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ABOUT THE AUTHOR

Gene Chianelli is a tax law attorney with more than 20 years of experience assisting private and public entities with state and federal tax policy, planning, and compliance. He is a member of the North Carolina Bar Association Tax Council and currently serves as an adjunct professor at Campbell University's Lundy-Fetterman School of Business, where he teaches advanced income taxation to law students and students enrolled in the school's Master of Trust and Wealth Management program.

The CARES Act: Business Tax Changes to Improve Liquidity

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On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") was signed into law by President Trump. The CARES Act is the third major piece of legislation in response to the COVID-19 pandemic, following the March 6 spending bill and the March 18 Families First Coronavirus Response Act. It is a massive stimulus bill and includes direct payments to individuals, expanded unemployment benefits, lending facilities to large and small businesses, and individual and business tax changes.

This Update discusses certain business tax changes in the CARES Act intended to improve liquidity. These changes are divided into two categories – new business tax rules and technical corrections to The Tax Cuts and Jobs Act of 2017 (the "TCJA").

NEW BUSINESS TAX RULES UNDER THE CARES ACT

Deferral of Employer Payroll Tax and Self-Employment Tax Payments: Under the CARES Act, employers may defer payment of the employer portion of Social Security taxes otherwise due during a "deferral period" beginning March 27, 2020 (the date of enactment) and ending on January 1, 2021. One-half of the deferred taxes are due December 31, 2021, with the remainder due December 31, 2022. Employers who have a small business interruption loan forgiven under the CARES Act are not eligible for this deferral.

Self-employed individuals may defer payment of one-half of the 12.4 percent self-employment tax due during the same March 27, 2020, to January 1, 2021 period.

Tax Credit for Employee Retention: For qualifying employers, the CARES Act provides a refundable employment tax credit equal to 50 percent of qualified wages paid to each employee, with a maximum credit (per employee) of $5,000. Qualifying wages must be paid to employees during shutdowns or periods of significant revenue loss from March 12, 2020, through December 31, 2020, which occur as a result of the COVID-19 pandemic.

Qualifying Employers. Employers of all sizes potentially qualify for the credit, however, the definition of “qualified wages” depends on whether the employer has more than 100 full-time employees (“FTEs”) or 100 or fewer FTEs. An employer is eligible for the credit if it was engaged in a trade or business in 2020 and: 1) its business operations were fully or partially suspended by a governmental authority due to the COVID-19 pandemic; or 2) the business saw a significant (at least 50 percent below the same calendar quarter of the prior year) decline in gross revenue. The credit applies until the business’s revenue recovers to 80 percent of the prior year’s revenue.

Amount of the Credit. The employer is allowed a credit equal to 50 percent of “qualified wages” paid to each employee during any quarter for which the credit is available (i.e., the business meets the qualification criteria above). The maximum amount of qualified wages per employee upon which the credit can be based is $10,000 for all quarters, therefore, the maximum amount of the credit is $5,000 per employee.

The credit is applied to the employer’s share of Social Security taxes for the quarter reduced by other allowable credits (including the credits for paid sick leave and paid family leave under the Families First Coronavirus Response Act). The credit is refundable, meaning that any credits in excess of tax liability will be refunded to employers.

Qualified Wages. The definition of “qualified wages” depends on the size of the employer. For employers who averaged fewer than 100 FTEs during 2019, “qualified wages” include wages paid to any employee during a shutdown and wages paid to any employee in a quarter during a significant revenue loss period (the at least 50 percent revenue decline test described above), regardless of whether or not the employee was actually working during those times.

Where an employer averaged more than 100 FTEs in 2019, “qualified wages” means wages paid to an employee not providing services because of a shutdown or during a significant revenue loss period (again, the at least 50 percent revenue decline test described above). Credited wages cannot exceed what the employee would have been paid for working the same amount of time during the preceding 30 days.

“Qualified wages” include allocable employer-paid qualified group health plan costs.

Restrictions. The credit is subject to several restrictions:

- The credit is not available to governmental employers;
- Employers may not claim the credit with respect to any employee for any period if the employer is allowed a work opportunity credit for the same employee during the same period;
- “Qualified wages” (as defined above) may not be taken into account for purposes of the Section 45S paid family and medical leave credit; and
- The credit is not available to employers who receive a small business interruption loan under the CARES Act.

Penalty Waivers. The CARES Act requires the IRS to waive penalties for failure to deposit payroll taxes if the failure was due to the reasonable anticipation of the credit.

Charitable Contribution Deduction Limit Increase for Corporations: The CARES Act increases the deduction limitation for corporations for charitable contributions made to 25 percent of taxable income, up from 10 percent of taxable income under prior law, so long as the contribution is made to a "public charity." Corporations can also deduct charitable contributions of food inventory up to 25 percent of taxable income, up from 15 percent of taxable income under prior law, again so long as the contribution is made to a "public charity."

TECHNICAL CORRECTIONS TO THE TAX CUTS AND JOBS ACT OF 2017

The CARES Act includes several "technical corrections" to the TCJA that are intended to provide liquidity to businesses undergoing economic hardships due to the COVID-19 pandemic.

Net Operating Loss Changes for Corporate Taxpayers: The TCJA made two important changes to the net operating loss ("NOL") rules applicable to corporate taxpayers. First, for losses arising after 2017, the TCJA generally limited the NOL deduction to 80 percent of taxable income. Second, the TCJA provided for the unlimited carryforward of NOLs but eliminated most corporations' right to carry the loss back to earlier years.

The CARES Act temporarily eliminates both the 80 percent of taxable income limitation and the prohibition on carrybacks. The elimination of the 80 percent of taxable income limitation means that corporations can offset a NOL carryforward with up to 100 percent of taxable income from 2018, 2019, and 2020.

The Act permits corporate taxpayers to carry back NOLs arising in 2018, 2019, and 2020 to the five preceding years. No election is required for this carryback. Insurers and farming businesses, who were allowed a limited carryback of NOLs under the TCJA, also benefit from this new rule.

It is expected that corporate taxpayers will claim refunds based on this expansion of the availability of the NOL deduction to boost liquidity.

Delayed Onset of Loss Limitations for Noncorporate Taxpayers: The TCJA created a limitation on noncorporate taxpayers' deductions for business losses in excess of an inflation-adjusted $250,000 ceiling ($500,000 for married taxpayers filing jointly). Disallowed losses may be carried forward as NOLs.

This limitation applies to years beginning in 2018 and continues through 2025. The CARES Act delays the application of this limitation until tax years beginning after 2020. This creates refund opportunities for noncorporate taxpayers who were subject to the limitation in 2018 and 2019.

Acceleration of Excess Corporate AMT Credit Refunds for 2018 and 2019: A taxpayer is allowed a credit against its regular income tax liability equal to all or part of its alternative minimum tax ("AMT") liability paid in previous years, with unused credits carried forward indefinitely. The TCJA repealed the AMT for corporate taxpayers effective for tax years beginning after 2017.

Any AMT credit carried forward to years after 2017 is generally limited to the taxpayer's regular tax liability. However, 50 percent of any excess AMT credit carried to 2018, 2019, and 2020 is refundable, and 100 percent of any remaining excess credit is refundable in 2021.

The CARES Act accelerates refunds of excess AMT credits by making 100 percent of the excess AMT credit refundable for 2019. The Act also permits taxpayers to elect to make the credit 100 percent refundable for 2018 by filing a tentative refund application no later than December 31, 2020.

Business Interest Deduction Increase: The TCJA imposed a limit on trade or business interest deductions. In general, the TCJA limits the deduction for net business interest to 30 percent of adjusted taxable income.

The CARES Act increases the net business interest deduction limit to 50 percent of adjusted taxable income for taxable years beginning in 2019 or 2020. Assuming that taxpayers will have lower taxable income in 2020, the Act permits taxpayers to elect to apply the 2020 limit by using 2019 adjusted taxable income.

With respect to partnerships, the CARES Act retains the 30 percent limitation for 2019, but a partner receiving an allocation of suspended interest in 2019 is permitted to deduct half of such interest in 2020.

Bonus Depreciation and 15-Year Recovery Period for Qualified Improvement Property: The TCJA created uncertainty with respect to the depreciation of qualified improvement property ("QIP"). QIP is generally interior improvements to nonresidential real property made after the property was placed in service.

The TCJA failed to designate a depreciation recovery period for QIP. Therefore, QIP was subject to a 39-year recovery period like other nonresidential real property. Also, QIP was ineligible for bonus depreciation because bonus depreciation is only available for property with a recovery period of 20 years or less.

The CARES Act provides that QIP has a recovery period of 15 years, therefore making it eligible for bonus depreciation. This technical correction is effective retroactively to taxable years beginning during or after 2018.

Income Exclusion of Small Business Loan Forgiveness: The CARES Act expands the Small Business Act to create a small business interruption loan program to make loans to a broad array of businesses and nonprofits to cover operating expenses. Taxpayers that receive loans before the end of June 2020 would be eligible to have the loan forgiven in an amount equal to the cost of maintaining payroll during the period from March through June.

Under general income tax principles, debt that is forgiven results in gross income for the debtor. The CARES Act provides that any debt forgiven under this new Small Business

Act program will be excluded from gross income.

We at Smith Debnam continue to monitor these and other developments closely as part of our comprehensive response to the COVID-19 pandemic. If you have any questions, please call tax partner Gene Chianelli at (919) 250-2231 or e-mail him at echianelli@smithdebnamlaw.com.

CONTACT US

919.250.2000
mail@smithdebnamlaw.com

RALEIGH OFFICE

The Landmark Center
4601 Six Forks Road, Suite 400
Raleigh, NC 27609

Phone: 919.250.2000
Fax: 919.250.2100

CHARLESTON OFFICE

171 Church Street
Suite 120C
Charleston, SC 29401

Phone: 843.714.2530
Fax: 843.714.2541