CARES Act Tax Considerations

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The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law on March 27, 2020, representing the so-called "Phase 3" of the response to the COVID-19 pandemic, as discussed in our client alert "CARES Act Provides Much-Needed Stimulus for U.S. Businesses, Individuals." The Act included numerous key business tax relief provisions (summarized below) intended to ease the financial burden on many companies affected by COVID-19.

As Congress and the White House are now considering a possible "Phase 4" stimulus, we also note a number of issues that went unaddressed in the CARES Act, as well as issues that were addressed but could benefit from future legislation or regulatory action.[1]

Relief on Net Operating Loss and Interest Deduction Limitations

The new legislation temporarily lifts certain deduction limitations imposed by the 2017 Tax Cuts and Jobs Act (the TCJA). As we noted in our client alert "Coronavirus/ COVID-19 Update," the market disruption caused by the coronavirus is likely to exacerbate the effects of these provisions.[2]

Net Operating Loss Rules

Under the TCJA, net operating losses (NOLs) arising after 2017 generally cannot be carried back and, when carried forward, can offset no more than 80% of taxable income. Thus, a taxpayer that recognizes a \$100x NOL in 2020 and \$100x of positive taxable income in 2021 will have to pay tax on \$20x of the 2021 income, even though over the two-year period it broke even. As a result of these limitations, losses and other deductions generally are more valuable from a cash-tax perspective when they are used to offset current-year income rather than carried forward to offset future-year income. Under the CARES Act, corporate taxpayers generally may carry back NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021, for up to five years. In addition, the 80% cap does not apply for tax years beginning before January 1, 2021.[3]

[1] For a discussion of the refundable payroll tax credit and other payroll- and compensation-related provisions of the CARES Act, see our client alert "CARES Act Provides Payroll Relief and Compensation Restrictions."

[2] In addition to the relief discussed in this client alert with respect to net operating losses and interest expense deductions, the CARES Act also corrected a drafting glitch in the TJCA under which 100% bonus depreciation was not available to certain improvements to real property that qualify as "qualified improvement property." Under the CARES Act, such improvements now qualify for bonus depreciation.

[3] The CARES Act also contains special NOL provisions relating to REITs, life insurance companies and the Section 965 "transition tax."

These changes are welcome — in particular, given the possibility of carrying back 2018–2020 NOLs into pre-TCJA years to claim refunds of tax paid at a 35% rate — but may be of limited immediate relief for many taxpayers. First, taxpayers with positive taxable income for pre-2020 tax years and a net operating loss for the 2020 tax year will have to wait until after filing the 2020 tax return to carry back such loss for a refund of prior years' tax. For the many taxpayers in positive income positions prior to the disruption caused by the COVID-19 pandemic, this provision will lead to delayed relief.

Moreover, for taxpayers with positive taxable income for the 2018 and 2019 tax years and an NOL in 2020, the temporary elimination of the 80% cap in and of itself may not provide taxpayers as much long-term benefit as the comparable grandfathering provisions of the TCJA. Because the CARES Act turns off the 80% cap for pre-2021 tax years but not for NOLs generated in such tax years and carried forward to future years — in contrast to the TCJA, which grandfathered pre-2018 NOLs such that the 80% cap does not ever apply to such losses — the only NOL carryforwards that would benefit from the elimination of the 80% cap for the 2020 tax year are those carried forward from 2018 or 2019.[4] In the event of a prolonged downturn, Congress should consider modifying this provision in a future stimulus package — either by extending the period during which the 80% cap is turned off or by turning off the 80% cap for 2018–2020 NOLs, whenever utilized. In the meantime, taxpayers who find themselves in this situation may want to consider engaging in transactions that accelerate taxable income to ensure the full utilization of the current-year losses without the potential application of the 80% cap in 2021 and subsequent years.

In addition, taxpayers that are currently engaging in M&A transactions — whether as buyers or sellers — will need to consider how to address the possibility of NOL carrybacks in their agreements, as was the case prior to the enactment of the TCJA. This typically includes provisions governing control over amended returns and economic rights to any refunds associated with NOL carrybacks. Similarly, taxpayers that engaged in M&A transactions following the enactment of the TCJA may wish to revisit their agreements (including tax receivable agreements) to determine how those agreements apply to the possibility of NOL carrybacks under the CARES Act, which may not have been contemplated at the time given the elimination of such carrybacks under the TCJA.

[4] The temporary elimination of the 80% cap together with the five-year carryback will provide a significant benefit for a taxpayer with an NOL in 2020 if the amount of such NOL is not in excess of the taxable income on any pre-2020 returns to which such NOL were carried. Generally, NOLs are carried to the earliest possible year first, followed by each subsequent year.

Finally, as described below in "International Tax Considerations," the interaction of the NOL rules and certain international provisions of the TCJA — in particular, the global intangible low-taxed income (GILTI) and base erosion and anti-abuse tax (BEAT) rules — may result in the value of NOLs being dramatically reduced or in some cases eliminated altogether.

Interest Deductibility Limitations

Section 163(j) of the TCJA sharply limited the ability of businesses to deduct interest payments when calculating their taxable income. Under this limitation, a taxpayer's allowable deduction for interest expense in a particular tax year generally is limited to the sum of its business interest income plus 30% of "adjusted taxable income" (which is intended to approximate a taxpayer's EBITDA), with any excess carried forward to future years. As a result, a distressed taxpayer easily could find itself owing cash taxes even when it has suffered an overall economic loss. For example, assume a taxpayer incurred indebtedness requiring $100 of annual interest expense at a time when the taxpayer anticipated earning $350 of adjusted taxable income. In that situation, the taxpayer would have been entitled to deduct all of its interest expense. But, if the taxpayer's income were to drop from $350 to $100 in 2020, the taxpayer would still owe $100 of interest to the lender but would be allowed to deduct only $30 of that interest expense for tax purposes. This would result in the taxpayer owing cash taxes of $70 in a situation where its income net of interest expense was zero. Many taxpayers that targeted debt levels in order to keep their interest expense within the Section 163(j) limits may have found that the coronavirus has unexpectedly put them in this position.

The CARES Act temporarily increased, for tax years beginning in 2019 or 2020, the threshold from 30% to 50% such that taxpayers generally may deduct interest up to the sum of 50% of adjusted taxable income plus 100% of business interest income. Taxpayers also may elect to use their 2019 adjusted taxable income for determining their 2020 interest deduction limitation.

The CARES Act left unchanged a rule contained in the TCJA that would reduce "adjusted taxable income" (and thus, interest capacity under Section 163(j)) by depreciation, amortization and depletion deductions for tax years beginning after December 31, 2021. Congress should consider delaying this switch from an EBITDA- to an EBIT-based computation in subsequent stimulus legislation. Although the temporary increase from a 30% cap to a 50% cap is a welcome change to many taxpayers, together with the looming dropping of the "DA," it heightens the "cliff effect" that taxpayers are facing as they make capital expenditure decisions and file tax returns.

The CARES Act modifications to Section 163(j) contain a special rule applicable to partnerships. For a partnership's tax year beginning in 2019, the 50% increase described above does not apply. Instead, unless a partner elects out of the provision, any "excess business interest" (that is, business interest subject to limitation based on the application of a 30% Section 163(j) limitation at the partnership level) allocable to a partner for a tax year beginning in 2019 is bifurcated and recharacterized as follows: (i) 50% of such excess business interest is treated as interest paid in the partner's first tax year beginning in 2020 that is no longer subject to limitation under Section 163(j) and (ii) the remaining 50% of such excess business interest is subject to the usual limitations under Section 163(j). For a partnership's tax year beginning in 2020, the pre-CARES Act Section 163(j) rules for partnerships apply other than for the rules described above (*i.e.*, 50% adjusted taxable income threshold and ability to use 2019 adjusted taxable income for determining 2020 interest deduction limitation).

For calendar year partnerships with suspended excess business interest deductions for 2019, the CARES Act modifications, which free up 50% of 2019 excess business interest from the restrictions of Section 163(j), may come as a welcome change, albeit one with little room for structuring. Fiscal year partnerships that have tax years that began in 2019 but have not yet closed, may want to consider accelerating borrowing to maximize the benefit of the CARES Act provisions.

Structuring Considerations

Taxpayers that expect to face ongoing limitations on NOL utilization or interest deductibility notwithstanding the favorable provisions of the CARES Act might consider structuring and planning techniques to mitigate the effects of those limitations. For example, taxpayers expecting to run a current-year loss that would otherwise become an NOL should consider whether it is an appropriate time to engage in taxable transactions with built-in gain assets, including cash sales of unwanted assets, sale/leaseback transactions, taxable spin-offs of unwanted business lines and other income-acceleration transactions. Such transactions would increase the use of current-year losses, thus reducing the amount of NOLs that will become carryforwards subject to the 80% limitation, and may permit the taxpayer to do a transaction that would be tax-prohibitive in a more profitable year. In addition, for a taxpayer running into the Section 163(j) limitation, a sale/leaseback transaction of leveraged property may have the additional benefit of converting 163(j)-limited interest expense into economically similar but nonlimited rent expense.

International Tax Considerations

As described above, the interaction of the NOL rules and the BEAT and GILTI rules may lead to an unintended failure of multinational taxpayers to fully realize the benefits of the CARES Act. Congress and Treasury should carefully consider the impact of these unintended consequences when drafting future legislation and/or regulations.

GILTI and NOLs

Under GILTI, the U.S. shareholder of a controlled foreign corporation (CFC) generally will recognize an inclusion equal to the CFC's "tested income" (generally, the CFC's taxable income under U.S. tax principles determined without regard to Subpart F income or certain other items), less a 10% "routine" return on such CFC's aggregate tax basis in its tangible, depreciable property. GILTI is generally thought of as being taxed at a 10.5% rate, which represents the current U.S. federal corporate income tax rate of 21% and a 50% deduction under Section 250 of the Code, which serves to cut the general corporate rate in half. A similar deduction applies to "foreign-derived intangible income" (FDII) to arrive at its baseline rate of 13.125%.

However, under Section 250(a)(2), the FDII and GILTI deductions are reduced to the extent a domestic corporation's FDII and GILTI exceeds its overall taxable income in a taxable year (*i.e.*, if the corporation is in a loss position aside from FDII and GILTI). The IRS has released proposed regulations that would, when finalized, provide that the domestic corporation's overall taxable income for purposes of this limitation is computed taking into account any deduction for carried-forward NOLs, as well as any allowed interest deduction. In effect, purely domestic losses (*i.e.*., losses aside from FDII and GILTI) or carried-forward NOLs first reduce purely domestic income (*i.e.*, non-FDII and non-GILTI income) taxable at a 21% rate, but any excess then reduces the lower-rate FDII and GILTI pro rata.

The effect of these rules (including the proposed GILTI regulations, if finalized in their current form) is to reduce the value of current-year domestic losses as well as any carried forward NOLs to the extent such losses effectively reduce lower-rate GILTI or FDII instead of income taxable at a 21% tax rate. Where the GILTI inclusion would have been offset by foreign tax credits (FTCs) — which in the case of GILTI-basketed FTCs can no longer be carried back or forward — this NOL value reduction can be worse still. At the extremes, in a case where the GILTI inclusion would have been subject to a 0% tax rate because of available FTCs, the NOL value can be effectively eliminated.

Taxpayers who want the full benefit of the Section 250 deduction for GILTI and FDII in a taxable year and otherwise would be in a loss position domestically (including by reason of carried forward NOLs) should consider whether it makes sense to engage in transactions that might be tax prohibitive in a better economic climate, such as taxable asset sales, in order to free up a portion of the GILTI or FDII deduction.

In addition, the foreign tax credit system applicable to GILTI no longer employs a "pooling" system, which had the effect of smoothing year-by-year variations in income and taxes paid. Instead, taxes attributable to GILTI must be used, if at all, in the year incurred. This "use it or lose it" system means that a taxpayer whose foreign subsidiaries incur income taxes attributable to GILTI is likely to bear double tax if it is unable to credit such tax in the relevant year (because of insufficient income in the relevant basket or otherwise). For example, taxes incurred by a CFC that has a "tested loss" (*i.e.*, a loss for GILTI purposes) in a tax year are per se noncreditable. In anticipation of a potential downturn, taxpayers should consider whether there are foreign restructuring steps that could maximize the ability to utilize foreign tax credits to mitigate the effects of this "use it or lose it" system. If the tested loss entity were held directly by an entity that reliably generates tested income, for instance, a step as simple as "checking the box" on the tested loss entity could, depending on the facts, result in the tax credits becoming utilizable. Alternatively, a CFC that otherwise would be in a tested loss position could engage in transactions that accelerate tested income to eliminate the tested loss for such tax year.

BEAT and NOLs

The BEAT serves as a new alternative minimum tax for certain domestic corporations. The BEAT is intended to target erosion of the U.S. tax base through deductible payments to non-U.S. related persons. The BEAT generally applies to taxpayers that have average annual gross receipts of at least $500 million and that have deductions paid or accrued to non-U.S. related persons that are greater than 3% of their total deductions (2% in the case of certain banks). The BEAT operates as a minimum tax, so a taxpayer is only subject to additional tax under the BEAT if the BEAT tax rate (currently 10%) multiplied by the taxpayer's "modified taxable income" exceeds the taxpayer's regular tax liability, as adjusted for certain credits.

Because of the BEAT's nature as an alternative minimum tax, increases in the taxpayer's "modified taxable income" or decreases in the taxpayer's regular tax liability are likely to increase BEAT liability. In a situation where a corporation has no regular tax liability (whether by reason of current year losses or a carried-over NOL), the BEAT would result in a cash tax liability for any taxpayer otherwise subject to the BEAT if such taxpayer has positive "modified taxable income." Unfortunately, under regulations finalized in December 2019, for purposes of computing "modified taxable income," taxpayers are generally only able to include a portion of their NOL carryovers (and may not use NOL carryovers to reduce "modified taxable income" to below zero), with the effect that taxpayers may be subject to BEAT liability even where they are in an overall loss position from an economic perspective. For example, suppose a taxpayer (DC) is subject to BEAT and in 2020 has gross income of $100x, a deduction of $80x that is not attributable to a payment to a related non-U.S. person and a deduction of $70x that is attributable to a payment to a related non-U.S. person. In addition, DC has an NOL carryforward to 2020 of $400x. Even though DC has an overall current-year loss of $(50x) without regard to the NOL and a loss of $(450x) taking into account the NOL, under the BEAT, DC computes "modified taxable income" by taking the $(50x) current year loss (determined without regard to the NOL, which cannot reduce "modified taxable income" to below zero) and adding back the $70x deduction attributable to a payment to a related non-U.S. person. Thus, DC has "modified taxable income" of $20x and is subject to tax under the BEAT of $2x ($20x * 10% BEAT rate). As this example illustrates, the BEAT rules can magnify a taxpayer's liquidity challenges during an economic downturn by imposing tax liability on a company that has incurred an economic loss in the relevant tax year and/or that has NOLs available.

Congress and Treasury should consider whether modifications can be made to the rules above to achieve the desired stimulus effect of the CARES Act's NOL provisions.

Debt Restructuring Issues — A Possible Topic for Future Legislation?

One issue that went unaddressed in the CARES Act is that many taxpayers will need to modify or otherwise restructure their debt in the event of a prolonged downturn. This can raise a host of tax issues. For example, a debtor that retires debt for less than its principal amount or modifies debt at a time when it is trading at a discount may recognize cancellation-of-indebtedness income (CODI) that results in an immediate cash tax owed, even though the debtor is in financial distress. Similarly, modified debt that trades at a discount may become subject to the applicable high-yield discount obligation (AHYDO) provisions, a punitive set of rules that defer and even in some cases wholly disallow a significant portion of the debtor's interest deductions.

In the aftermath of the 2008 financial crisis, Congress provided important relief on these issues, temporarily suspending the AHYDO rules for obligations issued between September 1, 2008, and December 31, 2009, and creating an election for taxpayers to defer CODI for up to five years (with the income to be recognized ratably beginning at the end of the initial five-year deferral period). As Congress turns to possible Phase 4 stimulus, hopefully relief of this type is on the table.

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