

# CARES ACT GUIDANCE PROVIDES TAXPAYERS WITH FLEXIBILITY TO MAKE FAVORABLE ADJUSTMENTS TO DEPRECIATION AND EXCESS BUSINESS INTEREST

In April 2020, the IRS released several pieces of guidance providing taxpayers with the ability to receive immediate cash flow benefits and implement tax planning opportunities associated with changes made to depreciation under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The procedures in the guidance summarized below present taxpayers with a limited time period in certain circumstances to claim additional depreciation expense for assets placed in service during 2018, 2019 and 2020. While many of the benefits are associated with the depreciation of qualified improvement property (QIP), several provisions apply to other types of depreciable property as well.

The legislative history to the 2017 tax law known as the Tax Cuts and Jobs Act (TCJA) signaled Congress' intent to treat QIP as 15-year, bonus-eligible property. However, due to a drafting error, QIP was inadvertently characterized as 39-year property ineligible for bonus depreciation. On March 27, 2020, the CARES Act corrected this drafting error by treating QIP placed in service after December 31, 2017, as bonus-eligible, 15-year property. In response to the retroactive correction, the IRS released Rev. Proc. 2020-25 to provide guidance allowing taxpayers to claim additional depreciation by amending their prior return(s) or filing an automatic Form 3115, Application for Change in Accounting Method. As further discussed below, Rev. Proc. 2020-25 also provides taxpayers the ability to revoke a prior election out of bonus depreciation or make a late election to elect out of bonus depreciation while Rev. Proc. 2020-22, provides taxpayers with the ability to make or revoke a late election under Section 163(j). Additionally, Rev. Proc. 2020-22 sets forth the procedures for taxpayers to make other Section 163(j) elections under the CARES Act, including the election out of the 50% adjusted taxable income (ATI) limitation for 2019 or 2020 and the election to use 2019 ATI

in a 2020 taxable year.

Under Section 163(j)(7)(A), as amended by TCJA, certain taxpayers are allowed to make an irrevocable election (real property trade or business election or farming business election) to opt out of the interest expense deduction limitation under Section 163(j). In exchange for being able to deduct the full amount of business interest expense, taxpayers making the election must calculate depreciation expense for nonresidential real property, residential rental property, and qualified improvement property using the Alternative Depreciation System (ADS), which generally requires longer recovery periods as compared to the General Depreciation System (GDS).

Given the drafting error in the TCJA, many taxpayers with QIP placed in service during 2018 or 2019 chose to make the real property trade or business election (or farming business election) due to the minimal difference between GDS and ADS depreciation for QIP. Now that QIP is bonus-eligible, many taxpayers may find more benefit if they deduct additional depreciation expense relative to the deferral of interest expense under Section 163(j). Accordingly, Rev. Proc. 2020-22 provides such taxpayers relief by allowing them to revoke their election made on prior year returns and claim additional depreciation expense under GDS.

Taxpayers that adjust their prior-year depreciation (and/or Section 163(j) limitation, if revoking an election under Rev. Proc. 2020-22) will need to consider any ancillary effects of the adjustments. For instance, provisions such as Section 263A, which requires taxpayers to capitalize depreciation associated with the production or resale of inventory, or Section 250, which involves the computation of a taxpayer's depreciable basis in tangible property, may need to be adjusted in certain instances. In

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In addition, if the additional depreciation expense from QIP results in a taxpayer generating a loss in a taxable year that is eligible for carryback to a prior year with a higher tax rate, the difference in tax rates may generate permanent tax savings. As such, it is essential for taxpayers to consider the comprehensive impact on their tax positions when evaluating potential action steps provided under the two revenue procedures.

## **Rev. Proc. 2020-25 – Adjusting Depreciation Expense for Prior Years**

Rev. Proc. 2020-25 provides that changing the depreciation of QIP to 15-year, bonus-eligible property constitutes a change from an impermissible to permissible method of accounting. With respect to QIP placed in service by the taxpayer after December 31, 2017, the revenue procedure allows taxpayers to correct their depreciation expense by either amending their returns or filing an automatic Form 3115 with a timely filed (including extensions) federal tax return.

Important considerations under Rev. Proc. 2020-25 are summarized below:

- Taxpayers choosing the amended returns option generally must file on or before October 15, 2021. Partnerships subject to the centralized partnership audit regime may file an amended Form 1065 under Rev. Proc. 2020-23, but must do so before September 30, 2020. If a partnership subject to the centralized partnership audit regime chooses not to file an amended Form 1065 or cannot file an amended Form 1065 (e.g., because the placed-in-service year of QIP is not within the scope of Rev. Proc. 2020-23), it may file an administrative adjustment request (AAR) instead. Partnerships that are not subject to the centralized partnership audit regime cannot file an AAR and must therefore file an amended return.
- The amended returns or AARs must include the adjustment to taxable income for the change in QIP depreciation expense as well as any collateral adjustments (e.g., Section 263A). Such collateral adjustments may include adjustments to original or amended returns for any affected succeeding taxable years as well, such as depreciation expense on a 2019 return that was filed by a partnership on or before March 15, 2020.
- Taxpayers choosing to file a Form 3115 may avail themselves of a new automatic change #244, which applies only to QIP placed in service after December 31, 2017. This new method change provides taxpayers with streamlined procedures by temporarily waiving certain eligibility rules and offering reduced filing requirements. If taxpayers choose the Form 3115 option, the additional depreciation is computed as a Section 481(a) “catch-up adjustment” that is included in the return as a reduction to taxable income for the year of change.
- Taxpayers are also allowed to make a late election to opt out of bonus depreciation, make a late election to use ADS, or revoke an election out of bonus depreciation by filing an amended return, amended Form 1065 or AAR for the year the property was placed in service. Alternatively, taxpayers can forego amending returns (or filing an AAR) by filing an automatic method change #245 for the first or second taxable year after the taxable year in which the taxpayer placed the property in service, or, if later, the taxable year for which the taxpayer timely files an original federal income tax return on or after April 17, 2020, and on or before October 15, 2021. Importantly, these late elections and revocation are not limited to QIP only.



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- Rev. Proc. 2020-25 also clarifies that for purposes of the Remodel-Refresh Safe Harbor under Rev. Proc. 2015-56, taxpayers may treat capital expenditures under the remodel-refresh safe harbor as QIP to the extent the taxpayer can substantiate that such expenditures qualify as QIP.

## Rev. Proc. 2020-22 – Elections under Section 163(j)

Rev. Proc. 2020-22 allows taxpayers to retroactively withdraw or make a late election under Sections 163(j)(7)(B) (real property trade or business) or 163(j)(7)(C) (farming business). Additionally, taxpayers may also make certain elections related to amendments made to Section 163(j) under the CARES Act. Key considerations of Rev. Proc. 2020-22 are described in further detail below:

- Taxpayers may withdraw a Section 163(j)(7) election for their 2018, 2019 or 2020 taxable year by filing an amended federal income tax return, amended Form 1065, or AAR, as applicable, on or before October 15, 2021. Partnerships filing an amended Form 1065 pursuant to Rev. Proc. 2020-23 must file the amended return and furnish corresponding Schedules K-1 before September 30, 2020. The adjustments to taxable income for the late Section 163(j) election must include any collateral adjustments to taxable income or to tax liability, including any additional depreciation allowed under GDS. Further, a taxpayer must also file amended federal income tax returns, amended Forms 1065, or AARs, as applicable, for any affected succeeding taxable years.
- Rev. Proc. 2020-25 clarifies that a taxpayer withdrawing an election under Section 163(j)(7) must do so under the provisions of Rev. Proc. 2020-22 exclusively. That is, taxpayers cannot retroactively withdraw a real property trade or business or farming

business election by filing a Form 3115 and claiming additional depreciation or adding back interest expense via a Section 481(a) adjustment. Partnerships contemplating claiming additional depreciation will need to fully evaluate the manner in which these benefits are obtained since a Form 3115 allows the current year partners to benefit from the bonus depreciation whereas an amended return or AAR gives the benefit to adjusted year partners.

- Taxpayers may make a late election under Section 163(j)(7) for their 2018, 2019 or 2020 taxable year by filing an amended federal income tax return, amended Form 1065, or AAR, as applicable, on or before October 15, 2021. Partnerships filing an amended Form 1065 pursuant to Rev. Proc. 2020-23 must file the amended return and furnish corresponding Schedules K-1 before September 30, 2020. Similar to the revocation of the Section 163(j)(7) election, the adjustments to taxable income for the late Section 163(j) election must include any collateral adjustments to taxable income or to tax liability, such as the amount of depreciation allowed or allowable as determined under the rules provided in Rev. Proc. 2019-8.

- Taxpayers may elect out of the 50% adjusted taxable income (ATI) limitation, which was increased from 30% under the CARES Act for a 2019 or 2020 year. A partnership can make this election only for a 2020 taxable year. To effectuate the election, a taxpayer must timely file a federal income tax return or Form 1065, an amended return, amended Form 1065, or AAR, as applicable, using the 30% ATI limitation. No formal statement is required.

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- If a taxpayer made the election not to apply the 50% ATI limitation for 2019 or 2020, but wishes to revoke the election later, it may file an amended federal income tax return, amended Form 1065, or AAR, as applicable, for the applicable tax year using the 50% ATI limitation.
  - Taxpayers may also elect to use their ATI for the last taxable year beginning in 2019 as the ATI for any taxable year beginning in 2020 under Section 163(j)(10)(B). This can be accomplished by timely filing a federal income tax return, Form 1065, an amended federal income tax return, amended Form 1065, or AAR, as applicable, for the 2020 taxable year using the amount of ATI from 2019. The election can also be revoked by amending the return/Form 1065 or filing an AAR.
  - A partner may elect out of the 50% excess business interest expense (EBIE) rule by timely filing a federal income tax return or Form 1065, an amended federal income tax return, amended Form 1065, or AAR, as applicable, for the partner's first taxable year beginning in 2020. The election is made by not applying the 50% EBIE rule in determining the Section 163(j) election. Similar to the election under Section 163(j)(10)(B), the election can be revoked by amending the return/Form 1065 or filing an AAR.
- effects on other provisions, the NOL carryback potential from a year when the tax rate was 21% to a tax year when rates were as high as 35 percent, and the administrative complexities associated with implementing the opportunities. For example, while amending a prior year return may be more burdensome from a compliance standpoint, taxpayers may find the additional effort worthwhile in exchange for the ability to receive an immediate refund and interest. Generally, filing a Form 3115 provides taxpayers with a more streamlined process of claiming additional depreciation, although additional complexities may arise if the taxpayer is a partnership with different partners in the year of change versus the year(s) the assets were originally placed in service.

As several of the beneficial opportunities provided in Rev. Proc. 2020-25 and Rev. Proc. 2020-22 must be made within a limited time period, taxpayers should begin evaluating their options as soon as possible to ensure adequate time to implement an appropriate action plan.

## Key Takeaways

Rev. Procs. 2020-25 and 2020-22, in conjunction with the changes made under the CARES Act, provide taxpayers with a multitude of immediate cash flow benefits and planning opportunities. As many of these changes involve multiple avenues for taxpayers seeking relief, taxpayers must consider several pertinent factors in assessing the most advantageous approach for their positions, including any corollary