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Client Alert Commentary

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COVID-19: CARES Act Eases Key US Tax Rules, Throwing a Lifeline to Some Businesses

The newly enacted CARES Act attempts to lessen taxpayers' federal income tax obligations and increase their cash flow during the COVID-19 pandemic.

Key Points:

- Allows a five-year carryback for net operating losses (NOLs) generated in 2018, 2019, and 2020 and temporarily lifts the 80% taxable income offset limitation for NOLs in such years
- Temporarily increases a taxpayer's business interest deduction limitation to 50% of "adjusted taxable income" (ATI) in 2019 and 2020 and allows a taxpayer to use 2019 taxable year ATI to determine its 2020 limitation (special rules apply for partnerships and their partners)
- Allows improvements to an interior portion of a nonresidential building placed in service after September 27, 2017, to qualify for 100% bonus depreciation

On March 27, 2020, President Donald J. Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to address the COVID-19 pandemic. This emergency relief includes a temporary rollback of some of the limitations imposed by the 2017 tax reform legislation that is referred to as the Tax Cuts and Jobs Act (TCJA) on the deductibility of NOLs and business interest. The CARES Act also includes a retroactive technical correction to the "retail glitch" under the TCJA's 100% bonus depreciation rules that did not allow bonus depreciation to apply to improvements to nonresidential real property, modifications to noncorporate business loss rules, and a provision allowing for quicker recovery of corporate alternative minimum tax refunds. Further guidance from the Department of Treasury (Treasury) and the Internal Revenue Service (IRS) may be necessary to implement these changes.

Modification of Section 172[1] "NOL Rules"

Pre-CARES Act

The TCJA significantly limited the ability of taxpayers to utilize NOLs arising in taxable years beginning after December 31, 2017. The TCJA prohibited the carryback of NOLs generated after December 31, 2017, to prior taxable years and imposed an annual limitation of 80% on the amount of taxable income that post-2017 NOLs may offset.

CARES Act

The CARES Act temporarily rolls back the limitations on the deductibility of NOLs. NOLs generated in 2018, 2019, and 2020 are now permitted to be carried back to each of the five preceding taxable years.[2] NOLs generally are carried back first to the earliest taxable year and then to subsequent years in which the taxpayer had taxable income. In addition, for 2018, 2019, and 2020 taxable years, the 80% taxable income offset limitation is removed. NOLs may fully offset taxable income in those years. For taxable years beginning after December 31, 2020, the 80% taxable income offset limitation is reinstated with certain modifications.[3]

The five-year NOL carryback allowance will not apply to real estate investment trusts (REITs), and any NOL generated by a corporation when it was not a REIT may not be carried back to any taxable year when it was a REIT. The CARES Act also includes special provisions with respect to life insurance companies.

If a taxpayer carries back an NOL to a taxable year in which it has a taxable inclusion for foreign earnings (the so-called Section 965(a) transition tax inclusion, which is taxed at lower federal rates), the taxpayer is treated as having made an election to not apply the NOL against the transition tax inclusion, preserving the NOL carryback for use against other income taxed at the regular corporate rate.[4]

General Observations

- Taxpayers should assess whether any of their prior-year deductions of NOLs were impacted by the 80% taxable income offset limitation and whether any NOLs generated in 2018 or 2019 may be carried back to offset income in prior years. If yes, taxpayers may file amended federal income tax returns and receive refunds (corporate tax refund procedures are described below). NOLs carried back to taxable years prior to 2018 generally will be more valuable than NOLs utilized in 2018 or subsequent years, because the TCJA lowered the corporate tax rate from 35% to 21% beginning in 2018. However, multinational enterprises will need to factor in the impact of a carryback on their foreign tax credits (FTCs) and the other considerations discussed below in "Impact on Multinational Enterprises."

- Taxpayers expecting to generate NOLs in 2020 as a result of the economic downturn or otherwise will not enjoy an immediate cash tax benefit from these NOLs. They must wait until filing their 2020 federal income tax returns to receive any benefit from carrying back NOLs generated in 2020.

- Corporations anticipating generating NOLs in 2020 that were tax positive in taxable years ending on or before December 31, 2017, should consider maximizing tax deductions in 2020 (*e.g.*, engaging in capital improvements subject to expensing) and carrying back the 2020 generated NOL. Doing so could result in tax savings at corporate federal rates of up to 35% rather than at the rate of 21% otherwise applicable in 2020 and subsequent years.

Corporate Refund Procedures

If a corporation seeks a refund in respect of an NOL carryback, the procedures are generally as follows:[5]

- 2018 NOL — Amend the 2018 tax return, which may be subject to IRS and Joint Committee on Taxation (Joint Committee) review. The refund is typically received within approximately six months. Subject to the IRS providing future administrative relief, the expedited refund process described below is not available.

- 2019 NOL — File the 2019 tax return and Form 1139 to make a claim for a "tentative" refund. The refund could be received within approximately 90 days, but may be subject to subsequent IRS audit and review by the Joint Committee.

- 2020 NOL — Follow the 2019 approach. In addition, to receive refunds of any 2020 estimated payments, a corporation should file Form 4466 after year-end and prior to filing the 2020 tax return. Refunds of estimated payments should then be received in the first quarter of 2021.

Impact on Multinational Enterprises

- The benefit of CARES Act changes to the use of NOLs could be significantly diminished for multinational enterprises.

- The TCJA provided deductions against certain foreign income, notably global intangible low taxed income (GILTI) or foreign derived intangible income (FDII), to effectively subject multinational enterprises to a lower tax rate on overseas income. These rules have not been changed by the CARES Act. Multinational corporations will therefore need to consider whether the carryback or carryforward of an NOL would result in income being offset that would be subject to tax at reduced federal rates through the application of these deductions.

- An NOL carryback or carryforward may also reduce the allowable GILTI or FDII deductions, and potentially eliminate such deductions entirely. There is also uncertainty around the analysis relating to GILTI, because Treasury has proposed regulations that would contain a GILTI high tax exception, and there is widespread commentary that there may be changes to the regulations when finalized.[6]

- If creditable foreign taxes were paid with respect to GILTI in a particular year, carrying back NOLs to that year may result in a permanent loss of FTCs.

  - Under the TCJA, 80% of foreign taxes paid on GILTI can be credited in the year accrued, subject to a separate GILTI basket for FTC limitation purposes.

  - If an NOL offsets GILTI that would otherwise be sheltered by FTCs, then that FTC cannot be carried over, and for practical purposes it would expire unused in the year in which it accrued.

- If NOLs are carried back to 2018 or 2019, taxpayers subject to the base erosion and anti-abuse tax (BEAT) may be subject to increased BEAT liability.

- The decision to carry back an NOL requires consideration of a number of known factors in the carryback year, including taxable income, tax rate, and tax attributes existing in the year. This decision must be weighed against the potential benefit from carrying an NOL forward to a future year, which calculation must rely on assumptions. In modeling the potential benefits of an NOL carryback, a multinational corporation must consider the points raised above as well as the following questions:

  - Does carrying back an NOL to 2018 or 2019 result in the loss of a GILTI or FDII deduction or of GILTI FTCs?

  - Does carrying back an NOL to a pre-TCJA tax year offset what would otherwise have been FTC-sheltered income under prior law (*i.e.*, through use of a Section 902 FTC), resulting in changes to FTC usage for 2016 and 2017 (*i.e.*, the pre-TCJA years)?

  - How would a potential GILTI high-tax exception affect a decision to carry back an NOL?

- Factoring in known past tax attributes, future projections, and business needs, are there planning techniques for prospective carryforward years (such as deferring GILTI taxes or accelerating US source income) that make carrying NOLs forward a potentially better option than carrying back?

- What would be the financial statement impact to the use of an NOL carryback?

Modification of Section 163(j) "Business Interest Deduction Limitation"

Pre-CARES Act: General Rules

The TCJA imposed a 30% of ATI general cap on net business interest deductibility. Any excess business interest expense disallowed under Section 163(j) is carried forward to the following tax year as a disallowed business interest expense carryforward (DBIC). ATI closely approximates EBITDA for tax years beginning before January 1, 2022, and EBIT for tax years beginning on or after January 1, 2022.

CARES Act: General Rules

The 30% general cap is increased to a 50% general cap for any taxable year beginning in 2019 or 2020. A taxpayer can elect out of this increase to the general cap for any applicable taxable year.[7] A taxpayer can also elect to use its 2019 taxable year ATI in computing its Section 163(j) limitation for 2020. For short 2020 taxable years, 2019 taxable year ATI will be prorated based on the number of months in the 2020 short taxable year.

See Figure A-1 in the Appendix for a mathematical illustration comparing the Pre-CARES Act and the CARES Act Section 163(j) limitation rules for a US consolidated group.

Pre-CARES Act: Special Rules for Partnerships

In general, the Section 163(j) limitation applies at the partnership level. Any business interest expense allowed as a deduction by a partnership under Section 163(j) will not be subject to further limitations at the partner level for purposes of Section 163(j).

To the extent a partnership has business interest expense in excess of its Section 163(j) limitation (excess business interest expense, or EBIE), the EBIE, unlike a DBIC, is not carried forward by the partnership. Rather, the EBIE is allocated to the partners, which reduces (but not below zero) their outside basis in their partnership interests. A partner's ability to deduct EBIE in subsequent years is limited by future allocations of certain taxable income and business interest income from the same partnership.

CARES Act: Special Rules for Partnerships

In general, the increased 50% general cap applies at the partnership level for any taxable year beginning in 2020 (but not 2019).The partnership can elect to use its 2019 taxable year ATI as its 2020 taxable year ATI in computing its Section 163(j) limitation, including the short taxable year rule described above.

The increased 50% general cap does not apply at the partnership level for 2019. Instead, a partner can treat 50% of its EBIE allocated from the partnership's 2019 taxable year as fully deductible in the partner's taxable year beginning in 2020. Thus, 50% of such 2019 EBIE will not be subject to further Section 163(j) limitations at the partner level. The remaining 50% of such EBIE generally will not be deductible until the partner is allocated certain taxable income or business interest income from the partnership.

Partnerships and partners can elect out of the increased 50% general cap and the special EBIE rule.

See Figures A-2 and A-3 in the Appendix for illustrations depicting the impact (and complications) of the Pre-CARES Act and the CARES Act Section 163(j) limitation rules for partnerships and their partners.

General Observations

- Electing to use 2019 taxable year ATI instead of 2020 taxable year ATI can be significant for taxpayers with measurable reductions in their EBITDA for the 2020 taxable year. Increased ATI will increase such taxpayers' business interest deduction caps in their 2020 taxable years, which may create or increase an NOL that could be carried back and generate refunds (in some cases, at a 35% rate for corporations).

- Taxpayers should consider their own circumstances and model whether the CARES Act changes are beneficial to them. For example, multinational taxpayers subject to BEAT may prefer to remain subject to the Pre-CARES Act 30% general cap to decrease the amount of deductible business interest payments to related non-US parties.

Technical Correction to Section 168(k) "100% Bonus Depreciation"

Pre-CARES Act

The TCJA allows for 100% bonus depreciation for qualified property (QP) placed in service after September 27, 2017, and before January 1, 2023.[8] The TCJA, however, inadvertently omitted improvements to an interior portion of nonresidential real property (qualified improvement property, or QIP) previously placed in service, from the definition of QP. As a result, QIP was ineligible for 100% bonus depreciation, and was required to be depreciated over the 39-year life of the building. Commonly referred to as the "retail glitch," the omission of QIP from QP disproportionately impacted the hospitality and retail industries.

CARES Act

QIP placed in service after September 27, 2017, and before January 1, 2023, is now eligible for 100% bonus depreciation. Taxpayers may file amended tax returns to claim refunds. The retroactive fix may increase cash flow to taxpayers in the hospitality and retail industries, which have been hit hard by the COVID-19 pandemic.

General Observations

- Due to the retroactive application of the retail glitch fix, taxpayers may be able to take 100% bonus depreciation on QIP placed in service after September 27, 2017, and thus reduce their 2017 taxable income, which generally was taxed at higher federal rates prior to TCJA (35% compared with the current 21% for corporations; 39.6% top rate compared with the current 37% for individuals).

- Taxpayers should consider their own circumstances and model the interaction of the retail glitch fix with the NOL rules and business interest deduction limitations modified by the CARES Act.

  - A taxpayer operating an eligible real property trade or business (ERP) can irrevocably elect for the ERP to be exempt from the business interest deduction limitation described above. Making the election, however, prevents the taxpayer from using bonus depreciation. A taxpayer that previously made such election may not have done so if it knew QIP ultimately would be eligible for 100% bonus depreciation. Electing taxpayers must await subsequent guidance from the

Treasury and the IRS to determine whether they will have the opportunity to reexamine those decisions.

Additional CARES Act Tax-Related Modifications

AMT Credit Carryovers

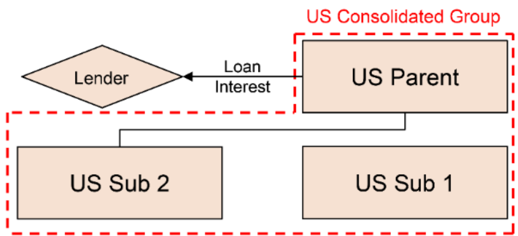
The TCJA repealed the corporate alternative minimum tax (AMT) and permitted corporations to treat prior-year AMT credit carryovers as refundable over four years ending in 2021. The CARES Act accelerates the timeline by allowing a corporation to elect to make all such AMT credit carryovers refundable in 2018. To take advantage of this accelerated timing, corporations must file an application for refund with the IRS prior to December 31, 2020.

Noncorporate Business Loss Limitation

The TCJA restricted noncorporate taxpayers from deducting business losses against nonbusiness income in excess of $250,000 for individuals or $500,000 for joint filers. The CARES Act delays the effective date of this limitation to 2021 and subsequent taxable years, clarifies that wages are treated as nonbusiness income, and excludes any business capital losses from the limitation.

APPENDIX: Illustrations of the Section 163(j) Limitation Rules

Figure A-1: General Rules — Section 163(j) Limitation



Calendar Tax Year 2019: $500 ATI, $300 business interest expense; $100 depreciation deduction
Calendar Tax Year 2020: $200 ATI, $100 business interest expense; $100 depreciation deduction

Pre-CARES Act

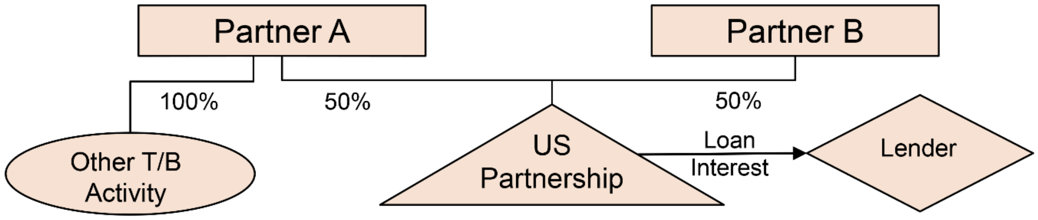
- **Year 2019**
  - US Consolidated Group's (Group's) § 163(j) limitation is $150 ($500 of 2019 ATI x 30% = $150).
  - Group deducts $150 of 2019 business interest expense (BIE); $150 is carried forward to 2020 as a DBIC.
  - 2019 Taxable Income / (Loss): $250 ($500 ATI - $100 depreciation deduction – $150 deducted BIE = $250). Thus, $52.5 federal income taxes paid (assuming 21% rate).
- **Year 2020**
  - Group's § 163(j) limitation is $60 ($200 of 2020 ATI x 30% = $60).
  - Group deducts $60 of its 2020 BIE; remaining $40 is carried forward to 2021 as a DBIC.
  - 2019 DBIC is unused and carried forward to 2021.
  - 2020 Taxable Income / (Loss): $40 ($200 ATI – $100 depreciation deduction – $60 deducted BIE = $40). Thus, $8.4 federal income taxes paid (assuming 21% tax rate); $190 of DBICs.
- **Total 2019 & 2020 Deducted BIE: $210 ($150 from 2019 + $60 from 2020).**

CARES Act

Red figures indicate changes under the CARES Act

- **Year 2019**
  - Group's § 163(j) limitation is **$250** ($500 of 2019 ATI x **50%** = $250).
  - Group deducts $250 of its 2019 BIE; remaining $50 is carried forward to 2020 as a DBIC.
  - 2019 Taxable Income / (Loss): **$150** ($500 ATI – $100 depreciation deduction – **$250** 2019 deducted BIE = $150). Thus, **$31.5** federal income taxes paid (assuming 21% rate).
- **Year 2020**
  - Group elects to use its 2019 ATI in 2020.
  - Group's § 163(j) limitation is **$250** ($500 of 2019 ATI x 50% = $250).
  - Group deducts all **$100** of its 2020 BIE and all **$50** of its 2019 DBIC in 2020.
  - 2020 Taxable Income / (Loss): ($50) ($200 ATI – $100 depreciation deduction – **$150** deducted BIE = $50 loss).
  - $50 NOL can be carried back to the preceding five-year period under the modified NOL rules; for example, if carried back to 2019, refund of $10.5 federal income taxes paid (assuming 21% rate).
- **Total 2019 & 2020 Deducted BIE: $400 ($250 from 2019 + $100 from 2020 + $50 from 2019 DBIC).**

Figure A-2: Partnerships — Section 163(j) Limitation



Pre-CARES Act

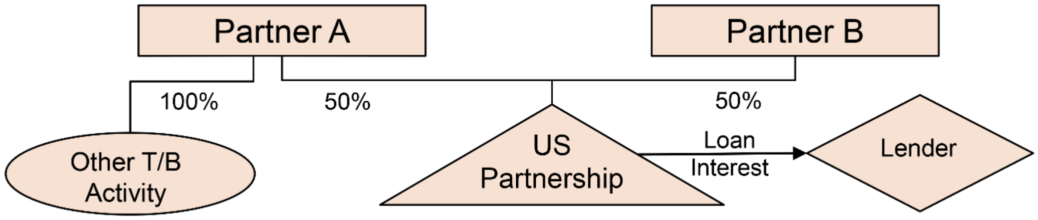
- **For US Partnership in Years 2019 and 2020:**
  - Year 2019:
    - US Partnership's § 163(j) limitation is $60 ($200 of 2019 ATI x 30% = $60).
    - US Partnership has $60 of deductible BIE, includable in US Partnership's non-separately stated income or loss and not subject to further § 163(j) limitation at the Partner A or B level.
    - US Partnership allocates $200 EBIE to each of Partners A and B ([$460 BIE – $60 deductible BIE] x 50% = $200).
  - Year 2020:
    - US Partnership's § 163(j) limitation is $45 ($150 of 2020 ATI x 30% = $45).
    - US Partnership has $20 of deductible BIE.
    - US Partnership allocates $41.7 excess taxable income (ETI) to each of Partners A and B (($150 of 2020 ATI x ([$45 § 163(j) limitation – $20 net business interest] / $45 § 163(j) limitation)) x 50% = $41.7).

CARES Act

Red figures indicate changes under the CARES Act

- **For US Partnership in Years 2019 and 2020:**
  - Year 2019:
    - US Partnership's § 163(j) limitation is $60 ($200 of 2019 ATI x 30% = $60).
    - US Partnership has $60 of deductible BIE, includable in US Partnership's non-separately stated income or loss and is not subject to further § 163(j) limitation at the Partner A or B level .
    - US Partnership allocates $200 EBIE to each of Partners A and B ([$460 BIE – $60 deductible BIE] x 50% = $200).
  - Year 2020:
    - US Partnership elects to use its 2019 ATI in 2020.
    - US Partnership's § 163(j) limitation is **$100** ($200 of 2019 ATI x 50% = $100).
    - US Partnership has $20 of deductible BIE.
    - US Partnership allocates **$80** ETI to each of Partners A and B (($200 of 2019 ATI x ([$100 § 163(j) limitation – $20 net business interest] / $100 § 163(j) limitation)) x 50% = $80).

Figure A-3: Partners — Section 163(j) Limitation



Years 2019 and 2020: $200 ATI, no interest

Year 2019: $200 ATI, $460 business interest expense
Year 2020: $150 ATI, $20 business interest expense

Pre-CARES Act

- **For Partner A in Years 2019 and 2020:**
  - Year 2019:
    - US Partnership allocates $30 deductible BIE and $200 EBIE to each of Partners A and B.
    - Partner A's § 163(j) limitation is $60 ($200 of 2019 ATI from its other trade or business activity x 30% = $60).
      - NOTE: Partner A is not able to use its $200 of 2019 ATI from its other trade or business activity to deduct the EBIE in Year 2019.
  - Year 2020:
    - US Partnership allocates $10 deductible BIE and $41.7 ETI to each of Partners A and B. As a result, Partner A increases its Year 2020 ATI by $41.7.
    - Partner A treats $41.7 of its $200 Year 2019 EBIE as business interest paid or accrued in Year 2020.
      - $158.3 of Partner A's EBIE remains outstanding and is carried forward to Year 2021 ($200 from Year 2019 – $41.7 treated as paid or accrued in Year 2020 = $158.3).
    - Partner A's § 163(j) limitation is $72.5 ([$200 of 2020 ATI from its other trade or business activity + $41.7 ETI] x 30% = $72.5). Thus, $41.7 of Partner A's BIE is deducted in Year 2020.
- **Partner A's Total Years 2019 & 2020 Deducted BIE: $81.7** ($30 from Year 2019 + $10 from Year 2020 + $41.7 of freed EBIE).

CARES Act

Red figures indicate changes under the CARES Act

- **For Partner A in Years 2019 and 2020:**
  - Year 2019:
    - US Partnership allocates $30 deductible BIE and $200 EBIE to each of Partners A and B.
      - Each of Partners A and B will be able to deduct $100 of its $200 Year 2019 EBIE in Year 2020 ($200 EBIE x 50% = $100).
    - Partner A's § 163(j) limitation is **$100** ($200 of 2019 ATI from its other trade or business activity x **50%** = $100).
  - Year 2020:
    - US Partnership allocates $10 deductible BIE and **$80** ETI to each of Partners A and B. As a result, Partner A increases its ATI by $80.
    - Partner A treats **$100** of its $200 Year 2019 EBIE as BIE deducted in Year 2020. Partner A's remaining $100 Year 2019 EBIE remains subject to the § 163(j) limitation rules.
    - Partner A treats **$80** of its remaining $100 Year 2019 EBIE as business interest paid or accrued in Year 2020.
      - **$20** of Partner A's EBIE remains outstanding and is carried forward to the next applicable tax year ($100 from Year 2019 – $80 treated as paid or accrued in Year 2 = $20).
    - Partner A's § 163(j) limitation is **$140** ([$200 of 2020 ATI from its other trade or business activity + $80 ETI] x **50%** = $140). Thus, **$80** of Partner A's BIE is deducted in Year 2020.
- **Partner A's Total Years 2019 & 2020 Deducted BIE: $220** ($30 from Year 2019 + $10 from Year 2020 + $100 of deducted Year 2019 EBIE + $80 of freed EBIE).

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Endnotes

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1 Unless otherwise specified, all "Section" references are to sections of the Internal Revenue Code of 1986, as amended, and all taxpayers are assumed to have a calendar tax year.

2 A technical correction also now permits non-calendar year taxpayers to carry back NOLs generated in a taxable year beginning before and ending after December 31, 2017 for two taxable years, which was not previously permitted under the TCJA.

3 The 80% taxable income offset limitation will be calculated without regard to deductions under Sections 250 and 199A, thus increasing the amount of NOLs that can be used in those years.

4 Taxpayers may elect to skip over years with transition tax inclusions in the five-year carryback of 2018, 2019, or 2020 NOLs.

5 Special considerations may arise if the corporation underwent a significant transaction during the relevant carryback period, such as a sale transaction. Such considerations are beyond the scope of this *Client Alert*.

6 Prop. Reg. Section 1.951A-2(c).

7 The Treasury will provide the time and manner of the election. Once the election is made for an applicable tax year, the election may be revoked only with the consent of the Treasury.

8 For property placed in service after December 31, 2022, the percentage of bonus depreciation is decreased over time until it is completely phased out for property placed in service on or after January 1, 2027.