WINSTON & STRAWN LLP

Tax Provisions in the CARES Act’s Phase Three Stimulus in Response to COVID-19

Mar 26, 2020

On March 25, 2020, the Senate passed H.R. 748, titled the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) (the “Bill”), as Phase Three of the response to the COVID-19 pandemic. The Bill, a modified version of a legislative proposal released last week by Senate Republicans, is the product of a compromise between Democrats and Republicans. The House is expected to pass the Bill, and the President is expected to sign it into law, in the near future. While the Bill provides economic stimulus through various means, this article focuses on its tax provisions.

PAYROLL TAX CREDITS

The Bill’s provisions include a refundable tax credit to eligible employers equal to 50% of qualified wages paid to employees during a calendar quarter, up to the first $10,000 of wages per employee. The tax credit would be applied against the employer’s Social Security payroll tax obligations for any calendar quarter, with any excess credit being refundable to the employer.

An eligible employer is any employer that conducted a trade or business during calendar year 2020, and either was required by a governmental authority to fully or partially suspend such trade or business due to COVID-19 circumstances, or experiences a significant decline in gross receipts. A business experiences a significant decline in gross receipts beginning in any calendar quarter in 2020 where its gross receipts are less than 50% of its gross receipts in the same calendar quarter of its prior year and ending in the first calendar quarter thereafter where its gross receipts recover to equal more than 80% of its gross receipts for the corresponding calendar quarter of its prior year.

The definition of qualified wages eligible for the 50% credit depends on the size of the employer. For employers that had on average more than 100 full-time equivalent employees in 2019, qualified wages are wages paid to employees during the applicable period when they are not providing services due to the COVID-19-related circumstances. For eligible employers that had on average 100 or fewer full-time equivalent employees in 2019, all employee wages qualify for the credit during the period in which the employer remains an eligible employer.

The payroll tax credit would not apply to companies that receive a covered loan under provisions of the Bill relating to loans authorized by the Small Business Act.

An aggregation rule applies that treats certain related parties as a single employer.

> ***Winston takeaway: This aggregation rule may result in multiple portfolio companies of a single investment fund being considered one employer for purposes of the payroll tax credit. Private investment funds and their portfolio companies should carefully review these provisions to determine which companies would be eligible for this payroll tax credit.***

PAYROLL TAX DEFERRAL

The Bill provides that payment of an employer's portion of Social Security payroll taxes with respect to wages paid in 2020 would be delayed. Specifically, 50% of an employer's Social Security payroll taxes otherwise due after the date of enactment in 2020 would not be due until December 31, 2021, with the remaining 50% deferred until December 31, 2022. A similar provision would apply to 50% of the Social Security portion of self-employment tax. The payroll tax deferral provisions would not apply to companies that take advantage of a loan forgiveness provision of the Bill relating to loans authorized by the Small Business Act.

MODIFICATION OF LIMITATIONS ON CHARITABLE DEDUCTIONS

For taxpayers who itemize deductions, the Bill provides that the limitations on charitable deductions would not apply to charitable contributions made in cash during 2020 if the taxpayer so elects (subject to a cap equal to the taxpayer's 2020 adjusted gross income less non-cash charitable contributions made in 2020). Notably, this modification also applies to contributions to operating private foundations, but not to donor-advised funds or supporting organizations. For corporations, the Bill increases the existing 10% taxable income limitation to 25% of taxable income (determined without regard to certain deductions).

The Bill also provides for an "above-the-line" charitable deduction of up to $300 for individuals who do not itemize deductions.

TAX CREDITS FOR INDIVIDUALS

The Bill provides for a refundable $1,200 tax credit against 2020 taxes for each eligible individual ($2,400 for individuals filing joint returns) with an additional $500 credit for every qualifying child under the age of 17. Eligible individuals are defined to include any individual who is not claimed as a dependent on another taxpayer's return. A phase-out provision reduces the tax credit by 5% of the amount of adjusted gross income in 2020 over $75,000 ($150,000 for individuals filing joint returns), so that the credit is reduced to zero for individuals with taxable income over $99,000 ($198,000 for joint filers), adjusted for the number of any qualifying children. The Bill also contains an advanced refund provision to enable the distribution of cash to taxpayers who would have been eligible based on their 2019 taxable income (or 2018 taxable income if the taxpayer's 2019 tax return has not yet been filed) as quickly as possible.

ROLLBACKS AND CORRECTIONS TO THE TCJA

In addition, the Bill provides for rollbacks of, and corrections to, certain tax provisions in the Tax Cuts and Jobs Act of 2017 (the "TCJA"), as described below.

TEMPORARY REMOVAL OF NOL LIMITATIONS

Under current law, the deduction for net operating loss ("NOL") carryforwards is limited to 80% of a taxpayer's taxable income computed without regard to NOLs. Additionally, taxpayers cannot currently carryback NOLs to claim a refund for taxes paid in prior years. These limitations on NOLs were originally enacted by the TCJA and apply to taxable years beginning after December 31, 2017.

The Bill would eliminate the 80% taxable income limitation for NOLs utilized in taxable years beginning before January 1, 2021, and the current 80% limitation would be reinstated for taxable years beginning after December 31, 2020.

The Bill also provides a five-year carryback period for NOLs incurred in taxable years beginning after December 31, 2017 and before January 1, 2021 (unless waived by the taxpayer). This carryback provision would allow taxpayers who have incurred losses in any of the past two years, or will incur a loss this year, to obtain a refund of taxes paid in the five years preceding the year of the loss. Special rules apply to REITs and life insurance companies, and with respect to the interplay between NOL carrybacks and any liability a taxpayer had under Section 965 of the Code (the 2017 transition tax relating to untaxed earnings of certain foreign corporations).

The five-year carryback provision temporarily addresses a criticism of the TCJA, namely that prohibiting NOL carrybacks deprives companies of a needed source of liquidity in down business cycles. Taxpayers would claim a refund under the carryback provision by filing an IRS Form 1045 (for individuals, estates, and trusts) or IRS Form 1139 (for corporations). The IRS generally will process the refund request within 90 days (or the last day of the month in which the tax return reflecting the NOL is due, including extensions, if later).

> ***Winston takeaway: Many purchase agreements in the M&A context provide for payment to sellers of tax refunds for pre-closing tax periods. Due to extraordinary expenses related to the acquisition, an acquired corporation may have NOL carryforwards from the pre-closing tax period. Corporations that have been acquired during the 2018–2020 tax periods should carefully analyze the tax refund provisions, if any, in the relevant purchase agreement before carrying back any NOLs to taxable years prior to the acquisition.***

TEMPORARY RELAXATION OF BUSINESS INTEREST DEDUCTION LIMITATIONS

Section 163(j) of the Code, relating to limitations on deductions for interest expense, was amended as part of the TCJA. In general, business interest expense deductions in any taxable year currently are limited to 30% of the business's adjusted taxable income for the year. Although not precise, for taxable years beginning before January 1, 2022, adjusted taxable income essentially equates to earnings before interest, tax, depreciation, and amortization ("EBITDA"), as used in the general sense and not how most banks use it (as it starts from taxable income, not book, and does not add back unusual or non-recurring cash charged). The Bill would change the 30% adjusted taxable income limitation to 50% for taxable years beginning in 2019 and 2020, allowing additional interest expense to be deducted for those years. In addition, a taxpayer would be permitted to elect to use its 2019 adjusted taxable income in making its Section 163(j) calculation for 2020. This election would be useful to businesses that see a reduction in EBITDA in 2020 because of the COVID-19 pandemic.

The relaxation of the Section 163(j) limitation would not apply to partnerships for taxable years beginning in 2019. Rather, unless a taxpayer elected out, 50% of a partner's allocable share of a partnership's excess business interest expense for 2019 (i.e., interest expense that would otherwise be nondeductible by the partner under Section 163(j)), is allowed as an interest deduction for 2020 without limitation. The remaining 50% of such excess business interest expense would remain subject to the normal Section 163(j) limitation.

> ***Winston takeaway: The relaxation of the Section 163(j) rules and the temporary five-year NOL carryback provision provide an avenue for liquidity for corporations that expect significant tax losses in 2020 as a result of the COVID-19 pandemic, although a large portion of that liquidity may be deferred until corporations file their 2020 U.S. federal income tax returns in 2021. In particular, the election to use a higher 2019 adjusted taxable income number in making a corporation's 2020 Section 163(j) interest deduction calculation will maximize a corporation's potential NOL in 2020. That NOL can then be carried back to obtain refunds for taxes paid for tax years 2015 through 2019.***

TEMPORARY ROLLBACK OF LIMITATIONS RELATING TO EXCESS BUSINESS LOSSES OF INDIVIDUALS, TRUSTS, AND ESTATES

The TCJA added Section 461(l) to the Code as an additional limitation on the use of losses by noncorporate taxpayers. This section disallows any excess business losses of taxpayers, other than corporations, for taxable years beginning after December 31, 2017 and before January 1, 2026. Disallowed losses are treated as NOLs in the following taxable year, subject to the 80% limitation described above. The Bill would modify the effective dates of this provision to apply only to excess business losses incurred in taxable years beginning after December 31, 2020 and before January 1, 2026. Taxpayers impacted by the excess business loss rules in 2018 (and taxpayers who have already filed their 2019 tax returns) could amend their 2018 (or 2019) tax returns to claim any resulting refund.

THE RETAIL GLITCH FIX

The Bill would also fix the so-called "retail glitch" of the TCJA. The TCJA attempted to combine various definitions of "improvement property" into a single definition of "qualified improvement property." Qualified improvement property was intended to have a 15-year depreciable life, thereby allowing taxpayers to deduct 100% of capital expenditures made on these improvements under the expensing provision of the TCJA. The "glitch" lay in the fact that the legislation failed to assign qualified improvement property a 15-year depreciable life. This meant that such improvements are treated as having a 39-year depreciable life under current law and therefore are not eligible for immediate expensing. The Bill would fix this glitch and thereby allow taxpayers to fully deduct expenditures made on qualified improvement property. The effective date of this provision is retroactive as if it were included in the TCJA.

CORPORATE ALTERNATIVE MINIMUM TAX CREDITS

The Bill also accelerates the recovery period for corporate alternative minimum tax ("AMT") credits. Under the TCJA, which repealed the corporate AMT, corporate AMT credits for prior years were recoverable over a four-year period. The new recovery period for these credits would be treated as if it had occurred in the 2018 and 2019 taxable years.

PROPOSAL NOT INCLUDED

A prior version of the Bill included a technical correction to the TCJA relating to the repeal of the limitation on "downward attribution" that applied for purposes of determining whether a foreign corporation qualified as a controlled foreign corporation. This technical correction was not included in the final Bill passed by the Senate. As a result, current law relating to such downward attribution will continue to apply.

For more information, please contact Rob Heller at rheller@winston.com, Olga Loy at oloy@winston.com, Rachel Ingwer at ringwer@winston.com or your Winston relationship attorney.

View all of our COVID-19 perspectives here. Contact a member of our COVID-19 Legal Task Force here.

RELATED PROFESSIONALS

Rachel Ingwer Partner
New York +1 212-294-4760

Robert B. Heller Partner
New York +1 212-294-6776

Olga A. Loy Partner
Chicago +1 312-558-6338