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Initial State Income Tax Responses to the CARES Act

On March 27, 2020, President Trump signed the Coronavirus Aid, Relief and Economic Security Act (CARES Act), which provided over $2 trillion in economic relief to both businesses and individuals in response to the COVID-19 pandemic.[1] The CARES Act contains significant tax provisions, many of which provide taxpayer-favorable changes to the Tax Cuts and Jobs Act of 2017 (TCJA).[2] Since the CARES Act significantly modifies the Internal Revenue Code (IRC), state and local income tax calculations that are based on federal taxable income will be affected. While just a few states have proactively addressed portions of the newly-adopted CARES Act provisions in the past month, all of the states that impose income taxes have much to consider as suspended legislative sessions eventually resume or special sessions are called.

Background

The major corporate income tax provisions contained within the CARES Act include changes to net operating loss (NOL) carryback rules, modifications to the business interest expense deduction limitation, and the reclassification of qualified improvement property (QIP) to be eligible for 100% bonus depreciation. These modifications affect state corporate income tax regimes using some measure of income determined by the IRC, such as federal taxable income, as the starting point for state taxable income computations. The state-specific impact of the CARES Act depends largely on how each state conforms to and incorporates changes to the IRC. "Rolling" conformity states automatically tie to the IRC as changes are adopted. In contrast, "static" or "fixed date" conformity states adopt the IRC as of a specific date and must decide whether to update their conformity through subsequent legislation. Finally, "selective" conformity states selectively conform to certain provisions of the IRC while decoupling from others.

Business Interest Expense Deduction Limitation

The TCJA modified IRC Sec. 163(j) to limit business interest deductions to 30% of a taxpayer's adjusted taxable income (ATI).[3] The CARES Act increases the percentage threshold from 30% to 50% of a taxpayer's ATI for tax years beginning after December 31,

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[1] P.L. 116-136 (2020).
[2] P.L. 115-97 (2017).
[3] IRC § 163(j)(1).

2018 and before January 1, 2021.[4] Taxpayers may also elect to use their 2019 ATI for purposes of calculating their allowable interest expense deduction in 2020.[5] This election is potentially significant for taxpayers that have seen a reduction in 2020 ATI as a result of government-mandated closures or a reduction in services due to COVID-19. Using 2019 ATI may result in a larger interest expense deduction in 2020 than would have otherwise applied.

The state tax implications of the changes to the Sec. 163(j) limitation depend largely upon whether the state conforms to the TCJA amendments to Sec. 163(j), and if so, whether the state conforms to the IRC on a rolling basis. Rolling conformity states that conform to Sec. 163(j) should automatically adopt the CARES Act's increase of the interest expense deduction limitation to 50% of ATI, along with the election to use 2019 ATI for their 2020 interest expense deduction calculation. However, static conformity states that updated their IRC conformity date to after the enactment of TCJA but before the enactment of the CARES Act will continue to apply the less favorable 30% deduction limitation, without the beneficial election. Such static states will not be able to apply the CARES Act changes until they update their IRC conformity dates to March 27, 2020 or later. Similarly, selective conformity states will generally need to incorporate the CARES Act changes to Sec. 163(j) for them to apply. Finally, the numerous states that decoupled from the Sec. 163(j) interest deduction limitation in response to TCJA will continue to decouple unless special action is taken to address this provision.

NOL Modifications

The TCJA imposed an 80% taxable income limitation on the use of NOLs generated after 2017. The CARES Act temporarily suspends the TCJA taxable income limitation to allow federal NOLs to be fully deductible for tax years beginning in 2018, 2019 or 2020.[6] Additionally, while NOL carrybacks were eliminated under the TCJA, the CARES Act allows taxpayers to carry back any NOL generated in a tax year beginning in 2018, 2019 or 2020 up to five years to offset income from prior tax years.[7] The NOL carrybacks will not be allowed to offset the Sec. 965 inclusion for the one-time repatriation tax.[8] However, NOLs will still be allowed against other income in the inclusion year, and taxpayers may elect to forgo applying the carryback to that particular year.[9]

Most states do not conform to federal NOL provisions for a number of reasons. Some states may use federal taxable income before the NOL deduction to determine state taxable income, and then provide for a state-specific NOL that may differ significantly from the federal concept. Others initially include

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[4] P.L. 116-136, § 2306(a), adding IRC § 163(j)(10)(A).
[5] P.L. 116-136, § 2306(a), adding IRC § 163(j)(10)(B).
[6] P.L. 116-136, § 2303(a)(1), adding IRC § 172(a)(2)(A).
[7] P.L. 116-136, § 2303(a)(1), amending IRC § 172(a); § 2303(b)(1), adding IRC § 172(b)(1)(D)(i).
[8] P.L. 116-136, § 2303(b)(1), adding IRC § 172(b)(1)(D)(iv).
[9] P.L. 116-136, § 2303(b)(1), adding IRC § 172(b)(1)(D)(v).

the federal NOL amount in the tax base, but then require the federal NOL to be added back, with a consequent state-specific NOL subtraction. In addition, a large number of states, even those that generally conform to federal NOL concepts, historically have disallowed carrybacks of NOLs. While most states will not conform to the liberal carryback rules adopted in the CARES Act, important considerations involving NOLs nevertheless will arise. In rolling conformity states that generally conform to federal NOL concepts, the suspension of the TCJA's 80% taxable income limitation should be similarly available from a state income tax perspective. That benefit will not be available in static conformity states tied to the federal NOL limitation until their IRC conformity date is updated to include the CARES Act changes.

Reclassification of QIP

The CARES Act includes a retroactive technical correction to make QIP eligible for the TCJA's 100% bonus depreciation provision. The TCJA amended Sec. 168(k) to allow full expensing in the first year for qualifying assets placed into service between September 28, 2017 and December 31, 2022.[10] In order to be eligible for bonus depreciation, the property must have a modified accelerated cost recovery system (MACRS) recovery period of 20 years or less. For property placed into service after December 31, 2017, the TCJA eliminated the 15-year MACRS classification for QIP.[11] Under the TCJA, QIP was mistakenly assigned a 39-year depreciable life, making it ineligible for the bonus depreciation provided under Sec. 168(k) as amended by the TCJA. The CARES Act amends this drafting error and categorizes QIP as a 15-year MACRS asset, and the amendment takes effect **as if** originally included in the TCJA.[12] As a result, QIP is eligible for the 100% bonus depreciation from the effective date of the TCJA.

State conformity to the QIP provision in the CARES Act will be particularly complex and will depend upon whether a state is a rolling or static state, as well as historic positions on bonus depreciation conformity. Approximately one-third of states both have rolling conformity to the IRC and conform to Sec. 168(k). These states should automatically adopt the CARES Act's technical correction to include QIP as property eligible for bonus depreciation. For the small number of states that have static conformity to the IRC but conform to Sec. 168(k), such states will not automatically incorporate the CARES Act amendments and will need to update their conformity dates in order to adopt the QIP technical correction. As for the significant majority of states that do not conform to the TCJA's 100% bonus depreciation rule, the distinction between rolling and static or selective states will matter greatly. For rolling states that do not conform to Sec. 168(k), but adopt the federal deduction for MACRS depreciation, the changes reducing the useful life of QIP property may still take effect because the

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[10] IRC § 168(k)(6).

[11] QIP is generally an improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was placed in service.

[12] P.L. 116-136, § 2307(a), amending IRC § 168(e)(3)(E)(viii), (e)(6)(A), (g)(3)(B). The amendments are retroactive to the date of the TCJA's enactment on December 22, 2017.

CARES Act amended Secs. 168(e) and (g), not Sec. 168(k). For static or selective states, the changes reducing the useful life of QIP property should not take effect until their general or selective conformity dates to the IRC, as the case may be, reach March 27, 2020.

Finally, there are various state tax implications to correcting the recovery period for QIP and for making or revoking bonus depreciation elections. Taxpayers may generally correct QIP depreciation by filing an amended federal tax return for the tax year in which the property was placed in service, or by attaching a Form 3115 to a timely filed federal return to reflect an accounting method change under Sec. 481(a). While amended state returns may be required when an amended federal return is filed, the accounting method adjustment presents additional state considerations. These include whether the state conforms to the federal accounting method change, and if so, whether separate permission and/or notification is required, and specific requirements for attachments to state returns.

Paycheck Protection Program Loans

Under the Paycheck Protection Program (PPP), the CARES Act allocated approximately $350 billion in loans to small businesses affected by the economic fallout of COVID-19.[13] Subsequent legislation authorized an additional $310 billion in small business loans under the PPP.[14] The loans are limited to the lesser of 2.5 times a business's average monthly payroll or $10 million. Under the terms of the program, the debt may be forgiven in whole or in part if the business meets specific requirements, including spending the money on approved expenses such as payroll, and maintaining existing employment and/or compensation levels. The CARES Act treats the forgiven portion of the loans as excluded from gross income for federal tax purposes.[15] The IRS subsequently issued guidance requiring taxpayers to reduce their deductions for business expenses paid using loan proceeds that are forgiven under the PPP.[16] However, Congress is currently considering legislation that would reverse the IRS position.

At the outset, it is too early to tell exactly how states plan to similarly exempt the forgiveness of PPP loans from their tax bases. For example, states with static or selective IRC conformity may determine that they do not conform to the CARES Act treatment of the forgiven loans because they do not conform to the latest version of the IRC. It is possible that rolling conformity states may also not conform to the tax-exempt treatment because the CARES Act does not amend IRC Sec. 108, but rather includes the exemption language in the statute itself. On the other hand, states using federal adjusted gross income or federal taxable income as the starting point for calculating state taxable income may automatically adopt the CARES Act's exclusion of forgiven PPP loans.

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[13] P.L. 116-136, § 1102(b).

[14] Paycheck Protection Program & Health Care Enhancement Act, P.L. 116-139 (2020).

[15] P.L. 116-136, § 1106(i).

[16] Notice 2020-32, Internal Revenue Service, Apr. 30, 2020.

Early State Responses to the CARES Act

A few states have already acted in response to various tax provisions of the CARES Act, some legislatively and others through clarifying guidance.

New York

On April 3, 2020, New York enacted budgetary legislation impacting state and local conformity to Sec. 163(j) as modified by the CARES Act for purposes of the New York corporate franchise tax, New York City business taxes and New York State and City personal income tax.[17] For corporate income tax purposes, both New York State and New York City conformed to Sec. 163(j) as enacted by the TCJA. The budget legislation essentially decouples New York corporate franchise tax law from the CARES Act changes by specifying that entire net income will be determined for the 2019 and 2020 tax years without increasing the federal business interest expense deduction limitation to 50% of ATI.[18] However, the legislation does not decouple from the CARES Act provision allowing taxpayers to elect to use ATI for the 2019 tax year in calculating their Sec. 163(j) limitation for the 2020 tax year. The same changes also apply for purposes of the New York City Business Corporation Tax, General Corporation Tax and Unincorporated Business Tax.[19]

The budget legislation did not explicitly address the QIP class life changes. Although New York does not conform to bonus depreciation for corporate income tax purposes,[20] the state implicitly conforms to Secs. 167 and 168 on a rolling basis, meaning that the new QIP rules should be incorporated into the tax law to reduce the useful life of QIP to 15 years. Such reclassification may impact depreciation computations retroactively for New York State and City purposes, potentially requiring amended returns for the 2018 tax year. As such, further guidance is expected on the mechanics of making the depreciation adjustments.

The budget legislation presents complex conformity issues for New York personal income tax (PIT) purposes. The New York PIT law conformed to the IRC on a rolling basis before the enactment of the TCJA. New York allowed taxpayers the option to decouple from the TCJA by using a New York-specific itemized deduction that excluded TCJA-related changes to the IRC.[21] The budget legislation decouples the New York PIT law from any amendments made to the IRC enacted after March 1, 2020, for tax years

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[17] S. 7508-B/A. 9508-B, Laws 2020.
[18] S. 7508-B/A. 9508-B, Part WWW, § 1, adding N.Y. TAX LAW § 208.9(b)(26).
[19] S. 7508-B/A. 9508-B, Part WWW, § 3, adding N.Y.C. ADMIN. CODE § 11-652.8(b); § 5, adding N.Y.C. ADMIN. CODE § 11-506(b); § 6, adding N.Y.C. ADMIN. CODE § 11-602(b).
[20] N.Y. TAX LAW § 208.9(b)(17), (n-1).
[21] N.Y. TAX LAW § 615.

beginning before January 1, 2022.[22] Accordingly, the CARES Act changes to the Sec. 163(j) limitation will not apply to taxpayers claiming the federal itemized deduction instead of electing the New York itemized deduction. By decoupling from the CARES Act, the budget legislation moves New York to static conformity for PIT purposes for IRC provisions enacted on or after March 1, 2020. The budget legislation decouples the New York City resident PIT law from both the TCJA and CARES Act provisions in a similar fashion to New York State PIT law.[23] As such, both New York State and City are no longer in conformity with federal NOL rules for PIT purposes as they were prior to enactment of the CARES Act.

Wisconsin

On April 15, 2020, Wisconsin enacted legislation that conformed the state to various healthcare and tax provisions of the CARES Act.[24] Typically a static conformity state with a current IRC conformity date of December 31, 2017 for the 2019 and 2020 tax years,[25] Wisconsin specifically adopted the CARES Act provision reclassifying QIP as a 15-year depreciable asset for all income tax purposes,[26] though it should be noted that the state still does not conform to the current bonus depreciation provisions in the IRC.[27] The legislation also selectively conforms Wisconsin tax law to other provisions of the CARES Act, including the exclusion from income for the forgiveness of PPP loans, conformity to single-employer plan retirement funding rules, and conformity to the federal tax treatment of certain COVID-19-related retirement plan distributions.[28]

Montana

On April 17, 2020, the Montana Department of Revenue released a notice regarding the CARES Act tax provisions and the implications for Montana income taxes. As Montana is a rolling conformity state, the Department noted that Montana would automatically conform to the CARES Act provisions modifying the Sec. 163(j) limitation and reclassifying QIP. While the Department noted that the five-year NOL carryback provision does not apply to C corporations having a Montana filing obligation, the notice

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[22] S. 7508-B/A. 9508-B, Part WWW, § 2, amending N.Y. TAX LAW § 607(a).
[23] S. 7508-B/A. 9508-B, Part WWW, § 3, amending N.Y.C. ADMIN. CODE § 11-1707(a).
[24] Act 185 (A.B. 1038), Laws 2020.
[25] WIS. STAT. § 71.22(4)(k)1.
[26] Act 185, §§ 23-29, amending WIS. STAT. §§ 71.01(6)(l)3; 71.22(4)(l)3; 71.22(4m)(l)3; 71.26(2)(b)12.d; 71.34(1g)(l)3; 71.42(2)(l)3; 71.98(3).
[27] WIS. STAT. § 71.98(3).
[28] Act 185, §§ 23-28, amending WIS. STAT. §§ 71.01(6)(l)3; 71.22(4)(l)3; 71.22(4m)(l)3; 71.26(2)(b)12.d; 71.34(1g)(l)3; 71.42(2)(l)3.

also specified that individuals, estates and trusts with an NOL incurred in the 2018 or 2019 tax years may carry back their NOL five years and amend the corresponding returns filed in those years.[29]

Commentary

The tax provisions of the CARES Act present unique considerations for state and local governments, many of which are facing significant revenue shortfalls and budgetary constraints resulting from the COVID-19 outbreak. Indeed, some very early estimates from different organizations show the dramatic amount by which state tax revenue is expected to decrease in the near future due to the pandemic and the resulting economic downturn.[30] As states face the decision of whether to conform or decouple from the favorable provisions of the CARES Act, they will need to weigh the need for tax revenue against repeated pressure to provide taxpayer relief during uncertain economic times.

With respect to the increased limitation on the business interest deduction limitation, states face several issues based on their conformity to Sec. 163(j). States have the option to conform to the new 50% limitation or retain the 30% limitation (similar to New York), but must also consider the separate issue of whether to conform to the ATI relief election provision. Further, many states impose related-party interest expense disallowance rules, which often conflict with the application of the Sec. 163(j) limitation, creating further ambiguity. The bottom line is that in the coming months, states effectively will have a second chance to evaluate whether to adopt the federal policy to limit interest expense deductions and possibly raise some revenue, or decouple from Sec. 163(j) entirely and incentivize taxpayers to undertake further debt as a possible method to increase cash flow during this time.

The CARES Act modifications to NOL rules allow businesses to fully apply losses and recover previous tax paid through refunds in loss carryback years. States will need to consider whether and how to conform, considering that many follow their own NOL provisions and disallow NOL carrybacks. For those states allowing NOL carrybacks or choosing to conform to the CARES Act provisions, taxpayers may consider how the carryback of NOLs may affect other components of federal taxable income to which states conform. Ultimately, there may be many situations in which a federal NOL that results from the CARES Act changes will not translate to state NOLs that are usable from the state income tax perspective. For example, New York's short-term static conformity for PIT presents unintended consequences for individuals electing to utilize the five-year NOL carryback for federal purposes under the CARES Act. As

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[29] *Net Operating Loss (NOL) Changes Due to COVID-19*, Mont. Department of Revenue, Apr. 17, 2020.

[30] For example, Moody's expects states to face a $160 billion tax revenue loss in the 2019-2021 fiscal year periods, while the Center for Budget and Policy Priorities expects a $650 billion gap in the 2020-2022 fiscal year periods. See James Nani, *Moody's Says States Face $160B Tax Loss from COVID-19*, Law360, Apr. 28, 2020; Michael Leachman, Center for Budget and Policy Priorities, *New CBO Projections Suggest Even Bigger State Shortfalls*, Apr. 29, 2020, https://www.cbpp.org/blog/new-cbo-projections-suggest-even-bigger-state-shortfalls.

a result, individuals would forgo the benefit of a New York NOL utilization, resulting in potential disparate treatment between individual and corporate taxpayers.

Likewise, while the modification to the recovery period for QIP provides a favorable answer for most taxpayers from a federal perspective, there may be much to do for taxpayers in tracking how QIP should be depreciated for state income tax purposes. While depreciation might be relatively simple in the states that conform to the CARES Act and bonus depreciation provisions, unique issues will arise for other states, with several sets of depreciation schedules a possibility given the states' differing approaches. Depending upon the state, an item that is designated as QIP could be fully depreciated in the year of purchase, be depreciated according to a 15-year schedule, be depreciated according to a 39-year schedule, or be subject to a different state-specific method. Further adding to the complexity, states will continue to evaluate post-CARES Act conformity for some time, and the conclusions one currently reaches on this issue could change in the next several months.

Finally, it remains to be seen whether states will exempt the forgiveness of PPP loans from their tax bases in conformity with the federal tax treatment. Additional guidance would be welcome to clarify the specific state treatment for planning purposes, especially as the second wave of loans is allocated to small business applicants. It is possible that states may address the issue when considering whether to adopt other provisions of the CARES Act in the coming months.

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information contained herein; Grant Thornton LLP assumes no obligation to inform the reader of any such changes. All references to "Section," "Sec.," or "§" refer to the Internal Revenue Code of 1986, as amended.