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CARES Act Provides Tax Relief in Response to COVID-19 Pandemic

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On March 27, 2020, President Donald Trump signed the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act) into law.

This client alert summarizes the main provisions of the CARES Act affecting the taxation of corporations and other businesses. For an overview of other business provisions of the CARES Act, **see our prior alert**. Cooley's **coronavirus resources hub** also contains information on a range of legal and business issues relevant to the COVID-19 pandemic.

The CARES Act provides temporary relief from certain aspects of the Tax Cuts and Jobs Act of 2017 (the TCJA) that had imposed limitations on the utilization of certain losses, interest expense deductions and alternative minimum tax credits. The new legislation also provides opportunities for businesses to improve their cash flows by obtaining refunds for prior taxable years and reducing their income and payroll tax liabilities for the current taxable year.

Income tax provisions

Relaxation of certain loss limitations

The CARES Act relaxes several of the limitations on losses that had been enacted as part of the TCJA. These changes are intended to allow companies to utilize current losses, amend prior year returns and apply for tax refunds with the goal of increasing cash flow and liquidity during the pandemic.

First, the TCJA limited deductions for net operating loss (NOL) carryovers and carrybacks to 80% of net income for taxable years beginning after December 31, 2017. Section 2303 of the CARES Act removes this 80% limitation entirely for taxable years beginning before January 1, 2021. The 80% limitation remains in place for taxable years beginning after December 31, 2020.

Second, the TCJA provided that NOLs arising in taxable years ending after December 31, 2017, could not be carried back to prior years and could be carried forward indefinitely to future taxable years. Section 2303 of the CARES Act restores a limited carryback, pursuant to which NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021, may be carried back to each of the five preceding taxable years. The indefinite carryforward of these NOLs remains unchanged. Further, the CARES Act provides a special exception to the standard filing deadline for carryback claims, permitting taxpayers to submit an application for tentative refund with respect to the carryback of an NOL arising in a taxable year beginning before January 1, 2018, and ending after December 31, 2017, within 120 days of the enactment of the CARES Act.

Corporations with NOLs arising in prior taxable years beginning in 2018 or 2019 can pursue refunds resulting from NOL carrybacks provided for under the CARES Act. NOL carrybacks could be especially valuable to corporate taxpayers that are able to offset income in 2017 or prior taxable years, during which corporations generally were subject to a 35% federal tax rate, rather than the current 21% rate. However, corporations that were profitable in 2018 and 2019 and are in a loss position for only the current taxable year generally will be required to wait until after the end of year to claim refunds attributable to NOL carrybacks.

The new carryback rule includes a limitation that prevents NOL carrybacks from being used to offset prior income inclusions under the transition tax provisions of Section 965 of the Internal Revenue Code (the Code). A taxpayer with Section 965 income inclusions is deemed to have made an election under that section not to use NOLs to offset the Section 965 amount. Alternatively, the taxpayer may elect to exclude from its NOL carryback any taxable years containing Section 965 inclusion amounts.

Finally, Section 2304 of the CARES Act temporarily eliminates the excess business loss limitation. The TCJA had imposed this limitation for all taxable years beginning after December 31, 2017, and before January 1, 2026, to prevent non-corporate taxpayers from using net business losses for a taxable year to offset other income of more than $250,000 (or $500,000 for married taxpayers filing jointly). Any disallowed losses are treated as an NOL carryover to the following taxable year. The limitation applied to the net business losses of sole proprietors, as well as partners' and S corporation shareholders' shares of pass-through net business losses. The CARES Act eliminates the limitation for taxable years beginning before January 1, 2021. The limitation will still apply for taxable years beginning after December 31, 2020, and before January 1, 2026.

Business interest deductions

Section 2306 of the CARES Act relaxes limitations on the deductibility of business interest expense that were enacted as part of the TCJA. Under the TCJA, for businesses with average annual gross receipts of $25,000,000 or more over the prior three years (for 2020, the inflation-adjusted amount is $26,000,000), interest deductions were limited to 30% of adjusted taxable income (ATI). ATI is generally taxable income increased by interest expense, NOLs and, for taxable years beginning before January 1, 2022, depreciation and amortization deductions. Businesses with interest expense above the 30% limit were allowed to carry these expenses forward into future tax years. The CARES Act increases the limitation to 50% of ATI for taxable years beginning in 2019 or 2020 while preserving taxpayers' ability to carry forward disallowed interest deductions.

Importantly, the CARES Act allows taxpayers to calculate the limitation for the taxable year beginning in 2020 based on ATI for the taxable year beginning in 2019. This provision should be helpful given the likelihood that many businesses will have less income in 2020 as compared to 2019.

For highly leveraged businesses that were denied immediate interest deductions under the TCJA, these changes should provide relief, since they will reduce cash taxes payable or generate or increase NOLs that, as noted above, are now able to be utilized more freely than under prior law. Partners in a partnership are subject to special rules with respect to business interest incurred by the partnership in taxable years beginning in 2019.

Bonus depreciation of qualified improvement property

Section 2307 of the CARES Act implements a technical correction that results in qualified improvement property being eligible for 100% bonus depreciation. Any improvement to the interior portion of a non-residential building made after it has been placed into service generally is qualified improvement property.

At the time of the TCJA, Congress had intended that qualified improvement property constitute 15-year property eligible for bonus depreciation, but failed to designate it as such in the applicable Code sections. The CARES Act remedies the drafting glitch, with an effective date that is retroactive to the enactment of the TCJA. The correction increases businesses' access to cash, as it allows them to amend prior year returns to claim the 100% bonus depreciation for qualified improvement property. It also incentivizes businesses to invest in property improvements, which would serve to stimulate the economy.

Acceleration of corporate AMT credits

Section 2305 of the CARES Act accelerates the timing for companies to claim refundable credits with respect to the corporate alternative minimum tax (AMT), allowing eligible corporations to obtain additional cash flow during the pandemic. The TCJA repealed the corporate AMT for taxable years beginning after December 31, 2017, and allowed corporations to recover unused AMT credits over taxable years beginning in 2018 through 2021. The CARES Act accelerates full recovery of outstanding AMT credits to no later than the taxable year beginning in 2019. Further, eligible corporations may instead elect to claim their entire AMT credit for the taxable year beginning in 2018 and apply for a tentative refund due to such election, which will be treated as timely if filed prior to December 31, 2020.

Tax-free loan forgiveness under the paycheck protection program

The CARES Act's paycheck protection program (the PPP) provides small businesses with federally guaranteed loans to help cover expenses and retain employees. Under this program, loans will be forgiven to the extent the recipient incurs qualifying payroll, mortgage interest, rent or utility expenses. Under Section 1106 of the CARES Act, loan amounts that are forgiven under the PPP are not included in gross income.

Tax treatment of federal loans and investments

Section 4003 of the CARES Act authorizes up to $500 billion of additional loans, guarantees and investments administered by the Federal Reserve and US Department of the Treasury to certain businesses, states and municipalities to provide liquidity related to losses incurred as a result of the pandemic. For federal income tax purposes, loans made or guaranteed by the Treasury Department under this section will be treated as indebtedness issued for its stated principal amount and stated interest on such loans will be treated as qualified stated interest. Therefore, businesses borrowing under these loans generally will be able to deduct the related interest payments, subject to applicable interest deduction limitations (some of which are temporarily relaxed, as described above). The principal amount of obligations under this program is not eligible to be reduced through loan forgiveness.

Additionally, the Treasury Department is directed to issue regulations providing that any equity investments under these programs will not result in an ownership change for purposes of Code Section 382. Thus, the NOLs of businesses receiving direct federal investments in the form of stock, warrants, options or other equity should not be limited under Section 382 as a result of such investments.

Payroll tax provisions

Payroll tax credits for affected businesses

As a means of encouraging employers to retain their workforce, Section 2301 of the CARES Act provides a refundable employment tax credit of 50% of the qualified wages paid by businesses affected by the pandemic. The credit applies only to employers whose business operations are fully or partially suspended because of a governmental shutdown order due to COVID-19 or that have experienced a significant decline in gross receipts. For purposes of these rules, a significant decline in gross receipts exists beginning with the first calendar quarter after December 31, 2019, for which gross receipts are less than 50% of gross receipts for the same quarter in 2019, and ending with the calendar quarter after the first calendar quarter for which gross receipts are greater than 80% of gross receipts for the same quarter in the prior year.

For employers that had on average more than 100 full-time employees in 2019, the credit applies only to wages that the employer pays to employees who are not working because the employer's business is fully or partially suspended because of a governmental shutdown order due to COVID-19 or because there has been a significant decline in the business' gross receipts. To prevent abuse, qualified wages for these employers cannot exceed the amount that the employee would have been paid for working an equivalent duration during the 30 days immediately preceding the period in question.

The credit applies to wages paid after March 12, 2020, and before January 1, 2021. Qualified wages are limited to $10,000 per employee in the aggregate and do not include wages for which an employer is receiving a tax credit for paid sick leave or paid family leave under the **Families First Coronavirus Response Act** (the FFCRA).

The CARES Act credit is applied against an employer's share of Social Security taxes (reduced by credits for paid sick leave and paid family leave allowed under the FFCRA and certain other tax credit provisions of existing law), which are 6.2% for the first $137,700 of an employee's wages for 2020. Credits in excess of these taxes are refundable and may be claimed by the employer on a quarterly basis. The tax credit is not available to employers that receive loans under the PPP. The CARES Act mandates that forms, instructions, regulations and guidance shall be issued to allow the advance payment of the credit, with reconciliation of such advance payment with the amount reported on the applicable tax returns.

Deferral of payroll tax payments for most employers

In order to reduce the strain on business cash flows, Section 2302 of the CARES Act allows most employers to defer, without interest, payment of their share of Social Security taxes that otherwise would be due for the period beginning March 27, 2020, and ending December 31, 2020. Under the CARES Act, 50% of such taxes will be due December 31, 2021, and the remaining 50% will be due December 31, 2022. Individuals subject to self-employment taxes are allowed to defer 50% of Social Security taxes on the same schedule. This relief does not apply to employers that have had loans forgiven under the PPP as a result of incurring qualifying payroll, mortgage interest, rent or utility expenses.

Advance refunding of credits available under FFCRA

Section 3606 of the CARES Act amends the FFCRA to allow for advances of payroll tax credits available under the FFCRA for sick leave and expanded family leave wages mandated under the FFCRA. That section also provides penalty relief for failure to deposit payroll tax amounts in anticipation of those credits.

Coronavirus resource hub

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