To Our Clients and Friends:

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Major Tax Changes in the CARES Act

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The COVID-19 pandemic has disrupted economic life throughout the United States (as it has all over the globe), and Federal, state, and local governments have acted to address the disruptions, to encourage employment, and to stimulate the economy. The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), signed by President Trump on March 27, 2020, includes many such initiatives. This mailing addresses some of the major Federal income tax changes effected by the CARES Act.[1]

Recovery Rebates

The income tax system has been coopted into the distribution of "rebates," generally $1,200 per adult and $500 per dependent child, to taxpayers whose incomes are below $75,000 ($150,000 in the case of married couples filing a joint return). Entitlement to the rebate phases out and is ultimately reduced to zero in the income range from $75,000 to $99,000 ($198,000 in the case of a joint return).

Charitable Contributions

The CARES Act includes several provisions intended to encourage charitable giving in 2020. In general, deductible charitable contributions can be made in cash or in property and can be made either "to" or "for the use of" a charity. However, the charitable contribution deduction cannot exceed (i) specified percentages (20%, 30%, 50%, or 60%) of an individual taxpayer's adjusted gross income, depending on the type of property contributed, the charity to which the contribution is made, and whether the contribution is made outright or in trust, or (ii) 10% of a corporate taxpayer's taxable income. The charitable contribution deduction is generally a "below the line" deduction not allowable in the computation of adjusted gross income, and it therefore provides no benefit to individual contributors who do not itemize deductions.

In the case of contributions made during 2020 in cash to a so-called "public charity," other than a donor-advised fund and other than a "supporting organization," the Act removes the percentage limitation on deductions by individuals and increases the limitation on contributions by corporations from 10% to 25%. These changes in the limitation do not apply to contributions of property other than cash or to contributions to most private foundations. They also do not apply to contributions "for the use of" charities, so they are not available for contributions to most charitable trusts. Cash donations to religious, educational, medical, and relief-oriented domestic charitable institutions generally will qualify.

Taxpayers in whose particular situations the change in percentage limitations results in an unfavorable tax result may elect not to apply the new rule.

The Act also provides that individuals who do not itemize deductions can claim an "above the line" deduction for up to $300 of cash charitable contributions made during 2020.

Paycheck Protection Loans

The Act creates the $349 billion "Paycheck Protection Program" ("PPP") aimed at providing targeted loans of up to $10,000,000 for small businesses to enable them to retain and to pay their employees. Under the PPP, substantial portions of the loans may be forgiven if the loan proceeds are used in specified ways during a specified time period (generally within eight weeks of receipt of proceeds). The amount of forgiveness decreases, and the amount of the loan that must ultimately be repaid correspondingly increases, if there are reductions in the number of the borrower's employees or in their compensation during the first eight weeks that the loan is outstanding, measured against comparable amounts in specified base periods. Loans under the PPP may be made from February 15, 2020, through June 30, 2020.

The Act prescribes extremely favorable income tax income treatment for forgiveness of a PPP loan. Ordinarily, income from the discharge of indebtedness is included in a taxpayer's gross income. However, the Act provides that "any amount which…would be includible in gross income of the eligible recipient by reason of forgiveness described in [this provision] shall be excluded from gross income." While a number of technical issues have been raised about the scope and collateral effects of this exclusion, it appears to have been Congress's intent here to confer a benefit with no associated tax cost.

Employee Retention Credit

The Act generally provides for a refundable payroll tax credit equal to 50% of the qualified wages paid by an employer after March 12, 2020, and before January 1, 2021, limited to $10,000 of wages paid per employee. Only employers who do not receive loans under the Paycheck Protection Program are eligible for the credit; therefore, the credit is of most use to employers who do not qualify for such loans, such as those with more than 500 employees. An employer who receives a loan is ineligible for the credit, even if no portion of the loan is ultimately forgiven.

Eligibility for the credit is determined on a quarter-by-quarter basis. In order to be eligible for the credit for a given quarter, an employer must have carried on a trade or business during the year 2020, and either (1) the operation of the trade or business is fully or partially suspended during the quarter due to a governmental order relating to coronavirus or (2) the trade or business experiences a "significant decline in gross receipts" for the quarter. A trade or business is treated as having a "significant decline in gross receipts" during a quarter if its gross receipts for that quarter are less than 50% of those for the comparable quarter of the prior year. It is then treated as continuing to have a "significant decline in gross receipts" for subsequent quarters, continuing through the end of the first quarter in which its gross receipts are more than 80% of those for the comparable quarter of the prior year.

For an employer with 100 or fewer average full-time employees in 2019, the "qualified wages" used to calculate the credit are all wages paid during the period that operation of the business is suspended or during which there is a significant decline in gross receipts, regardless of whether the employees are actually working. For an employer with more than 100 average full-time employees in 2019, qualified wages only include those paid to employees for time not spent working, and only if such wages are equivalent to wages the employees would have been paid for working an equivalent duration during the 30-day period before the period at issue. For these purposes, related employers are aggregated with one another and wages paid to certain related persons are not taken into account.

An employer may claim this tax credit on its quarterly employment tax return (Form 941). However, in advance of filing such a return, an employer may receive the benefit of the credit by taking back funds that it had previously set aside for deposit of employment taxes with the IRS. To the extent these funds are less than the employer's expected tax credit, the employer may file Form 7200 to receive an advance payment from the IRS. An employer will not be liable for penalties for failure to deposit employment taxes if the employer has paid qualified wages to its employees in the calendar quarter prior to the time of deposit and the amount of employment taxes the employer does not deposit is no more than its anticipated credits (less any advance credits sought by filing Form 7200).

For income tax purposes, it appears that an employer's deduction for payroll taxes is reduced by the amount the credit offsets its payroll taxes, and that the employer has taxable income to the extent the credit exceeds such payroll taxes.

Delay in Payment of Employment Taxes

An employer may defer payment of its share of payroll taxes for the period beginning on March 27, 2020, and ending on December 31, 2020.[2] Fifty percent of the payroll taxes for this period are now due on December 31, 2021, and the remaining 50% of the deferred payroll taxes are now due on December 31, 2022. The deferral applies only to employers' share of OASDI taxes (generally 6.2% of wages, but subject to a cap); employers must continue to pay their share of Medicare taxes (generally 1.45% of wages, without a cap) as scheduled.

The Act provides comparable benefits to self-employed individuals, allowing them to defer up to 50% of OASDI self-employment taxes (at a 6.2% rate) from the period beginning on March 27, 2020, and ending on December 31, 2020. As with employer payroll taxes, 50% of these deferred taxes are due on December 31, 2021, and the remaining 50% are due on December 31, 2022. Self-employed individuals must continue to pay all self-employment taxes attributable to Medicare and the remaining 50% of OASDI self-employment taxes, as currently scheduled.

A taxpayer that has had any portion of a loan made under the Paycheck Protection Program forgiven is not eligible for the deferral of the employer's share of payroll taxes. Therefore, to avoid potential interest and penalties on underpayments of employment taxes, a taxpayer that expects to have any such loan forgiveness should continue to pay all payroll taxes on their regularly scheduled due dates. A taxpayer that borrows under the PPP, but repays the loan in full, is eligible for the deferral.

For income tax purposes, an accrual-method taxpayer will generally not be able to deduct payroll taxes deferred under this provision until the year of payment.

Increased Deductibility of Business Interest, Business Losses, and Net Operating Loss Carryovers

Business Interest

A taxpayer's deduction for business interest for a taxable year is generally limited to the sum of the taxpayer's business interest income for that year plus 30% of the taxpayer's "adjusted taxable income" ("ATI") for that year. The CARES Act makes a number of significant changes to this limitation.

First, for taxable years beginning in 2019 and 2020, 50%, rather than 30% of ATI can be taken into account in computing the limitation, except in the case of partnerships' business interest expense for 2019, with respect to which the rules are more complicated. For partnerships, the limitation on deductible business interest expense for 2019 remains at 30%. However, each partner in the partnership may then treat 50% of that partner's share of the disallowed business interest expense as a deductible expense incurred in 2020. The remaining 50% of disallowed 2019 interest expense remains suspended at the partner level until the partner has sufficient income to "free" it in 2020 or subsequent years, as under the current rules. Partnerships' business interest expense for 2020 is subject to a 50% of ATI limitation at the partnership level, and the special partner-level rules do not apply. Taxpayers may elect out of the new rules.

Second, any taxpayer may elect to treat that taxpayer's 2020 ATI as equal to that taxpayer's 2019 ATI for purposes of calculating the 2020 business interest limitation. This election will generally be beneficial for taxpayers whose ATI declines from 2019 to 2020.

The Act does not address the impact of these changes on "electing real property trades or businesses" that are not subject to the business interest limitation rules. As a toll charge for being permitted to make this election, such a business is required to "stretch out" its depreciation deductions under the alternative depreciation system ("ADS"). An electing taxpayer might now determine that it would be willing to be subject to the less onerous version of the limitation imposed by the Act, so long as it was permitted to shift away from ADS. However, the election is stated by prior law to be irrevocable, and the Act does not provide any explicit rule that lifts that restriction.

Business Losses

Since January 1, 2018, a limitation has existed on the ability of non-corporate taxpayers (individuals, estates, and trusts) to offset "excess business losses" against their investment income. "Excess business losses" are the excess of a taxpayer's trade or business deductions over the sum of the taxpayer's gross income attributable to trades or businesses plus $250,000 ($500,000 in the case of joint return filers). Any disallowed excess business losses were carried to later years, and the Internal Revenue Service seems to have conceded that they could be used against investment income in the later years to which they were carried.

The Act revokes this limitation for taxable years beginning before January 1, 2021, and leaves it applicable only for taxable years beginning after December 31, 2020, and before January 1, 2026. Taxpayers the deductibility of whose losses was limited on 2018 returns (or, less likely, on 2019 returns already filed) may need to file amended returns to take advantage of this change.

Net Operating Loss Carryovers and AMT Credits

Prior to the Act, a taxpayer could use net operating loss carryovers from prior years against only 80% of the income for the year to which they were carried. A taxpayer could not carry net operating losses back to a prior year. The Act removes the 80% limitation with respect to the use of net operating loss carryovers in years beginning before January 1, 2021. The Act also allows net operating losses arising generally in 2018, 2019, and 2020 to be carried back for five years. In the case of net operating losses incurred in 2018 and 2019, this may give taxpayers an opportunity to obtain refunds within a fairly brief period of time. (Since tax rates were higher in years before 2018, this may be a particular benefit.)

The ability of certain corporate taxpayers to use certain alternative minimum tax credits is accelerated by the Act.

Disaster Relief Payments

Present circumstances have also renewed focus on an existing provision of the Internal Revenue Code, section 139, which excludes "qualified disaster relief payments" received by an individual from gross income. Such payments include amounts paid to or for the benefit of an individual "to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster" and amounts paid by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster, "in order to promote the general welfare." The exclusion does not apply to amounts received to reimburse for expenses otherwise compensated (including by insurance).

At the time that a nation-wide "emergency" was initially declared with respect to the pandemic, technical questions were raised regarding whether that "emergency" fits the definition of a "qualified disaster" that invokes section 139. Those questions have largely been put to rest by subsequent IRS guidance.

There is little authority defining exactly what sorts of expenses may be reimbursed with payments that qualify under section 139 and how one demonstrates that such expenses were incurred "as a result" of a qualified disaster. However, the legislative history of the provision indicates a liberal approach to such matters in its statement that "it is anticipated that individuals will not be required to account for actual expenses in order to qualify for the exclusion, provided that the amount of the payments can be reasonably expected to be commensurate with the expenses incurred."

Enhanced Depreciation for "Qualified Improvement Property"

In 2017, Congress liberalized the "bonus depreciation" rules, under which a depreciation deduction equal to 100% of the cost of certain categories of tangible property can be claimed in the year in which that property is placed in service. Unfortunately, the 2017 Act contained a technical error, as a result of which "qualified improvement property," which had been intended by Congress to qualify for this benefit and to be depreciated over a 15-year period if bonus depreciation was not elected, was excluded from the relevant statutory definitions. The CARES Act corrects this error.

QIP, generally, is any interior improvement to nonresidential real property. In order to qualify as QIP, property must be an improvement to an existing building; ground-up construction does not qualify. QIP can include nonstructural improvements to common areas of a building, as well as nonstructural improvements made by a lessor to space leased to a tenant (or by a tenant to its own space).

The CARES Act makes QIP eligible for bonus depreciation and provides that the cost of QIP for which bonus depreciation is not elected may be recovered over 15 years (rather than over 39 years, as was the case before the CARES Act). As the change is retroactive to the effective date of the corresponding provisions of the 2017 Act, taxpayers may amend returns for prior years to take advantage of these changes.

Two complications are worthy of mention. First, as noted in the discussion of the business interest limitation, above, the Act does not address the impact of these changes on "electing real property trades or businesses" that are not subject to the business interest limitation rules, and, as a toll charge, have been subjected to a more onerous depreciation regime that does not allow for bonus depreciation on any property. Second, the Act specifically limits the definition of QIP to improvements "made by the taxpayer." Since taxpayers can generally not claim any depreciation deductions with respect to improvements made by others, it is unclear what additional restrictions are intended by this language.

Employer Payment of Employee's Student Loans

The Act excludes from tax employer contributions made to repay employees' student loans for higher education. The employer payment can be made to the employee or to the lender. The exclusion applies to payments made between March 27, 2020, and December 31, 2020, and is applicable for both the principal and interest portions of the loan.

There is a $5,250 cap on the amount that can be excluded under this provision. Any 2020 contribution made by an employer to an educational assistance program will reduce the amount available for these student loan repayments and vice versa.

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Income taxes will be only one of many concerns as businesses and individuals face the many personal and financial challenges presented by the pandemic. If you have any questions about how the CARES Act is likely to affect your individual situation, please contact Elliot Pisem (212-903-8777; episem@rhtax.com), Stuart Gross (212-903-8723; sgross@rhtax.com), Ellen Brody (212-903-8712; ebrody@rhtax.com), or any of our other attorneys.

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[1] Our memorandum on selected pension and employee benefit provisions of the CARES Act is available at Stimulus Package Includes Financial Relief for Retirement Plan Participants Affected by COVID-19.

[2] The Act is ambiguous as to whether all payroll taxes payable during this period may be deferred or whether only those that accrue during this period may be deferred.