The Real Estate Roundtable

April 4, 2020

The Honorable David J. Kautter
Assistant Secretary of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Michael Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: CARES Act and Prior Tax Returns

Dear Assistant Secretary Kautter and Chief Counsel Desmond:

The CARES Act included a number of critical tax provisions designed to deliver short-term economic relief to American businesses to help employers cover their expenses and preserve jobs. In the understandable rush to enact the CARES Act, Congress did not have an opportunity to consider fully how provisions in the legislation would interact with various aspects of existing tax law and regulations. In the comments below, The Real Estate Roundtable highlights specific areas where current tax rules could undermine the intent and effectiveness of the CARES Act by limiting the law's applicability to partnerships and real estate businesses. The letter proposes administrative solutions to these concerns. These changes, if implemented, will help potentially millions of tax partnerships and real estate businesses receive the tax relief Congress intended during this unprecedented public health emergency and economic crisis.

Background

In three key areas, the CARES Act modified existing tax provisions and made the changes retroactive to prior tax years:

- First, the law includes a technical correction that allows qualified improvement property ("QIP") to qualify for 100 percent bonus depreciation and reduces the depreciable life of QIP for purposes of the alternative depreciation system ("ADS") from 40 years to 20 years. In both cases, the changes are retroactive to enactment of the Tax Cuts and Jobs Act, P.L. 115-97 ("TCJA"). QIP generally includes any improvement to an interior portion of a building that is nonresidential real property if that improvement is placed in service after the building was first placed in service

- Second, the law temporarily increases the amount of interest expense businesses are allowed to deduct on their tax returns by increasing the limitation from 30 to 50 percent of adjusted taxable income in 2019 and 2020.[1]

- Third, the law relaxes limitations on the use of net operating losses by a business, allowing businesses to carry back five years their losses arising in a tax year that began in 2018, 2019, and 2020.

Congress expressly intended for these changes to generate deductions in prior years that could be "monetized" today to help businesses stay afloat during this extraordinary period of economic turmoil. For example, the official summary of the CARES Act from the Senate Finance Committee states, "[t]hese changes will allow companies to utilize losses and amend prior year returns, which will provide critical cash flow and liquidity during the COVID-19 emergency."

CARES Act and the Bipartisan Budget Act

The Bipartisan Budget Act of 2015 ("BBA") overhauled the way in which underpayments of tax are collected from partnerships and partners. In so doing, BBA fundamentally reformed the rules and process that apply to a partnership that seeks to adjust taxes owed in a prior year. Unfortunately, the partnership audit regime enacted in the BBA could prevent a large share of the 3.9 million partnerships in the United States, and their 27 million partners, from generating needed cash flow by amending prior tax returns.

Under BBA, a partnership may request an adjustment to a prior return, but the partnership might not obtain any benefit from the adjustment. In fact, the adjustment might make the partners worse off. This is a trap that partnerships might not appreciate when requesting an adjustment pursuant to the CARES Act and an unintended consequence of the well-meaning legislation.

When a partnership return is subject to the BBA, it does not adjust a previously filed return by filing an amended return. Instead, it must generally file an administrative adjustment request ("AAR"). With an AAR, the reviewed-year partners are not entitled to a refund, and refunds are not available in conjunction with an AAR.

A BBA partnership files an AAR and new IRS Forms (e.g., IRS Form 8985, 8986, 8978s) in the current tax year (the reporting year, or 2020 in the example below) in order to account for a reduction in its income for a prior year. The IRS and Treasury issued regulations providing that, when a partner takes a BBA-AAR adjustment into account in the reporting year (i.e. 2020) and that adjustment results in a reduced tax liability in the reviewed year (i.e. 2018 or 2019), the partner is effectively allowed a credit against taxes owed in the reporting year but is not entitled to claim a refund of any excess amount on the partner's reporting year return. See Treas. Reg. Sec. 301.6227-3(b)(1). Under the audit regime, taxpayer-favorable adjustments reflected on an AAR are reported to partners as supplemental

[1] Recognizing that business income will be greatly reduced in 2020 in light of the COVID-19 pandemic, and business interest expense is unlikely to decline in the same proportion, Congress also included a provision in the CARES Act that permits taxpayers to use their 2019 adjusted taxable income for purposes of calculating the amount of nondeductible business interest in 2020.

items related to the tax year in which the AAR is filed. Thus, under this process, for a partner seeking to claim bonus depreciation for qualified improvement property that a partnership placed in service in 2019, the partnership would file an AAR that would effectively provide a nonrefundable credit for taxpayers when they file their 2020 returns, in April 2021.

> By way of example, assume that a partnership pays $100 million in 2019 for QIP. It reported $2.56 million of depreciation for 2019 (based on a 39-year life). If it had instead been able to deduct $100 million as bonus depreciation, it would have reported an additional $97.44 million of depreciation, and the partners would have paid $36 million less tax (37% of $97.44 million). In 2020, the Partnership files an AAR for 2019 to report the $100 million of bonus depreciation. Under the AAR rules, you have to treat this like a 6226 election. This means that the partners recalculate the amount of excess tax they paid for 2019 (i.e., $36 million). The partners can then in theory use that $36 million in the same manner as a nonrefundable credit <u>for 2020</u>. Unfortunately, the partners have net losses for 2020 – so they get no tax benefit from the $36M. They are also precluded from carrying that amount back to a prior year or forward to a future year. Thus, the partners get no benefit from the bonus depreciation.

To make matters worse, it seems possible that the partnership would be required to reduce its basis in the QIP to $10 as of 2019, so that it would not be entitled to any depreciation in any later year. In addition, the partners from 2019 might also be required to reduce their basis in their partnership interests by the full $100 million of bonus depreciation reported on the AAR, even if they receive no tax benefit from that depreciation.

We request that Treasury and the IRS provide relief from this unintended outcome by extending the original due date for 2018 and 2019 tax returns, to the extent that a taxpayer has already timely filed an original 2018 or 2019 tax return.[2] This would allow taxpayers, including partnerships, to file a superseding tax return that would be treated as replacing the originally filed 2018 tax return. Pursuant to the Internal Revenue Manual Section 21.6.7.4.10, a superseding return is a "second return submitted by a taxpayer before the due date which changes information on a return previously submitted." Generally, the superseding return is treated as the taxpayer's return and any corrections made on the superseding return are incorporated into and modify the original return. This would allow taxpayers to receive the intended economic relief offered in the retroactive QIP provision by avoiding the inequities of the AAR process.

<u>Section 163(j) and the Electing Real Property Trade or Business Election</u>

Pursuant to the TCJA, Section 163(j) limits the deductibility of business interest. However, under Section 163(j)(7)(B), taxpayers can avoid the business interest limit by making an irrevocable election as a real property trade or business ("RPTOB"). The proposed section 163(j) regulations interpret the term "irrevocable" to mean that a taxpayer may not change its election in a future year. If a taxpayer makes an RPTOB election, the taxpayer is required pursuant to Section 168(g) to use ADS for QIP and thus QIP would not be eligible for bonus depreciation.

---

[2] The extension of the due date may also require the Treasury Secretary to waive certain rules in Treas. Reg. §§ 1.6081-1 and 1.6081-2, which limit extensions to six months.

Four changes in the CARES Act potentially affect how a taxpayer would analyze the RPTOB election decision: (a) the immediate expensing of QIP; (b) the increase in the Section 163(j) interest limit; (c) the ability to use 2019 adjusted taxable income for purposes of calculating their 2020 interest limit, and (d) the liberalization of the use of losses. All of these retroactive changes in the law could influence the tax consequences of the RPTOB election. In short, for many taxpayers, if they had known in 2018 what they know now, they may not have made the RPTOB election. The irrevocability of the RPTOB election is compromising taxpayers' ability to fully benefit from the relief Congress intended in the CARES Act.

Consistent with our earlier recommendation, we request that Treasury and the IRS extend the original due date for 2018 and 2019 tax returns, to the extent that a taxpayer has already timely filed an original 2018 or 2019 tax return, in an effort to permit taxpayers, including partnerships, the ability to file a superseding tax return that would be treated as replacing the originally filed 2018 tax return. Alternatively, we request that Treasury and the IRS provide taxpayers, including partnerships, with a mechanism to revoke the RPTOB election so they can claim the full benefits of the CARES Act by amending prior year returns.

* * *

The COVID-19 pandemic is putting enormous economic strain on commercial real estate owners, their tenants, and their lenders. The CARES Act provides important tax relief that will help Americans bridge the current period of economic inactivity. By adopting the modest changes recommended above, Treasury and the IRS can help ensure that existing tax rules do not interfere with the clear intent of the legislation. We recognize that you and your staff are under enormous pressure and working in difficult conditions. We appreciate your efforts on behalf of American taxpayers and welcome an opportunity to discuss further these issues. Please do not hesitate to contact me or Ryan McCormick, Real Estate Roundtable Senior Vice President and Counsel, at (202) 639-8400 or rmccormick@rer.org with any questions or requests for additional information.

Sincerely,

Jeffrey D. DeBoer
President and Chief Executive Officer