Decisions, Decisions: COVID-19 Guidance and Real Estate

by James B. Sowell

Reprinted from Tax Notes Federal, May 11, 2020, p. 931
Decisions, Decisions: COVID-19 Guidance and Real Estate

by James B. Sowell

James B. Sowell is a principal at KPMG LLP’s Washington National Tax practice.

In this article, Sowell discusses decision points of tax provisions and guidance relevant to the real estate industry issued in response to the COVID-19 pandemic.

The author would like to thank Lynn Afeman, Ossie Borosh, Carol Conjura, and Jon Finkelstein for their helpful comments in connection with this article.

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP.

Table of Contents

I. Introduction .................................................. 931

II. CARES Act Provisions and Other Disaster Relief .................................................. 932

A. Deductible Amounts .................................. 932
B. Eliminating Loss Limitations .................. 934
C. Loss Carrybacks ........................................ 934

III. Decision Points ............................................ 935

A. All Taxpayers Are Not the Same ............ 935
B. Partnership Reporting ......................... 935
C. Qualified Improvement Property, Depreciation, and Expensing ............ 937
D. Deductible Business Interest Under Section 163(j) ......................... 939
E. NOLs ...................................................... 940
F. Excess Business Losses ......................... 940
G. Disaster Losses ........................................ 940
H. Refund Opportunities ......................... 942

IV. Conclusion ............................................... 943

I. Introduction

The COVID-19 pandemic has created a rapid and unprecedented change in economic conditions in the U.S. and around the world. Efforts are being undertaken on many fronts to provide relief to individuals and businesses. Among the relief tools are the tax provisions in the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Subsequent guidance issued by the Treasury Department and Internal Revenue Service has made some of the CARES Act provisions more accessible and valuable for the real estate industry.

The tax provisions that are most relevant to the real estate industry can be categorized into three buckets: (1) increased deductions, (2) relaxed limitations on deductibility of losses, and (3) permitted carryback of losses to generate tax refunds and hence, liquidity. Note that these categories are interrelated. That is, increased deductions can generate losses, the limitation on those losses are relaxed so that losses may produce more benefit, and those losses can be carried back without limitation so that the benefit is available over an expanded number of tax years, producing even more benefit.

The purpose of each provision, standing alone, is reasonably easy to understand. But determining a strategy to produce the greatest benefit from these interrelated provisions is
anything but simple. Taxpayers will confront a number of decisions regarding whether to make elections and how to report the results of the new provisions.

This article is intended to highlight these decision points. The article begins with a brief discussion of the relevant CARES Act and other disaster relief provisions along with related guidance. The article then, in a separate section, discusses the decision points created by these provisions and guidance.

Rarely will the optimal combination of decisions be intuitive. Critical factual points relating to the decision process will include income history and projections, entities in the investment structure, and profile of investors. Accounting for these facts, financial modeling to address different decisions will be imperative to determine the most beneficial course of action.

II. CARES Act Provisions and Other Disaster Relief

A. Deductible Amounts

The two primary provisions under the CARES Act that increase available deductions relate to defining the recovery period of qualified improvement property and relaxing the limitation on deductibility of business interest.

1. Qualified Improvement Property, Depreciation, and Expensing

The change to qualified improvement property is a technical correction to the rules enacted under the Tax Cut and Jobs Act of 2017. Under the TCJA, it was intended that the recovery period of qualified improvement property depreciable under the general depreciation system (GDS) would be 15 years or, under the alternative depreciation system (ADS), 20 years. With a GDS recovery period of 20 years or less, qualified improvement property was intended to qualify for the additional first-year depreciation deduction (“bonus depreciation”) under section 168(k). Famously, however, the statutory provision defining qualified improvement property as 15-year property was inadvertently excluded from the statute. As a result, qualified improvement property was 39-year property under GDS, was depreciable over 40 years under ADS, and did not qualify for bonus depreciation under section 168(k). The CARES Act has corrected the error under the TCJA so that, retroactive to the TCJA effective date, the shorter depreciable lives apply and bonus depreciation is available.

Following enactment of the technical correction, Treasury and the IRS issued Rev. Proc. 2020-25. In addition to providing guidance on reporting of the retroactive changes to the treatment of qualified improvement property, the revenue procedure generously provides that, for tax years ending in 2018, 2019, and 2020, taxpayers generally can retroactively make, revoke, or withdraw elections with respect to bonus depreciation and the use of ADS in lieu of GDS in deprecating property placed in service during that period.

2. Business Interest Deduction Limitation Under Section 163(j)

Also as part of the TCJA, section 163(j) was enacted to create a limitation on the deductibility of business interest by reference to the sum of business interest income and 30 percent of adjusted taxable income. Interest that is limited under section 163(j) may be carried forward indefinitely.

For partnerships, the section 163(j) limitation applies at the partnership level. Business interest that is limited at the partnership level is allocated to the partners as “excess business interest expense” and is treated as paid or accrued by the partner in future years only to the extent that the same partnership allocates to the partner “excess business interest income” (that is, business interest income in excess of the amount needed by the partnership for full current-year deduction of business interest expense) and/or “excess taxable

---

1 IRC section 168(e)(6) (definition of qualified improvement property).
2 IRC sections 168(e)(3)(E)(vii) and (g)(3)(B).
4 2020-19 IRB Lexis 785.
5 IRC section 163(j)(1). Floor plan financing interest has no relevance to the real estate industry and hence is not discussed in this article.
6 IRC section 163(j)(2).
7 IRC section 163(j)(4).
income” (that is, ATI in excess of the amount needed by the partnership for full current-year deduction of business interest expense).\(^8\) Once such excess business interest expense is treated as paid or accrued by the partner, it may be deducted based on the partner’s own section 163(j) limitation.\(^9\)

Taxpayers engaged in a real property trade or business could elect not to be subject to section 163(j).\(^10\) As a trade-off for making the election, nonresidential real property, residential rental property, and qualified improvement property would be depreciable under ADS\(^11\) (and hence not eligible for bonus depreciation).

The CARES Act relaxes the limitation under section 163(j) in a number of ways for a limited period. In general, the 30 percent of ATI limitation is increased to 50 percent for tax years beginning in 2019 or 2020.\(^12\) For purposes of calculating the section 163(j) limitation amount, the CARES Act also permits a taxpayer to elect to substitute the ATI for its last tax year beginning in 2019 for its ATI in any tax year beginning in 2020.\(^13\)

For partnerships, the CARES Act contains a different rule applicable to tax years beginning in 2019. Rather than applying the 50 percent of ATI limitation, a partner will be allowed to deduct in 2020 50 percent of excess business interest expense incurred in, and carried forward from, 2019.\(^14\) (The other 50 percent would be subject to the ordinary pre-CARES Act limitations, but using 50 percent for ATI rather than 30 percent of ATI for tax years beginning in 2020.)\(^15\) The 50 percent of ATI limitation will apply to a partnership for any tax year beginning in 2020,\(^16\) and the partnership may elect to use its 2019 ATI amount in applying section 163(j) in 2020.\(^17\)

Taxpayers are permitted to elect not to apply these more generous CARES Act limitation rules.\(^18\)

Given the retroactive ability to take bonus depreciation for qualified improvement property and relaxed limitations on deducibility of business interest expense, in hindsight, the factors to consider in making the real property trade or business election to be excluded from section 163(j) have changed dramatically. In recognition of this fact, Treasury and the IRS issued Rev. Proc. 2020-22\(^19\) allowing taxpayers to change their election decisions. That is, a taxpayer may make or withdraw a real property trade or business election for 2018, 2019, or 2020 by filing an amended federal income tax return, and a partnership may do so by filing an amended Form 1065\(^20\) or an administrative adjustment request (AAR) under section 6227.\(^21\) The filing deadline is October 15, 2021 (or before September 30, 2020, if filing an amended Form 1065)\(^22\) but in no event later than the applicable period of limitations on

\(^{15}\) Id. For tax years that begin in 2020, it appears that all excess business interest expense that is not deductible by the partner under section 163(j)(10)(B)(ii)(II) or (i.e., excess business interest expense accrued prior to a tax year beginning in 2019, and excess business interest expense analyzed under section 163(j)(10)(B)(ii)(II) will be treated as paid or accrued by the partner to the extent of any excess business interest income and excess taxable income allocated to the partner and could then be deducted by the partner based on the partner’s own section 163(j) limitation. For a partner’s 2020 tax year, the partner’s section 163(j) limitation would be computed by reference to 50 percent of the partner’s ATI (which would include any excess taxable income allocated to the partner). For subsequent tax years, the partner’s section 163(j) limitation would be computed by reference to 30 percent of ATI under the normal section 163(j) rules.

\(^{16}\) IRC section 163(j)(10)(A)(i).

\(^{17}\) IRC section 163(j)(10)(B)(ii) and Rev. Proc. 2020-22 at section 6.02, 2020-18 IRB 745.

\(^{18}\) IRC section 163(j)(10)(A)(ii) and (iii); and Rev. Proc. 2020-22 at sections 6.01 and 6.03, 2020-18 IRB 745.

\(^{19}\) 2020-18 IRB 745.

\(^{20}\) Note that the filing of an amended Form 1065 is allowed only to the extent provided under Rev. Proc. 2020-23, 2020-18 IRB 749.


\(^{22}\) As discussed below, under Rev. Proc. 2020-23, 2020-18 IRB 749, the partnership must file any amended partnership return and furnish corresponding Schedules K-1 before September 30, 2020.
assessment for the tax year in which the election is being changed.\(^{23}\)

### B. Eliminating Loss Limitations

The TCJA enacted two rules that imposed significant limitations on a taxpayer’s ability to deduct losses — one applicable to net operating losses and the other applicable to active business losses.

#### 1. Net Operating Losses

For tax years beginning after December 31, 2017, a taxpayer became limited in its ability to deduct NOL carryovers by reference to 80 percent of taxable income.\(^{24}\) Under the CARES Act, the 80 percent limitation is eliminated for NOLs deducted in a tax year beginning before January 31, 2021.\(^{25}\)

#### 2. Excess Business Losses

Following the TCJA, for tax years beginning after December 31, 2017, and ending before January 1, 2026, taxpayers other than C corporations were not allowed to deduct excess business losses.\(^{26}\) For this purpose, “excess business loss” essentially means an applicable taxpayer’s otherwise deductible trade or business losses (excluding the section 199A deduction and deduction for NOLs under section 172) in excess of $250,000 (or $500,000 for married taxpayers filing jointly).\(^{27}\) The excess business loss amount is adjusted for inflation. Disallowed excess business losses were carried forward and treated as an NOL under section 172 in subsequent tax years.\(^{28}\)

As a result of the CARES Act, the excess business loss limitation for non-C corporation taxpayers is retroactively eliminated for tax years beginning before January 1, 2021.\(^{29}\)

### C. Loss Carrybacks

#### 1. NOLs

Also as part of the TCJA, taxpayers were no longer permitted to carry back NOLs generated in tax years beginning after December 31, 2017.\(^{30}\) Under the CARES Act, NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021, may be carried back to each of the five tax years preceding the tax year of the loss.\(^{31}\) This five-year carryback rule does not apply to real estate investment trusts.\(^{32}\) It is important to note that the carryback rule permits carrying back losses to years before 2018 when tax rates were higher, particularly for corporations.

#### 2. Disaster Losses

Although not part of the CARES Act, it also is important to be aware of section 165(i). Under section 165(i), a taxpayer may elect to deduct any loss that occurs in a disaster area and is attributable to a federally declared disaster in the tax year immediately preceding the tax year in which the disaster occurred.\(^{33}\) As a result of Proclamation 9994 issued by President Trump on March 13, 2020,\(^{34}\) the entire United States was designated as a disaster area, thus making a disaster loss possible anywhere in the country. While many past disasters often have given rise to casualty losses, given that more typical disasters like hurricanes and earthquakes create significant property damage, a disaster loss can include any deductible loss that falls within the scope of section 165 and occurs “in a disaster area and [is] attributable to a federally declared disaster.”\(^{35}\) Accordingly, losses associated with items like the closure of stores or restaurants, abandonment of pending business deals for which costs have been capitalized, and abandonment of leasehold improvements, if brought about by the COVID-19 pandemic, may qualify as a disaster loss. Because a disaster loss must qualify as a loss under section 165(a), such losses do not include ordinary-course

---

\(^{23}\) Rev. Proc. 2020-22 at sections 4.02 and 5.02, 2020-18 IRB 745.  
\(^{24}\) IRC section 172(a)(2) (pre-CARES Act).  
\(^{25}\) IRC section 172(a)(1).  
\(^{26}\) IRC section 461(l)(1) (pre-CARES Act).  
\(^{27}\) IRC section 461(l)(3).  
\(^{28}\) IRC section 461(l)(2).  
\(^{29}\) IRC section 461(l)(1).  
\(^{30}\) IRC section 172(b)(1)(A)(i).  
\(^{31}\) IRC section 172(b)(1)(D)(i).  
\(^{32}\) IRC section 172(b)(1)(D)(ii).  
\(^{33}\) IRC section 165(i)(1).  
\(^{34}\) 85 F.R. 15337.  
\(^{35}\) IRC section 165(i)(1).
trade or business deductions under section 162(a), bad debts that are deductible under section 166, NOLs under section 172, a decline in property value (as opposed to a recognized loss), or lost revenue.

III. Decision Points

A. All Taxpayers Are Not the Same

At first blush, it would seem that the goal in navigating the provisions discussed above would be to maximize current or prior losses and carry back those losses to produce the maximum refund. But taxpayer profiles will vary significantly, and for many taxpayers, this approach will not produce the greatest benefit. For example, a taxpayer who has already reported losses during the carryback period may not benefit from the production of additional losses. In fact, because NOLs carried over to 2021 will again be limited to 80 percent of taxable income, the conversion of future deductions to current or past losses (for example, via bonus depreciation for qualified property) that would be carried over may be counterproductive. For REITs, the inability to carry back NOLs and hesitancy in issuing revised Forms 1099 obviously creates different issues. For partnerships, potentially disparate tax profiles for partners (and often a lack of information regarding those profiles), possible hesitancy to force partners to file amended returns or otherwise recalculate taxable income by reference to prior-year partnership reporting, and issues with the partnership audit rules enacted under the Bipartisan Budget Act of 2015 (BBA) all may cause partnerships to adopt approaches that are different than would be adopted if the partnership was a stand-alone taxable entity.

There are a number of levers that might be pulled to accelerate or delay the impact of the provisions described above and to realize the related benefits. Understanding these levers will be important in developing an optimal plan to account for these provisions.

B. Partnership Reporting

To account for statutory and administrative changes resulting from the COVID-19 crisis, it may be necessary to alter prior reporting of items. The process is relatively straightforward for most taxpayers — that is, file an amended return.

Since enactment of the BBA rules, however, changing prior reporting for partnerships follows a different path than is the case for other taxpayers. For partnership tax years beginning after December 31, 2017, a partnership that is subject to the BBA rules could not file an amended return to adjust items within the scope of the new regime. Instead, to adjust such items previously shown on an original Form 1065 or Schedule K-1, the partnership must file an AAR under section 6227.36

Under section 6227, if a partnership reports adjustments on an AAR that result in an imputed underpayment (that is, increased income or reduced deductions or losses), the partnership may pay the imputed underpayment (under the section 6225 rules, using more limited rules for modifications) or may “push out” the adjustments (under the section 6226 rules) to the partners from the reviewed year.38 If a partnership reports adjustments on an AAR that do not produce an imputed underpayment (that is, reduced income or increased deductions or losses), the partnership must push out the adjustments (under the section 6226 rules) to the partners from the reviewed year.39

If the partnership follows the push-out procedure, partners that are individuals or taxable entities and receive a statement under the AAR procedures must compute their “additional reporting year tax,” which may be less than zero.40 This is done by determining for each year, beginning with the partner’s tax year that includes the partnership’s reviewed year (that is, the partnership tax year in which adjusted items would have been reported), the amount by which the partner’s income tax would have increased or decreased (and properly adjusting attributes) had the AAR adjustments been properly reported on the partner’s return for that year.41 This calculation

36 IRC section 6227; Treas. reg. section 301-6227-1.
37 Treas. reg. section 301.6227-2(a)(2) and (b)(1).
38 Treas. reg. section 301.6227-2(c).
39 Treas. reg. section 301.6227-2(d).
40 Treas. reg. section 301.6226-3(a).
41 Treas. reg. section 301.6226-3(b).
is replicated for subsequent tax years, and the sum of these amounts is computed for each year through the “reporting year” (that is, the partner’s tax year in which the statement under section 6227 is received) to determine the increased or decreased reporting year tax, and this amount is then reflected on the partner’s income tax return as an increase or decrease in income tax due for the reporting year. 42

In some ways, the AAR process may be preferable to the filing of an amended partnership return, as it does not require that the partners file amended returns. Instead, when the net adjustments are taxpayer-favorable, each partner will recompute its tax liability (and adjust attributes) as if the adjustments had been originally reported and then reflect the change in tax liability (for the reviewed year and all succeeding tax years) as a reduction of the income tax liability otherwise due on the partner’s tax return for the reporting year. A significant flaw exists in these rules, however. While the favorable adjustments reduce the partner’s tax liability for the reporting year, the adjustments cannot independently produce a refund when the partner is not otherwise overpaid for the tax year. 43 Accordingly, if the partner does not otherwise owe income tax, or has not overpaid tax for the reporting year, the adjustments will produce no benefit. 44

In recognition of this unfair result and the fact that the result is contrary to the purpose of the CARES Act tax provisions (that is, create liquidity by putting cash in taxpayers’ hands), Treasury and the IRS issued Rev. Proc. 2020-23 45 to allow partnerships to file amended returns for tax years beginning in 2018 and 2019, as long as the original return was filed, and Schedules K-1 furnished, before April 8, 2020. 46 According to Rev. Proc. 2020-23:

BBA partnerships that filed a Form 1065 and all required Schedules K-1 for the taxable years beginning in 2018 or 2019 prior to the issuance of this revenue procedure [(that is, April 8, 2020)] may file amended partnership returns and furnish corresponding Schedules K-1 before September 30, 2020. The amended returns may take into account tax changes brought about by the CARES Act as well as any other tax attributes to which the partnership is entitled by law. 47

Rev. Proc. 2020-23 contains procedural requirements for the filing of amended returns and describes special considerations for BBA partnerships whose returns are under examination and that have previously filed AARs for the relevant year.

In the context of favorable adjustments that reduce income or increase deductions, note that there are two significant differences between filing an AAR and amended return in the context of the distressed times in which we find ourselves. First, as mentioned above, a refund is not possible (except for current-year estimated taxes) when filing an AAR, so an amended return will be necessary in situations in which a refund of previously paid taxes is the only way to benefit from the CARES Act provisions. Second, for partners who will have a positive tax liability for 2020 and hence could use the AAR adjustment to reduce their liability, the AAR process does provide a means of benefiting from the CARES Act provisions, but timing in realizing the benefit could be very different. Rev. Proc. 2020-23 highlights the latter point with the following statements:

Filing an AAR would result in the partners only being able to receive any benefits from that relief on the current taxable year’s federal income tax return. Thus, if

---

42 Id. If the adjustment does not result in an imputed underpayment, each pass-through partner of the partnership (i.e., a partnership, a trust that is not a grantor trust, estate, and S corporation) must further “push out” the adjustments until reaching the individuals or entities for whom tax would be assessed regarding the adjustment. Treas. reg. section 301.6227-2(c)(2).

43 Treas. reg. section 301.6226-3(b)(1).

44 See generally Kate Kraus, “Partnership Administrative Adjustment Requests Are Dangerous,” Tax Notes Federal, Apr. 20, 2020, p. 435.


46 If a partnership that is subject to the BBA filed Form 1065 or Schedules K-1 on or after April 8, 2020, the partnership would be required to use an AAR to adjust items for the 2019 tax year. 47 Rev. Proc. 2020-23, 2020-18 IRB 749.
an AAR were filed, the partners generally would not be able to take advantage of CARES Act benefits from an AAR until they file their current year returns, which could be in 2021. This process would significantly delay the relief provided in the CARES Act intended to apply to the affected taxable years and provide an immediate benefit to taxpayers. 46

When adjustments result only in increased income or reduced deductions (for example, partnership retroactively elects not to expense property or slows depreciation) for all partners, there is an additional difference between filing an AAR and amended return. Under an AAR, the partnership may itself pay any imputed underpayment, thus avoiding any requirement for the partners to amend returns or otherwise recalculate income. 47

C. Qualified Improvement Property, Depreciation, and Expensing

The CARES Act technical correction regarding qualified improvement property creates significant opportunities to adjust income and loss on a retroactive basis. Rev. Proc. 2020-25 50 sets forth flexible options for reporting the qualified improvement property changes and presents further opportunities in allowing retroactive changes to depreciation methods for other types of property.

Before describing the details of the revenue procedure, it is useful to highlight the broad-based choices that are presented. First, there is the option to claim bonus depreciation or elect not to claim bonus depreciation. Second, there is the option to choose between GDS and ADS depreciation. Third, there is the choice to reflect the changed depreciation methods through filing amended returns (or AARs for partnerships), or through a change in method of accounting with a section 481 adjustment to reflect depreciation deductions that should have been claimed in prior years. These three choices present significant opportunities to alter income and loss numbers and to target those changes to specific tax years.

Section 3 of Rev. Proc. 2020-25 addresses changes regarding the depreciation of qualified improvement property brought about by the CARES Act technical correction. As a result of the technical correction, the recovery period for qualified improvement property placed in service after December 31, 2017, changed on a retroactive basis from 39 years (GDS) and 40 years (ADS) to 15 years (GDS) and 20 years (ADS). To account for these changes, the revenue procedure generally allows taxpayers to file an amended return 51 (or AAR for partnerships) 52 for tax years ending in 2018, 2019, or 2020, generally on or before October 15, 2021. Or taxpayers may file a Form 3115, “Application for Change in Accounting Method,” for qualified improvement property placed in service after December 31, 2017, and in the taxpayer’s tax year ending in 2018, 2019, or 2020. 53

If the taxpayer files an amended return, the adjustment will be reflected in the tax year of the amended return. If a partnership files an AAR, the adjustment will be calculated by reference to the difference in the relevant partner’s tax due for the tax years when greater depreciation would have been reported (because of the shorter recovery period), but the tax impact of the adjustment will be treated as a reduction to taxes owed by the partner in the partner’s tax year when the statement of adjustment is received. If the taxpayer files a Form 3115 to change to a permissible method of accounting, the cumulative amount of underreported depreciation for qualified improvement property would be reported as a section 481 adjustment reducing taxable income in the tax year when the accounting method is changed. 54 Taxpayers that

---

46 Id.
47 Treas. reg. section 301.6227-2(b)(1). Depending on the nature of the partners and available modifications (see Treas. reg. section 301.6227-2(a)(2)), the tax liability paid by the partnership under section 6225 could be greater than if the adjustments were pushed out to the partners.
48 2020-19 IRB 785.
50 An amended return generally must be filed by October 15, 2021, to conform to the requirement of Rev. Proc. 2020-25. However, Rev. Proc. 2020-23 allows for the filing of amended Forms 1065 by partnerships only before September 30, 2020. In neither of the situations may the amended return be filed after the period of limitation for making adjustments.
52 Rev. Proc. 2020-25 permits the filing of an AAR to account for the changes by October 15, 2021, but no later than the period of limitation for making adjustments.
53 A Form 3115 must be filed with the taxpayer’s timely filed federal income tax return or Form 1065 under the automatic change procedures in Rev. Proc. 2015-13, 2015-5 IRB 419.
are making or withdrawing an election under section 163(j) in accordance with Rev. Proc. 2020-22 (relating to a real property trade or business) must correct qualified improvement property depreciation on an amended return or AAR as provided in that revenue procedure, rather than through an accounting method change.55

Section 4 of Rev. Proc. 2020-25 allows an extension to make some elections related to the depreciation and expensing of property. For property placed in service in tax years ending in 2018, 2019, or 2020, a taxpayer may retroactively elect (1) under section 168(g)(7) to depreciate property using ADS rather than GDS,57 (2) under section 168(k)(7) not to take bonus depreciation for qualified property,58 and (3) under section 168(k)(10) to take bonus depreciation of 50 percent rather than 100 percent for qualified property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during its tax year that included September 28, 2017.

Under the revenue procedure, a taxpayer may make a late election under section 168(g)(7) or (k)(7), if the taxpayer (1) placed in service depreciable property during a tax year ending in 2018, 2019, or 2020, (2) timely filed its federal income tax return or Form 1065 for the placed-in-service year of such depreciable property and such return was filed on or before April 17, 2020, and (3) did not previously revoke or withdraw such election. A taxpayer may make a late election under section 168(k)(10) if the taxpayer (1) timely filed its federal income tax return or Form 1065 for the taxpayer’s tax year that included September 28, 2017, and (2) did not previously revoke or withdraw its section 168(k)(10) election.

As with the processes accounting for changes to qualified improvement property depreciation described in section 3 of the revenue procedure, a change resulting from a late election described in section 4 may be accounted for in an amended return, AAR, or accounting method change. The timing for filing amended returns and AARs is the same under section 4 as section 3. The Form 3115 reflecting a change in method of accounting must be filed with the taxpayer’s timely filed original federal income tax return or Form 1065 (1) for the taxpayer’s first or second tax year succeeding the tax year when the taxpayer placed the property in service, or (2) that is filed on or after April 17, 2020, and on or before October 15, 2021.

Finally, section 5 of Rev. Proc. 2020-25 provides procedures whereby a taxpayer may retroactively revoke previously made elections under sections 168(k)(7) and 168(k)(10) and may withdraw an election made under section 168(g)(7). The revocation of the election under section 168(k)(7) would provide for bonus depreciation regarding the assets in the class that are the subject of the revocation. Consistent with sections 3 and 4 of the revenue procedure, the elections regarding section 168(k)(7) and (k)(10) may be revoked by filing amended returns, AARs, or an accounting method change. A taxpayer may withdraw an election under section 168(g)(7) only by filing an amended return or AAR. The timing and processes for revoking or withdrawing such elections are the same as provided for making late elections under section 4 of the revenue procedure.

Sections 4 and 5 of Rev. Proc. 2020-25 obviously present taxpayers with the opportunity to increase deductions (by taking bonus depreciation or increasing depreciation through a change from ADS to GDS) or reduce deductions (by not taking bonus depreciation, reducing bonus depreciation under section 168(k)(10), or decreasing depreciation through a change from GDS to ADS) in a tax year. These results can be reported to the taxpayers as if recognized in the earlier tax years through amended returns, amended Forms 1065 (to the extent permitted under Rev. Proc. 2020-23), or AARs for partnerships. If deductions are increased and the change is accounted for as a change in method of accounting, the cumulative adjustment for the affected years before the change will be accounted for as a negative section 481 adjustment (that is, a
reduction to taxable income) in the year of the change. If deductions are reduced and a change in method is used, the positive section 481 adjustment (that is, an increase in taxable income) will be spread equally among the year of the change and the three subsequent tax years.

**D. Deductible Business Interest Under Section 163(j)**

 Whereas the decisions on qualified improvement property and other depreciable property affect the timing of deductions, decisions to forgo current deductions under section 163(j) may mean that the business interest expense deductions will never be available, at least as deductions against ordinary income. Thus, if a choice will be made not to claim the maximum current benefit under section 163(j), the taxpayer generally will want to be fairly comfortable that deferred interest ultimately will be freed up at a time when the deduction will be of greater value to the taxpayer.

 There are two clear decision points brought about by the CARES Act statutory changes to section 163(j). The first is whether to use 2019 ATI instead of 2020 ATI for purposes of applying the section 163(j) limitation in 2020. Given the financial stress created by COVID-19 in 2020, use of 2019 ATI often will result in more deductible business interest expense under section 163(j). A taxpayer also may opt to apply section 163(j) as if the CARES Act changes had not been made and thus use 30 percent of ATI in calculating the limitation amount. For partnerships, there are two separate elections. A partner can elect not to deduct 50 percent of its excess business interest expense from 2019 and 2020, forgoing the real property trade or business interest expense remains deferred at a time when the real property trade or business election and being subject to section 163(j) is potentially less burdensome. It is important to recognize, however, that if some business interest expense remains deferred at a time when the real property trade or business election decision for previous years under Rev. Proc. 2020-22 has significant implications. First, bonus depreciation for qualified improvement property becomes available to taxpayers who revoke a real property trade or business election. Also, nonresidential real property, residential rental property, and qualified improvement property may be depreciated using GDS rather than ADS. The difference in depreciation systems can be particularly significant for residential rental property acquired before January 1, 2018, as the GDS recovery period for such property is 27.5 years compared with the ADS recovery period of 40 years, and the conversion of such property to ADS beginning in 2018 may have slowed depreciation significantly. The difference is less significant for property acquired beginning in 2018 since the ADS recovery period was reduced to 30 years for such property.

 Given the relaxed section 163(j) limitation for 2019 and 2020, forgoing the real property trade or business election and being subject to section 163(j) is potentially less burdensome. It is important to recognize, however, that if some business interest expense remains deferred at a time when the real property trade or business election decision for previous years under Rev. Proc. 2020-22 has significant implications. First, bonus depreciation for qualified improvement property becomes available to taxpayers who revoke a real property trade or business election.
election will be made in the future, it is likely that such disallowed interest will not be deductible after the election is made.69

E. NOLs

As indicated above, the CARES Act eliminates the 80 percent of taxable income limitation on deductibility for NOLs carried over or carried back to tax years beginning before January 1, 2021.70 Also, NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021, will be carried back to each of the five preceding tax years beginning with the earliest tax year.71

Again, the NOL provision contains choices to be made by the taxpayer. A taxpayer may elect to relinquish the entire carryback period.72 Two other elections relate to the interaction of NOL carrybacks and the transition tax on deemed repatriation income under section 965.73 Both elections have the effect of not applying the NOL carrybacks to affect the amount of the section 965 transition tax. Under one option, a taxpayer may elect to forgo the carryback of any NOL to a tax year in which an amount was includable in gross income by reason of section 965(a).74 If a taxpayer does not make this election, the taxpayer will be deemed to have made an election under section 965(n) so that the NOL carryback will not be taken into account in calculating the section 965 transition tax.75 Rev. Proc. 2020-2476 provides guidance on NOL carrybacks under the CARES Act.

It is important to note that the elimination of the 80 percent limitation on NOLs does not apply by reference to the year when the losses are incurred but instead applies by reference to losses carried forward or carried back to the specified year.77 Accordingly, an NOL arising in 2019 that is carried forward to 2021 will become subject to the 80 percent limitation, even though that same loss carried forward to 2020 was not subject to the limitation.

F. Excess Business Losses

As described above, under the TCJA, a taxpayer who was limited by section 461(l) could carry over the disallowed excess business loss as an NOL to the subsequent year.78 Accordingly, a taxpayer who was limited in 2018 had an NOL to apply against taxable income in 2019.

As a result of the CARES Act change, the disallowed business loss in 2018 is now available for deduction against other nonbusiness income in 2018. Importantly, however, the taxpayer no longer has an NOL to apply in 2019. Accordingly, if the taxpayer does not file an amended return to claim the benefit of the CARES Act change, unless guidance is issued to provide relief, it appears that the taxpayer will lose the loss that formerly was disallowed in 2018.

G. Disaster Losses

With the allowance of NOL carrybacks, one might think that the ability to carry back losses for one year under section 165(i) would be of little use. But the application of section 165(i) is nuanced — the provision can provide benefits in instances when an NOL carryback will not be available.

69 When a taxpayer makes a real property trade or business election under section 163(j)(7)(A)(ii), all items of that taxpayer will cease to be treated as “trade or business” items for purposes of section 163(j).

70 IRC section 172(a)(1).

71 IRC section 172(b)(1)(D)(i).

72 IRC section 172(b)(3); and Rev. Proc. 2020-24 section 4.01(1), 2020-18 IRB 750. See also CARES Act section 2003(d)(4)(B) (for NOLs arising in a tax year beginning before January 1, 2018, and ending after December 31, 2017, an election to forgo carryback, limit period of carryback, or revoke election to carryback the NOL may be filed within 120 days after March 27, 2020 (i.e., the date of enactment)).


74 IRC section 172(b)(1)(D)(v); and Rev. Proc. 2020-24 section 4.01(2), 2020-18 IRB 750.


78 IRC section 461(l)(2).
First, it is important to understand that section 165(i) applies to specific loss items that arise from a disaster. Thus, it may be possible to carry back loss items under section 165(i) from a year when the taxpayer is otherwise profitable. Obviously, the benefit in this situation is one of timing. That is, for a disaster loss incurred in 2020, the taxpayer may carry back the disaster loss and reduce the tax owed on its 2019 return or request a refund if the return has already been filed instead of using the loss to reduce estimated taxes due on its 2020 return.

Second, from a timing perspective, a taxpayer does not need to file its return for the year when the disaster loss is incurred in order to carry that loss back to the prior tax year. Instead, the taxpayer simply treats the disaster loss as having been incurred in the prior year and never reports it on the return for the year when the loss is incurred. Thus, unlike carrying back an NOL from the return that is filed for the loss year, a disaster loss can be reported on the prior-year return at any time after the disaster loss is incurred.

Third, for noncorporate taxpayers, a disaster loss may reflect an item that is not included in the calculation of an NOL. The loss items that qualify under section 165(i) often will represent capital losses, and for noncorporate taxpayers, losses from the sale or exchange of capital assets cannot exceed gains from the sale or exchange of such assets in calculating NOLs. Also, capital loss carrybacks generally are not permitted for individuals. Thus, section 165(i) represents a way for individuals to carry back some capital loss items that otherwise could not be carried back.

Fourth, REITs are not allowed to carry back NOLs under the CARES Act provision. Section 165(i) presents an opportunity for a REIT to reduce its 2019 taxable income. For a REIT that was planning to use a throwback dividend to satisfy its distribution requirement for 2019, the throwback dividend election may be avoided.

Before going to the effort of electing to carry back a disaster loss under section 165(i), it will be important to confirm that the loss will actually produce a benefit for the relevant taxpayers. For individuals, a disaster loss under section 165(i) that is not associated with a trade or business or does not produce a capital loss generally will be nondeductible under section 67 as a miscellaneous itemized deduction. Obviously, the carryback of an unusable deduction will not make the recipient taxpayers very happy.

Note that treating the disaster loss deduction as occurring in the prior tax year may affect that calculation of other limitations like section 163(j).

Finally, there is a question regarding the application of section 165(i) in the partnership context. It appears that the partnership must make the election, so partners cannot choose separately based on whether they, personally, would benefit from such an election. Section 165(i) provides that the election will be made by the “taxpayer,” and a partnership is treated as a taxpayer for most purposes. Also, the instructions for Form 4868 appear to indicate that the partnership is the relevant party for electing under section 165(i). Obviously, the position of partners may be different in the benefit they would derive from an election under section 165(i), and the partnership could be put in a difficult position in deciding to make such an election. Beyond the obvious situation when partners may have different timing preferences in reporting the disaster loss based on their specific...
tax positions, there also may be inequities in reporting a 2020 disaster loss as occurring in 2019 if some portion of the loss could be allocated to partners who have sold or redeemed their interests before the loss was incurred.

H. Refund Opportunities

In the case of a taxpayer who may claim a refund based on the carryback of an NOL, the taxpayer has two choices regarding how it will pursue the refund claim.

In general, if an individual or corporate taxpayer wishes to make a claim for refund regarding a tax year for which the tax return has already been filed, the claim must be made on Form 1040X, “Amended U.S. Individual Income Tax Return,” or Form 1120X, “Amended U.S. Corporation Income Tax Return.” Receipt of a refund following these procedures can be a prolonged process, as the IRS often will undertake a complete audit of the returns for which the refund is requested. If the requested refund exceeds $2 million (or $5 million for a C corporation), the IRS is required to make a report to the Joint Committee on Taxation, and the refund may not be paid until the expiration of a 30-day period following submission of the report.88

An expedited process is provided, however, under section 6411 that permits a tentative refund or credit based on the carryback of an NOL. A taxpayer generally is required to file the tentative carryback application within 12 months of the close of the tax year when the NOL arose.89 Corporations must file the application for the tentative carryback adjustment on Form 1139, “Corporation Application for Tentative Refund,” and other taxpayers must use Form 1045, “Application for Tentative Refund.”90 In Notice 2020-26,91 Treasury and the IRS have relaxed the 12-month requirement for NOLs that arose in a tax year that began during the 2018 calendar year and ended on or before June 30, 2019.92 The IRS also has established a temporary fax procedure for processing forms 1139 and 1045 to expedite eligible refund claims.93

The IRS is required to act on an application under section 6411 (1) within 90 days after the application is filed or (2) within 90 days after the last day of the month that the return for the year reflecting the NOL is due (including extensions), whichever is later. Upon receipt of a tentative refund claim, the IRS will undertake a preliminary examination to discover omissions and computational errors.94 The IRS may refuse an application containing computational errors or material omissions that the IRS believes cannot be corrected within the 90-day period.95 If the IRS approves the application, the reduction in taxes that results from the NOL carryback first will be credited against unpaid taxes and the remainder will be tentatively refunded.96 The IRS may make the tentative refund or credit against taxes before submitting any report to the JCT when the tentative refund amount exceeds the $2 million/$5 million cap.

Following the issuance of a tentative refund or credit, the IRS generally will undertake a full examination of the return following its normal auditing procedures. Notwithstanding approval of the tentative refund application, the IRS still may later determine that the amount refunded or credited under the tentative procedure exceeded the correct amount for the year and may institute procedures for collecting the excess. When the proper refund or credit amount is finally determined and exceeds the $2 million/$5 million cap, the IRS must file a report with the JCT.97

---

89 IRC section 6411(a); and Treas. reg. section 1.6411-1(c).
90 Treas. reg. section 1.6411-1(b)(1).
91 2020-18 IRB 744.
92 See also CARES Act section 2003(d)(4)(A) (for NOLs arising in a tax year beginning before January 1, 2018, and ending after December 31, 2017, an application under section 6411(a) may be filed within 120 days after March 27, 2020 (i.e., the date of enactment)).
93 IRS, “Temporary Procedures to Fax Certain Forms 1139 and 1045 Due to COVID-19,” last updated May 1, 2020.
94 Treas. reg. section 1.6411-3(b).
95 Treas. reg. section 1.6411-3(c).
96 Treas. reg. section 1.6411-3(d).
97 IRC section 6405(b).
IV. Conclusion

As this article highlights, the CARES Act statute and other disaster relief provisions and guidance present many opportunities to alter a taxpayer’s taxable income or loss on a current and retroactive basis.

First, current deductions generally will be increased, although there are opportunities to reduce or delay deductions. The technical correction regarding qualified improvement property will increase depreciation deductions starting in 2018, and the increase will be multiplied if bonus depreciation is claimed for these assets. Related administrative guidance allows changes in elections relating to depreciation methods or expensing that can increase or decrease taxable income on a retroactive basis. Modifications to section 163(j) make it likely that increased deductions will be available for 2019 and 2020 (or all in 2020 for partners and partnerships). Also, the ability of taxpayers to retroactively revoke real property trade or business elections under section 163(j)(7)(A)(ii) presents opportunities to increase depreciation deductions (including bonus depreciation), possibly at the cost of some increased limitation on deductibility of interest.

NOLs in 2018, 2019, and 2020 may be carried back five years with no limitation. The “80 percent of taxable income” limitation returns, however, for losses carried forward to tax years beginning after December 31, 2020, so it may be advisable to avoid accelerating deductions that would create NOLs carried over to that period. Section 165(i) presents limited carryback opportunities for disaster losses, and in some circumstances, the loss items may be in addition to those included in NOLs. For individuals and other noncorporate taxpayers, the limitation under section 461(l) for deduction of excess business losses is turned off until tax years beginning after December 31, 2020, and it appears that previously limited losses will disappear unless the taxpayer files an amended return to claim the disallowed losses.

The timing for recognition of the increased income or deductions relating to qualified improvement property and other depreciable assets can vary depending on whether the taxpayer files an amended return, AAR, or Form 3115 for a change in method of accounting. For partnerships, the chosen alternative can affect whether partners themselves have to file amended returns or instead recalculate income or loss as if the items had been accounted for on an amended return, and thereafter include the adjustment to tax in the partner’s tax year when the AAR report is received. Using a change in method of accounting will be the simplest route for partners, but choosing this route may prevent the creation of NOLs in earlier years that could be carried back further into the past.

Finally, for taxpayers who are entitled to a refund, there are two options for pursuing the refund — the regular process or the faster, tentative refund process. The IRS is taking steps to streamline and expedite the tentative refund process and is encouraging taxpayers to follow this process.

If the reader is confused, this is completely understandable. The myriad choices make for a complicated exercise. In all but the simplest of situations, it will be advisable to identify the potential decisions and model the results in different scenarios. Undertaking this exercise will force taxpayers to identify the decision points and think through whether alternative decisions can produce meaningfully different tax results. It should be the case that if a taxpayer makes proper assumptions, understands the relevant decision points, and develops a model to reflect the results of decisions made, the numbers will not lie. Hopefully, this article will be of use in that pursuit.