State Tax Conformity to Key Taxpayer: Favorable Provisions in the CARES Act

by Karl A. Frieden and Stephanie T. Do

Reprinted from Tax Notes State, April 20, 2020, p. 303
State Tax Conformity to Key Taxpayer: Favorable Provisions in the CARES Act

by Karl A. Frieden and Stephanie T. Do

The COVID-19 crisis has upended all other state tax legislation for 2020. States are now in a precarious fiscal situation that may require balancing conflicting priorities — drafting balanced budgets in the face of sharply declining tax revenues, and providing businesses (and individuals) with tax and other financial relief to help them cope with the onslaught of mandatory business shutdowns or slowdowns.

In this volatile environment, the federal government responded first with an unprecedented $2 trillion package of financial and tax relief, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, aimed at stabilizing the national economy and providing badly needed assistance to states, hospitals, workers, and businesses. While much of the CARES Act consists of loans, grants, and other nontax measures, there are several significant corporate tax relief provisions that have implications for state corporate income taxes. These provisions generally provide temporary rollbacks of some taxpayer-unfavorable base broadeners included in the Tax Cuts and Jobs Act.

The primary federal corporate income tax changes in the CARES Act with state implications are:

• changes in the limitations on business interest deductions that provide for a higher cap in 2019 and 2020;
• changes in the net operating loss rules that provide for a carryback of losses generated in 2018, 2019, and 2020; and
• the reclassification of qualified improvement property to make it eligible for 100 percent bonus depreciation or a shorter depreciation schedule.

The state tax implications of these changes depend on whether (and how) a state conforms to the IRC, or alternatively, whether the state has similar statutory provisions of its own that it chooses to modify to achieve equivalent outcomes.

Karl A. Frieden is vice president and general counsel and Stephanie T. Do is tax counsel for the Council On State Taxation.

In this article, the authors discuss the CARES Act, identify the states that have (and have not) conformed to the Act’s corporate income tax relief provisions, and explain the importance of states adopting similar relief provisions.

Economic Security (CARES) Act, aimed at stabilizing the national economy and providing badly needed assistance to states, hospitals, workers, and businesses. While much of the CARES Act consists of loans, grants, and other nontax measures, there are several significant corporate tax relief provisions that have implications for state corporate income taxes. These provisions generally provide temporary rollbacks of some taxpayer-unfavorable base broadeners included in the Tax Cuts and Jobs Act.

The primary federal corporate income tax changes in the CARES Act with state implications are:

• changes in the limitations on business interest deductions that provide for a higher cap in 2019 and 2020;
• changes in the net operating loss rules that provide for a carryback of losses generated in 2018, 2019, and 2020; and
• the reclassification of qualified improvement property to make it eligible for 100 percent bonus depreciation or a shorter depreciation schedule.

The state tax implications of these changes depend on whether (and how) a state conforms to the IRC, or alternatively, whether the state has similar statutory provisions of its own that it chooses to modify to achieve equivalent outcomes.

3 There are other smaller revenue changes, including allowing greater deductions for corporate charitable contributions. There are also some other potentially larger revenue changes that apply primarily to small businesses, such as the Paycheck Protection Program, which treats any loan forgiven under the program as excluded from gross income under the IRC, although not necessarily excluded from the state income tax base.
This article identifies the states that have conformed to these CARES Act corporate income tax relief provisions. It highlights the larger number of states that have not conformed and the importance of them mirroring these CARES Act provisions to expedite economic recovery.²

It is important to emphasize that all three of these taxpayer-favorable changes in the CARES Act involve timing differences solely affecting when a taxpayer receives a deduction, not if a taxpayer is entitled to the deduction. None of these changes involve a corporate tax rate reduction or some other form of corporate tax cut. It is for precisely this reason that these changes are an important part of the federal government’s COVID-19 economic recovery program and should be considered by states that have not adopted similar provisions.

**Modifications to the Business Interest Deduction (CARES Act section 2306)**

The TCJA generally limited business interest deductions to 30 percent of a taxpayer’s adjusted taxable income.³ Under the CARES Act, this percentage threshold is increased from 30 percent to 50 percent of a taxpayer’s ATI for tax years beginning in 2019 and 2020.⁴ Also, the CARES Act allows taxpayers to elect to use their 2019 ATI in 2020 for purposes of the interest deduction limitation.⁷ As a result of the TCJA and CARES Act, federal business interest deductions can be used as set forth in the table above.

Use of the 2019 ATI is important because considering the economic impact on most businesses of the government-directed closures and work-from-home requirements, it may be much higher than the taxpayer’s 2020 ATI. The election could result in a significantly larger interest expense deduction in 2020 than would have applied even with the percentage threshold increase permitted by IRC section 163(j)(10)(A). This change could even result in larger NOLs in 2020, which, in conjunction with the CARES Act’s allowance of loss carrybacks under IRC section 172, could generate much-needed cash flow for businesses.⁸

The CARES Act’s taxpayer-favorable changes to the interest expense deduction limitation are directly related to counteracting one of the principal negative consequences of the COVID-19 crisis — companies incurring more debt to stay afloat. Businesses in many industries have fully or partially shuttered their operations either because of government orders to close or because of the loss of customers given the travel and social distancing restrictions now in place in virtually all states. The impact is particularly severe in the food and hospitality, transportation, manufacturing, construction, and service industries. Under these circumstances, businesses may rapidly exhaust cash reserves and take on additional debt to pay operating costs amid sharply declining revenues. This federal relief provision is consistent with the

---

1. The authors would like to thank members of the Council On State Taxation staff including Nikki Dobay, Aziza Farooki, Priya Nair, Fred Nicely, and Patrick Reynolds for their assistance in researching state conformity with the CARES Act provisions.
2. IRC section 163(j)(1). ATI is initially computed before interest, tax, depreciation, and amortization. Beginning in 2026, ATI is computed only before interest and tax.
3. CARES Act section 2306(a) (adding section 163(j)(10)(A)).
4. The CARES Act’s new net operating loss carryback rules are examined further below.
5. CARES Act section 2306(a) (adding section 163(j)(10)(B)).
6. The CARES Act’s new net operating loss carryback rules are examined further below.
substantial efforts of the Federal Reserve Board to lower the cost of borrowing, enhance liquidity in the financial markets, and ease the availability of different debt instruments.

Moreover, the corporate debt burden was already high before the COVID-19 pandemic. Between 2000 and 2019, corporate debt (from nonfinancial companies) more than doubled from slightly above $4 trillion to $10 trillion. Additional debt raised in 2020 to offset near-catastrophic declines in revenue in many business sectors will significantly increase corporate interest expenses, accentuating the need for a higher threshold of allowable interest expense deductions.

Thus far, the state tax implications of the CARES Act changes to IRC section 163(j) depend almost entirely on two factors: (1) whether the state conforms to the TCJA changes to section 163(j); and (2) if so, whether the state has rolling conformity with the IRC or fixed date conformity. In states that previously conformed to the TCJA changes to section 163(j), those with rolling conformity automatically pick up the CARES Act’s increase of the interest expense deduction cap from 30 percent to 50 percent of ATI and the election to use 2019 ATI for 2020. Conversely, those states with fixed date conformity that updated their conformity date to a date after the TCJA’s enactment, but before the enactment of the CARES Act, remain under the less-favorable TCJA rules capping interest at 30 percent of current-year ATI.

Chart 1 illustrates the status of state corporate income tax law conformity with the federal interest expense deduction limitation after the CARES Act. Eleven states did not adopt or affirmatively decouple from the section 163(j) interest expense limitations in the TCJA. These states generally do not impose any limitation on interest expense deductions. Twenty-one states conformed to the TCJA interest expense limitations, and because they maintain rolling conformity with the IRC, they adopt the more beneficial CARES Act treatment of interest expense deductions.

Fourteen states, however, conform to the TCJA interest expense limitations in section 163(j), but because they have fixed date or selective conformity with the IRC, they do not immediately adopt the taxpayer-beneficial increase of the interest expense deduction cap to 50 percent or the election to use the 2019 ATI for calculating the allowable interest expense deduction in 2020. Thus, these states provide less favorable treatment of debt than the other states that impose either no limit or a 50 percent limit on the interest deduction, unless they act to conform to these provisions.

To date, New York is the only state that has enacted legislation relating to the CARES Act change in the interest expense deduction limitation. Unfortunately, New York moved in the opposite direction, switching from rolling to selective conformity with section 163(j). The New York budget bill, passed on April 3, excludes from the definition of entire net income “the amount of the increase in the federal interest deduction allowed pursuant to section 163(j)(10)(A)(i) of the internal revenue code.” This is the provision that increases the threshold from 30 percent to 50 percent of ATI for the 2019 and 2020 tax years.

The optimal treatment of debt for corporate income tax purposes is for a state to decouple entirely from the TCJA’s limit on interest expense deductibility under section 163(j). The TCJA’s changes to section 163(j) at the federal level were designed as a corporate income tax base broadener to fund, at least in part, the substantial reduction in federal corporate tax rates to make the United States more competitive internationally. Few states followed the federal government’s lead to provide rate reductions, and consequently, state conformity with the business interest expense deduction limitations in 2018 simply resulted in a substantial increase in state corporate income taxes.

[9] Andrew Hughes, “The OECD and Tax Authorities Should Relax Interest Expense Deduction Limitations,” Tax Notes Int’l, Apr. 13, 2020, p. 215. (There are many publicly traded companies on U.S. stock exchanges that have exceeded the 30 percent interest expense ratio.).


[11] New York Budget Bill, S. 7508-B/A. 9508B, Part WWW, section 1 (affecting New York state corporate franchise tax under Art. 9-A of the New York Tax Law (amending N.Y. Tax Law section 208.9(b) by adding new subparagraph (26)); section 4 (making a similar change under New York City Admin. Code section 11-652.8(b) by adding new subparagraph (26)); section 4 (making a similar change under New York City Admin. Code section 11-652.8(b) by adding new subparagraph (26)); section 4 (making a similar change under New York City Admin. Code section 11-652.8(b) by adding new subparagraph (26))); section 4 (making a similar change under New York City Admin. Code section 11-652.8(b) by adding new subparagraph (26)).

[12] Id. Note, the New York statutory change does not specify IRC section 163(j)(10)(B), which allows a taxpayer to elect to use its 2019 ATI as its 2020 ATI for purposes of the business interest expense calculation. It appears this taxpayer-favorable change is still available in New York.

Moreover, at the federal level, the section 163(j) business interest expense deduction limitation was linked with the TCJA’s enactment of section 168(k), which allows full and immediate expensing of most capital expenditures. One of the primary purposes of the business interest expense limitation under the TCJA was to discourage excessive debt financing of assets subject to immediate expensing under section 168(k). However, most states have historically decoupled from section 168(k) and do not conform to the immediate expensing of capital investments provided for in the TCJA. Therefore, the equitable outcome at the state level is for states to either conform to both the interest expense limitation and the immediate expensing provision, or to neither provision.

At a minimum, a state that chooses to conform to the TCJA’s corporate-tax-increasing section 163(j) changes should conform with the taxpayer-favorable change in the CARES Act to provide a 50 percent cap for tax years 2019 and 2020 (and the flexibility to use 2019 ATI for the 2020 calculation). A wide gamut of businesses will clearly need to borrow heavily to withstand the negative impact of the COVID-19 crisis on corporate income in 2020. It is only fair that they should be able to deduct all (or, consistent with the CARES Act treatment, at least more) of the interest paid on the additional financing from their adjusted taxable income.

**NOL Modifications (CARES Act section 2303)**

CARES Act section 2303 eases some of the limitations on companies deducting their losses, significantly changing the rules previously set forth in the TCJA and temporarily restoring more favorable treatment of federal NOLs. The CARES Act provides that NOLs generated in a tax year beginning in 2018, 2019, or 2020 can be carried back (up to five years) to offset income from prior tax years. Under the TCJA, NOL carrybacks were eliminated. The CARES Act also suspends the TCJA’s taxable income limitation to allow NOLs to be fully deductible through 2020. As a result of the TCJA changes as amended by the CARES Act, federal NOLs can be used as follows:

14 CARES Act section 2303(a)(1) (amending IRC section 172(a)) and (b)(1) (adding new subparagraph (b)(1)(D)(i) providing the temporary five-year carryback).

15 CARES Act section 2303(a)(1) (adding IRC section 172(a)(2)(A)).
The CARES Act changes allow companies to fully use losses and recover some of the tax paid previously through refunds in loss carryback years. For many companies, restoring the carryback provision and removing the 80 percent taxable income limitation will significantly boost critical cash flow and liquidity desperately needed during the COVID-19 crisis and anticipated global economic downturn.

During the major economic downturn in 2008-2009 (the Great Recession), many businesses experienced significant losses. But at the time, the federal tax code (and many state tax codes) allowed not only NOL carryforwards, but also NOL carrybacks. Federal relief during the recession temporarily extended the existing two-year carryback period to five years. This allowed companies to recoup their NOL deductions much more quickly through NOL carrybacks that generated tax refunds rather than waiting to recoup the losses in future tax years. Federal corporate NOLs attributable to the Great Recession peaked at $722.4 billion in the IRS’s 2010 processing year. The NOLs reported in the 2007 processing year — the last year before the economic downturn — were $225.5 billion. Of the approximately 2 million federal corporate returns in the 2010 processing year, 45.3 percent reported an NOL. Between the IRS’s 2007 and 2010 processing years, the number of carryback claims more than doubled from 54,618 to 114,233 before declining to 44,308 in the 2012 processing year.

The impact of the COVID-19 crisis on the national economy is already projected to be much greater than the Great Recession, with estimates of the national unemployment rate reaching 20 percent or more by this summer. These are levels of unemployment unseen in the United States since the Great Depression of the 1930s. The grim economic forecast highlights the need for fast and effective tax relief at both the federal and state levels. Thus, relaxing the NOL rules was one of the key federal tax responses in the CARES Act to the economic crisis and should be replicated by states.

Unfortunately, because of the lack of conformity to the federal NOL provisions and lack of uniformity among the states in their NOL provisions, similar cash flow relief, particularly as it relates to NOL carrybacks, is not available in most states. Regardless of whether a state generally conforms to the IRC and to the federal NOL provision (section 172), states have historically deviated from the federal carryback and carryforward rules.

Chart 2 illustrates the state adoption and conformity to the federal NOL carryback provisions, including those changes brought about through enactment of the CARES Act. As compared with the new federal rule, 33 states provide no carryback relief.

<table>
<thead>
<tr>
<th>Loss Generated</th>
<th>Carryback</th>
<th>Carryforward</th>
<th>NOL Offset Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before TCJA (On or before December 31, 2017)</td>
<td>2 years</td>
<td>20 years</td>
<td>100%</td>
</tr>
<tr>
<td>Resulting from TCJA, now delayed by the CARES Act</td>
<td>None allowed</td>
<td>Indefinite</td>
<td>80%</td>
</tr>
<tr>
<td>(On or after January 1, 2021)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resulting from the CARES Act (After December 31, 2017, and before January 1, 2021)</td>
<td>5 years</td>
<td>Indefinite</td>
<td>100% (before 2021) 80% (after 2020)</td>
</tr>
</tbody>
</table>

17 Treasury Inspector General for Tax Administration, “The Internal Revenue Service Administered Corporate Net Operating Losses Efficiently and Effectively; However, Financial Reporting Could Be Improved” (Oct. 13, 2015).
18 Id.
19 Id.
20 Id.
21 Five states — Nevada, Ohio, South Dakota (except for financial services companies), Washington, and Wyoming — do not impose a corporate income tax, and Texas’s franchise tax is a hybrid having features of a gross receipts tax and an income tax but does not provide for NOLs.
Of the remaining states with a corporate income tax, five allow NOL carrybacks: Alaska, Mississippi, Missouri, New York, and Oklahoma. Also, Delaware, Idaho, and Montana allow NOLs to be carried back, but they significantly cap the amount that can offset prior tax periods. Finally, four states that adopted the TCJA’s carryback disallowance — Georgia, Hawaii, Virginia, and West Virginia — are fixed date conformity states and would permit carrybacks if they updated conformity to the current version of the IRC, including changes made to section 172 under CARES Act section 2303. All these states align (or would align with an update to IRC conformity) closer to the tax policy behind the CARES Act by providing some cash flow (by means of NOL carrybacks) to stimulate and maintain commercial activity at a time when companies need it the most.

The lack of state tax conformity to the federal NOL carryback rule is replicated, albeit to a lesser degree, with the CARES Act’s suspension of the TCJA’s 80 percent taxable income limitation. A number of states that conformed to the TCJA’s taxpayer unfavorable NOL limitation have not adopted the more favorable CARES Act elimination of the cap. Florida, Georgia, Hawaii, Indiana, Kentucky, South Carolina, Virginia, and West Virginia are all tied to the TCJA’s 80 percent taxable income limitation because they have static conformity to section 172 and have not yet updated their statutes to include the CARES Act.

Almost all states with a corporate income tax — especially those that parallel the TCJA’s NOL rules — can adopt measures like the CARES Act provision for NOL carrybacks and suspension of

---


24 Several states still limit the amount of state NOLs that can be used in a future year to the amount of federal NOLs that the taxpayer used in the current year. In states that do not allow a carryback (or that subject a carryback to a limitation), the ability to fully use state NOLs could be severely restricted to the extent that federal NOLs were carried back to earlier years and are no longer available in future years.
the 80 percent cap. This targeted relief is temporary but critical to addressing the unique circumstances at hand. Previously robust and healthy companies, especially those in the food and hospitality, transportation, manufacturing, construction, and service industries, may not be able to rebound without adequate cash flow. Although states, too, are facing difficult budgetary and tax pressures, adopting NOL provisions like those in the CARES Act could provide essential cash flow and liquidity targeting the companies suffering the most from the COVID-19 economic downturn. To repeat an important point made earlier, the NOL deductions are all timing differences, so taxpayers will eventually get to reduce taxable income by their carried-over NOLs. Now is the time when businesses most desperately need the cash infusion. Assuming that the states can afford to do so, these measures to have the state NOL provisions mirror the new federal NOL provisions included in the CARES Act could help ensure that states have an economically viable business sector and a stable corporate income tax base once the COVID-19 pandemic is over.

Reclassification of Qualified Improvement Property (CARES Act section 2307)

In addition to the more taxpayer-favorable treatment of business interest deductions and NOLs, the CARES Act included a retroactive technical correction to make qualified improvement property eligible for the TCJA’s 100 percent bonus depreciation (also referred to as “full expensing”). This change will benefit some of the industries hit hardest by the pandemic — the hospitality and retail industries.

The TCJA allows 100 percent first-year depreciation for qualifying assets placed in service between September 28, 2017, and December 31, 2022, under section 168(k).26 One of the requirements to be eligible for this bonus depreciation is that the property must have a modified accelerated cost recovery system recovery period of 20 years or less. But for property placed in service after December 31, 2017, the TCJA eliminated the 15-year MACRS classification for qualified retail improvement property, qualified restaurant property, and qualified leasehold improvement property. These classifications were consolidated into a single classification — qualified improvement property (QIP). 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 first placed in service.26 These are generally interior buildouts or remodels undertaken by retail stores, hotels, and restaurants.

Because of a drafting oversight in the TCJA, however, QIP was mistakenly assigned a 39-year depreciable life, making it ineligible for the bonus depreciation provided by section 168(k) as amended by the TCJA. CARES Act section 2307 fixes this error and categorizes QIP as a 15-year MACRS asset. This amendment takes effect as if originally included in the TCJA.27 Thus, QIP is eligible for the 100 percent bonus depreciation from the effective date of the TCJA.

Like the federal NOL rules, most of the states do not conform to the TCJA’s 100 percent bonus depreciation rule because most of these states already did not conform to earlier federal bonus depreciation provisions (for example, 50 percent bonus depreciation). But approximately one-third of states with a corporate income tax do conform to section 168(k).28 Virtually all these states conform through rolling conformity to the IRC, and therefore will also pick up the CARES Act’s technical correction for QIP. States that only conform to section 168(k) as a result of static conformity, such as Oregon and West Virginia, however, would not immediately incorporate the amendments made by CARES Act section 2307 and will retain the TCJA’s QIP glitch until they

---

26 QIP excludes expenses from enlarging a building, elevators and escalators, or the internal structural framework of a building.
27 CARES Act section 2307(a) (amending section 168(e)(3)(E)(vii), 168(e)(6)(A), and 168(g)(3)(B)). Subsection (b) of CARES Act section 2307 makes these amendments retroactive to the date of enactment of the TCJA.
28 The states that conform to section 168(k) and 100 percent bonus depreciation include Alaska, Alabama, Colorado, Delaware, Illinois, Kansas, Louisiana, Missouri, Montana, North Dakota, Nebraska, New Mexico, Oklahoma, Oregon, Utah, and West Virginia.

For more Tax Notes® State content, please visit www.taxnotes.com.
amend their tax laws to conform. Here, an update of the state codes to the post-CARES Act federal code will be critical.

Another conformity issue relating to section 168(k) affects states that do not conform to bonus depreciation. With the exception of states such as California and Wisconsin, most of the remaining states that do not conform to section 168(k)’s bonus depreciation still adopt the federal deduction for MACRS depreciation. Once again, among these states, those with rolling conformity will obtain the benefit of the CARES Act’s correction of treating QIP as a 15-year depreciable asset. However, those states with static conformity will treat QIP as a 39-year depreciable asset unless they conform to the CARES Act amendments to section 168. About two-fifths of the states fall into the latter category.

Those states that do not have full conformity with the taxpayer-favorable changes to section 168(k), included partially in the TCJA and partially in the CARES Act, should consider adopting the federal rules to give the maximum allowable depreciation deduction for QIP and other capital improvements and provide economic relief to the businesses and industries that have invested most heavily in the state’s economy, before and after the COVID-19 crisis.

Conclusion

The COVID-19 health and economic crisis is putting significant fiscal pressure on both state governments and businesses. With many state budgets forecasted to be in dire straits for the remainder of the 2020 fiscal year as tax revenues decline precipitously, it may be difficult for states to enact taxpayer relief measures to supplement federal financial assistance. However, one way in which states should act, if possible, is to follow the lead of the federal government in the CARES Act and reverse taxpayer-unfavorable provisions included in the TCJA. If a state never conformed to the relevant provisions in the TCJA, it can still independently adopt similar legislative reforms such as the allowance of NOL carryovers or more rapid expensing of capital investments. For instance, the NOL carryback provision will target assistance to businesses that, through no fault of their own, but because of the unforeseen and unprecedented stoppage or slowdown of the country’s economic life, are now suddenly experiencing large losses where previously they had significant income in recent tax years.

This is good public policy at the state level for the same reason it is at the federal level — it provides relief for companies that face a drastically different economic environment than the booming economy in 2017, when the TCJA was enacted. It is also the right thing to do for states from a competitive perspective, since a substantial minority of them have already conformed, in one way or another, to these corporate tax relief measures. Moreover, all three of these taxpayer-favorable changes to the corporate income tax included in the CARES Act involve timing differences and do not involve a rate reduction or another form of a tax cut. These changes generally only affect when a taxpayer pays tax, not whether the tax will be paid.

Finally, none of the federal provisions present radical departures from conventional federal corporate income tax policies. In fact, all were in place in the years before the TCJA was enacted. Generally, the limitations on these deductions enacted as part of the TCJA reflected the need for revenue-raising base broadeners to offset large reductions in the federal corporate income tax rate (for example, changes to sections 163(j) and 172) or drafting errors in the TCJA (for example, change to section 168(k)).

And there is a good post-COVID-19 crisis precedent for states following the lead of the federal government: the extension of filing and payment due dates for state income tax returns. Here, most states have followed the lead of the federal government and extended the due dates for both the filing and payment of individual and corporate income taxes to July 15. To be sure, the tradeoffs may become more difficult for states, particularly when their rainy day funds and federal financial assistance are exhausted. Nonetheless, it behooves states to look for the most cost-effective ways to provide economic relief to their businesses. Keeping businesses alive after the COVID-19 emergency passes is imperative for future economic recovery and growth. Conforming to the corporate income tax changes in the CARES Act is a good starting point.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.