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Q&A: How a New Federal Law Aids the Economy

Key takeaways

- On March 27, 2020, Congress passed and the president signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which provides economic support intended to be quickly available to individuals and businesses.
- The law is innovative in targeting aid as quickly as possible to individuals and businesses, and for how it works with the Federal Reserve to support the U.S. financial system.

What it may mean for investors

- Whether the CARES Act is sufficient to end the selloff still depends upon the pace of infections. We continue to believe that some equity market consolidation is likely, including the possibility that the S&P 500 Index may retest its recent lows.

What is the detail behind the direct payments to households?

The Act sets aside approximately \$269 billion for direct payments to individuals. Individuals with adjusted gross income of up to \$75,000 (\$150,000 for married couples) are eligible to receive a one-time direct deposit of up to \$1,200 (\$2,400 for married couples), plus \$500 per child (under the age of 17) so long as they filed a tax return in either 2019 or 2018.¹ If a taxpayer had adjusted gross income higher than these amounts, the payment is reduced by \$5 for every \$100 above the threshold. The payment phases out for individuals with income exceeding \$99,000 and joint filers at \$198,000.

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¹ Based on adjusted gross income (line 7 on the 1040 tax form). See *NBC News*, "Coronavirus checks, direct deposits are coming. Here's everything you need to know", March 27, 2020. See also *Forbes*, "The CARES Act Has Passed: Here Are the Highlights", by Leon La Brecque, March 28, 2020. For those who did not file a return and do not receive Social Security benefits, a simple return may be filed, per IR-2020-61 IRS.gov.

Treasury Secretary Mnuchin said Wednesday, March 25, that the government will make direct deposits within three weeks, and that there is no need to complete a form or sign up to receive a payment if the taxpayer has been paying taxes or received Social Security payments since 2018.²

How are retirement plans affected?

In order to prevent investors from being forced to sell financial instruments while equity market prices are falling, the Act waives the requirement for 2020 required minimum distributions (RMDs) for everyone. The waiver includes distributions for those who turned 70½ in 2019 and otherwise would have had to take a minimum distribution before April 1, 2020. Investors who have already taken a distribution from their IRA may be able to transfer the funds back and not pay income tax on the distribution. However, investors must be within 60 days from the original distribution and not have completed any other IRA-to-IRA 60-day rollovers in the past 365 days. Inherited IRAs are eligible for the 2020 RMD suspension only and generally cannot be reversed unless the surviving spouse is the beneficiary.³

The Act also allows investors impacted by COVID-19 to take retirement-plan distributions of up to \$100,000 without the usual 10% early withdrawal tax for those younger than 59½. What's more, distributions taken in 2020 can be reported as income evenly over 2020, 2021, and 2022, or can be repaid within those three years to avoid income tax. These provisions apply to qualified individuals, defined as people who:

- (i) are diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (COVID-19) by a test approved by the Centers for Disease Control and Prevention; or
- (ii) have a spouse or a dependent with the virus; or
- (iii) experience financial hardship as a result of quarantine, furlough, lay-off, or reduced hours at work; or
- (iv) are unable to work due to lack of childcare; or
- (v) own and operate a business that suffers closing or reduced hours.

The Act also increases the loan limit from 401(k) accounts from \$50,000 to \$100,000 and allows up to 100% of the vested balance whichever is less, to be used. Any payments may be deferred for up to one year.

Our perspective is that suspending RMDs gives investors choices. In general, we believe it is a positive not to have to take a distribution while equity market prices are low and, instead, spread out distributions into the future, when we could see higher financial market prices. Still, investors who do not have much taxable income may want to study whether it makes sense for them to take the distribution this year to take advantage of their lower tax bracket. We favor avoiding withdrawals at this point, unless an investor has no other adequate source of funds. Otherwise, our strongest preference is to keep the IRA on a course to grow towards the investor's long-term goals.

Investors may also want to consider whether this year is a good opportunity for a Roth IRA conversion. As individual situations vary widely and several items need to be considered, this discussion is best had with an investment professional and a tax professional.

How are unemployment benefits extended?

The Act includes roughly \$250 billion to extend unemployment benefits—not only the period and amount of payments but also the eligibility. While individual states manage unemployment insurance benefits, the CARES Act provides federal funding, through December 31, of an additional \$600 per week for up to four months and removes the one-week waiting period for benefits. The program also extends coverage to those who ordinarily

² The Internal Revenue Service has a website with more information, <https://www.irs.gov/coronavirus>.

³ "COVID-19 and your IRA: Here's What You Need to Know", *Forbes*, by Bernie Kent, March 28, 2020.

would not qualify for state unemployment, including the self-employed, independent contractors, and gig workers.⁴

How does the Act support small businesses in maintaining payrolls?

The Paycheck Protection Program is one of the largest sections of the Act and offers an estimated \$349 billion in government-guaranteed loans to small businesses that have fewer than 500 employees, select types of businesses with fewer than 1,500 employees, 501(c)(3) non-profits with fewer than 500 workers, and some 501(c)(19) veterans organizations.⁵

Loans made through this program are based on 250% of the business' average monthly payroll—with a maximum loan amount of \$10 million. Loans cannot exceed 4% in interest and do not require collateral. The program also expands the existing network of over 800 lenders who can extend credit to eligible businesses, and allows borrowers to defer fees, principal, and interest for 6 to 12 months.⁶ In general, as long as a borrowing firm continues normal payroll payments (with caps for compensation exceeding \$100,000 per year) during the eight weeks after the loan is made, then the borrower can receive forgiveness in the amount of payroll costs, mortgage interest, rent payments, and utility payments paid during that eight-week period.

Other benefits include tax credits and delayed tax payments connected to COVID-19 sales losses, as well as expanded eligibility for the Small Business Administration's Economic Injury Disaster Loans.⁷ The CARES Act significantly expands this disaster loan eligibility and may provide emergency grant cash advances that may qualify for forgiveness if used for paid leave, payroll maintenance, meeting higher supply chain costs, and other qualified expenses. Taxpayers may wish to consult with a tax professional regarding which benefit to receive, as the CARES Act denies certain benefits if the taxpayer selects other benefits.

There are restrictions on businesses that receive the loans. These borrowers must maintain, as close as possible, at least 90% of their employment (as of March 24) through September 30. Also, these businesses may not issue dividends for a year after the loan is repaid.

Are there other tax provisions that are immediately available?

Yes. Congress made adjustments to deduction rules in the existing tax law. Individual taxpayers who do not itemize deductions may reduce taxable income by up to \$300 for cash gifts to qualified charitable organizations. Additionally, a taxpayer who itemizes may deduct 2020 cash gifts to qualified charitable organizations up to their adjusted gross income. Gifts to donor advised funds and supporting organizations do not qualify for this increased deduction or the \$300 non-itemized deduction.

The provisions for deducting net operating losses are more generous, in our opinion.⁸ The Act repeals the 80% income limitation for net operating losses for years beginning before 2021. In addition, contrary to the change made in the Tax Cuts and Jobs Act of 2017, these losses can be carried back five years. These changes may be worth an additional \$28 billion. It is difficult to estimate the total cost of these allowances at this time due to the unknown losses that may be generated from 2020 going forward.

⁴ Gig workers are independent contractors who enter into formal agreements with companies that use their services on an as-needed or on-demand basis.

⁵ U.S. Chamber of Commerce, "Coronavirus Aid, Relief, and Economic Security Act", by Sean Ludwig, March 27, 2020. Also, Forbes, "\$2.2 Trillion CARES Act Provides a Lifeline to Small Businesses", by Rohit Arora, March 27, 2020.

⁶ The program builds on the existing Small Business Administration's 7(a) loan program that is already familiar to many businesses. For more details, please see www.SmallBusinessDisasterSupport.com for details.

⁷ For more information, please see "How to Apply for an SBA Disaster Relief Loan", U.S. Chamber of Commerce, March 26, 2020.

⁸ Losses can now be extended back by five years, excess loss limitation rules for pass-through entities are suspended, and more of a business' interest expense is deductible.

What does the Act do for industries hit directly by the COVID-19 virus?

The Act provides \$500 billion in business loans, loan guarantees, and other investments, with a dedicated inspector general to oversee these funds. The allocations include \$25 billion for passenger airlines and \$4 billion for cargo airlines, and up to \$17 billion for businesses critical for national security. The provisions limit the terms of loans to not more than five years, and the loans cannot be forgiven. Such loans and guarantees require that a borrowing company not repurchase shares, pay dividends or make other capital distributions, and maintain employment close to current levels through September 2020. As well, the loan restricts executive total compensation for up to one year after loan repayment.

Do hospitals and local governments receive additional help?

The Act allocates over \$130 billion for the health care system, including \$100 billion for hospitals, and the balance to acquiring personal and protective equipment for health care professionals, testing supplies, workforce training, accelerated Medicare payments, among other health needs, including free COVID-19 testing across the country. State, local, and tribal governments qualify for another \$150 billion in assistance, including disaster relief, transit programs, and educational institutions.⁹

Does the CARES Act coordinate with Federal Reserve financial system support programs?

Yes. Of the \$500 billion allocated to business lending, \$454 billion is available to support Federal Reserve programs that provide lending to the financial system and to eligible states and municipalities, in order to increase liquidity in financial markets, including the municipal debt market. The Act also allows the Treasury Secretary to use the Treasury's Exchange Stabilization Fund to establish a guarantee program for the U.S. money market mutual fund industry, until December 31, 2020. The Federal Reserve has established a facility to purchase assets from U.S. money market mutual funds in order to maintain money market fund liquidity.

Conclusion

An overriding theme through all these provisions is direct assistance to those whose incomes or revenues are under pressure from the pandemic, and greater flexibility for how and where the Federal Reserve may shore up financial markets. The recent increase in legislative tempo has encouraged financial markets, insofar as the Act allows workers and businesses to bridge the next few months. Most of the provisions of the CARES Act expire between September and December 2020, however. If it takes beyond the third quarter to see a peak in the virus, Congress may need to return with another package.

Ultimately, we believe that the federal government will extend, as necessary, and the economy should rebound by late 2020. Even a strong rebound is possible, once more typical spending rates resume across the economy. Our 12-month outlook is for a rebound in economic growth, earnings growth, and valuations, which should support a broad recovery in equity prices. Yet, beyond the next two years, the implications of today's strong fiscal and monetary response is likely to include a strong potential for higher tax rates and somewhat higher interest rates, depending upon how much additional economic aid ultimately is added to counter the economic fallout from the virus.

⁹ See also *Forbes*, "The CARES Act Has Passed: Here Are the Highlights", by Leon La Brecque, March 28, 2020.

Risk Considerations

All investing involves risks including the possible loss of principal. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

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