciation to QIP placed in service in 2018 or 2019.

There are still several areas for which we don’t have all of the answers. The IRS will inevitably continue to release guidance over the coming weeks and months. State conformity will evolve over the coming months as state legislatures adopt legislation to respond to the pandemic. Contact a member of the National Tax Office if you have questions specific to a client situation.