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Real Estate Tax Tips During the Coronavirus Pandemic

Andrew Gradman

Introduction

This article describes selected deadline extensions and tax refund opportunities relating to real estate and the coronavirus pandemic. The refund opportunities arise from retroactive changes to net operating loss carrybacks (IRC §172), excess business losses (IRC §461(*l*)), bonus depreciation of qualified improvement property (IRC §168), and business interest (IRC §163(j)). The deadlines discussed are for Qualified Opportunity Funds (IRC §1400Z–2), like-kind exchanges (IRC §1031), involuntary conversions (IRC §1033), and low-income housing tax credits (IRC §42).

This article reflects all relevant IRS guidance through May 5, 2020. For the latest tax developments, see *Coronavirus and Economic Impact Payments: Resources and Guidance* at https://www.IRS.gov. For information on the Small Business Administration's Paycheck Protection Program, EIDL Loan Advance, SBA Express Bridge Loans, and SBA Debt Relief (all of which are beyond the scope of this article), see *Coronavirus Relief Options* at https://www.sba.gov. The author thanks Michael Wiener for his comments.

Sources of Authority

Between March 22, 2020, and April 11, 2020, the President declared a major disaster in all 50 states. These declarations are retroactive to January 20, 2020. A nationwide disaster declaration is unprecedented. See Congressional Research Service Report, *The Stafford Act Emergency Declaration for COVID-19*, p 1 (Mar. 13, 2020).

A disaster declaration activates several "permanent" disaster relief provisions in the tax law. See Congressional Research Service Report, *Tax Policy and Disaster Recovery*, p 1 (Feb. 11, 2020). Among these is IRC §7508A, which authorizes the Internal Revenue Service to postpone tax deadlines for up to 1 year for "affected" taxpayers. Initially, in IRS Notices 2020–17, 2020–18, and 2020–20, the Service merely granted extensions for income, gift, and generation-skipping transfer returns and taxes due April 15. On April 9, 2020, the Service acted more robustly, extending to July 15 many other deadlines otherwise falling on or after April 1. See IRS Notice 2020–23.

Further tax relief appears in two recent laws:

- The Families First Coronavirus Response Act (Pub Law 116–127, 134 Stat 178); and
- The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (Pub Law 116–136 134 Stat 281).

Among other things, the CARES Act retroactively amends parts of the Tax Cuts and Jobs Act (TCJA) (Pub L 115–97, 131 Stat 2054).

Disaster declarations also free up federal funds. These nontax implications are beyond the scope of this article. For details, see California Legislative Analyst's Report, *COVID-19 Disaster Declarations and Funding Implications*, at https://lao.ca.gov/.

Net Operating Loss (NOL) Carrybacks (IRC §172)

Net operating loss (NOL) carryovers are popular when the economy is good; they allow growing startups to escape taxation on their future profits. NOL carrybacks become popular when the economy falters, as established businesses seek to restate their pre-slowdown profits. By eliminating the 20-year limit on loss carryovers while also eliminating the conventional 2-year carryback, the TCJA projected an optimism about the economy that has been belied by the current crisis.

The CARES Act restores the ability to carry back losses only for NOLs arising in 2018, 2019, and 2020. These can now be carried back 5 years, making it possible to use post-TCJA losses to offset income that arose under the higher pre-TCJA rate structure. The CARES Act also reverses a provision in the TCJA that limited the ability to absorb the NOL deduction to 80 percent of taxable income for the year. (This reversal will sunset in 2021, but only for NOLs arising after 2017.) The CARES Act does not permit NOL carrybacks by real estate investment trusts (REITs), nor does it permit a non-REIT to carry NOLs back to a prior year when it was a REIT.

Note that in 2019, California conformed to the elimination of the NOL carryback for NOLs arising in 2019 tax years and after. See Rev & T C §§17276, 17276.21, 17276.22 (individual taxpayers); Rev & T C §§24416, 24416.21, 24416.22 (corporate taxpayers); Rev & T C §19131.5.

Limitation on Excess Business Losses (IRC §461(*l*))

The TCJA also imposed a new $250,000 limit on excess business losses of noncorporate taxpayers. Excess losses must be carried forward as an NOL.

Like the TCJA's prohibition on NOL carrybacks, the limitation on excess business losses has proved to be an Achilles heel. As the California Legislative Analyst's Office points out, such a limitation "could discourage investment in new or expanded businesses.... [W]hen losses cannot be used to offset nonbusiness income, the impact falls more heavily on the business owner." See California Legislative Analyst's Report, *The 2019–20 Budget: Tax Conformity*, at https://lao.ca.gov/. Limiting business losses also runs contrary to the pattern in tax law, which usually discriminates against nonbusiness losses.

To alleviate this, the CARES Act delays the onset of the excess business loss limitation until 2021. It also makes technical corrections to the process for calculating these

losses. As amended, the amount of the loss limitation is no longer reduced to reflect NOLs, the §199A deduction, deductions from a trade or business of performing services as an employee, or losses from the sale of capital assets. At the same time, the amount of the limitation is no longer increased to reflect income from such services, or gains from sales of capital assets in excess of capital gain net income. The carve-out for capital assets reflects that capital losses generally cannot offset ordinary income (IRC §1211), even when carried forward (IRC §1212). These changes apply retroactively to 2018.

Note that in 2019, California conformed to the TCJA rule, with two exceptions. First, California's version does not sunset in 2026. Second, the excess business loss does not become an NOL. Instead, it is carried forward as excess business loss, and thus cannot be applied against nonbusiness income. California's rule remains in place. See Rev & T C §17560.5.

Depreciation of Qualified Improvement Property (QIP)

Commercial property is depreciable using the straight-line method over 39 years. Prior to enactment of the TCJA, an exception applied to certain retail improvements, which instead had a 15-year recovery period. Because "bonus depreciation" is generally available for property with a recovery period of 20 years or less, it was thus possible to recover half (later all) of the cost of these improvements in the year placed into service. (Note that California has never allowed bonus depreciation.) When the TCJA eliminated the special 15-year recovery period for this property, it thus eliminated the availability of bonus depreciation. This elimination of bonus depreciation was inadvertent, see 84 Fed Reg 50110 (Sept. 24, 2019), and has been dubbed the "retail glitch."

The CARES Act fixes this glitch by granting a 15-year recovery period to "qualified improvement property" (QIP), meaning improvements to existing commercial building interiors (other than structural changes, building enlargements, or elevators and escalators). These changes are retroactive and apply to QIP placed in service after December 31, 2017. A cost segregator should be retained to identify the property. To prevent taxpayers from retroactively claiming bonus depreciation for purchased QIP, the CARES Act further limits the definition of QIP to improvements "made by the taxpayer."

However, as discussed below, due to the interaction of these rules with the TCJA's business interest limitation, for some taxpayers it may not be desirable to amend returns to reflect this change.

Business Interest Limitation

In another uncharacteristically business-unfriendly provision, the TCJA introduced a new limit on the deductibility of noninvestment interest allocable to a trade or business. See IRC §163(j). (California has not conformed.) This business interest limitation effectively increases the cost of borrowing and is particularly onerous for real estate.

Under the TCJA, tax planning for real estate clients has typically entailed finding ways to avoid this limitation. For larger joint ventures, the only practical way out is by becoming an "electing real property trade or business" (referred to as a §163(j)(7) election). There is another way out, but it is unavailable for registered offerings, for ventures with significant passive investment, and for ventures in which the business and its affiliates have gross receipts above $25 million.

Before the CARES Act, owners of commercial property (including QIP) had little reason not to make the §163(j)(7) election. It merely subjected their property to alternative depreciation, increasing its recovery period from 39 to 40 years. Alternative depreciation property also happens to be ineligible for bonus depreciation, but this was not a deterrent because (as mentioned above) the "retail glitch" already made QIP ineligible for bonus depreciation. Now that the CARES Act retroactively treats QIP as 15-year property, these taxpayers are discovering that their decision to make the §163(j)(7) election is the *only thing* preventing them from enjoying bonus depreciation on these improvements. Technically, that election was "irrevocable." See IRC §163(j)(7)(B). However, recognizing that taxpayers made the election relying on the retail glitch, the IRS recently released guidance allowing the election to be retroactively revoked. Rev Proc 2020–22, 18 Int Rev Bull 745. The deadline to do so is October 15, 2021.

Affected taxpayers now must decide which benefit they want more:

- Bonus depreciation on QIP (in which case they should revoke the §163(j)(7) election); or
- Avoidance of the business interest limitation (in which case they should keep the election in place).

Considering that the CARES Act also reduces the alternative depreciation period for QIP from 40 to 20 years, some taxpayers may prefer not to revoke their §163(j)(7) election and to continue using alternative depreciation.

Finally, note that the CARES Act also mitigates the business interest limitation in two ways. First, for tax years beginning in 2020, taxpayers may elect to use their 2019 adjusted taxable income to determine the limitation amount. Since incomes have plummeted while debt remains unchanged, this makes sense. Second, the CARES Act increases the limit on deductibility, from 30 percent to 50 percent of adjusted taxable income, for tax years beginning in 2019 (for all taxpayers except partnerships) and 2020 (for all taxpayers). For excess business interest expense that was

allocated from a partnership in years beginning in 2019, partners may treat half this allocation as fully deductible in the following year.

Method for Amending Returns

New Rev Proc 2020–23, 2020–18 Int Rev Bull 749 makes it easier to amend partnership returns. In normal times, partnerships are prohibited from amending a partner's Schedule K-1 (statement reflecting each partner's distributive share of partnership income, gain, loss, deduction, credit, and other tax items). See IRC §6031(b). Instead, they must file an Administrative Adjustment Request under IRC §6227, meaning that refunds might not be available until 2021. To make cash available faster, Rev Proc 2020–23 creates a special procedure for tax years beginning in 2018 or 2019. For these years, partnerships have until September 30, 2020, to amend their returns and K-1s.

For NOLs arising in a year beginning in 2018 and ending by June 30, 2019, there is also an expedited procedure that can lead to a refund within 90 days of the application. See IRS Notice 2020–26. Applications under this procedure must be filed by June 30, 2020. For NOLs arising in a fiscal year that straddles 2017 and 2018, a similar expedited procedure is available, with an extended deadline of July 27, 2020. See Rev Proc 2020–24.

New Rev Proc 2020–25 also makes it easier to make or withdraw elections affecting depreciation. Specifically:

- It temporarily lets the taxpayer withdraw the (otherwise irrevocable) election to use alternative depreciation. The deadline to do so is October 15, 2021 (and not later than the statute of limitations for the year in question).
- Similarly, it temporarily lets taxpayers retroactively make (or revoke) the elections to not use (or use less) bonus depreciation using the simplified technique in Form 3115 (Application for Change in Accounting Method). The deadlines are the same as above.
- It addresses how to retroactively fix depreciation of QIP (except that, for taxpayers who will also change their §163(j)(7) election, the subject is wholly addressed in Rev Proc 2020–22, 18 Int Rev Bull 745). Now that the CARES Act has cured the retail glitch, owners of QIP technically have been using an "impermissible" depreciation method in their prior returns. Revenue Procedure 2020–25 provides several options for retroactively choosing a correct recovery period. If the QIP has only been in service for a year, this may be done using Form 3115.

Deadlines for Qualified Opportunity Zones (IRC §1400Z–2)

Under normal circumstances, the qualified opportunity zone (QOZ) regulations provide that operating subsidiaries of Qualified Opportunity Funds (QOFs) have 31 months to consume their working capital assets and 12 months to reinvest returns of capital. However, if the QOZ is in a disaster area, the 31-month safe harbor may be extended by 24 months and the 12-month reinvestment period may be extended by 12 months. See Treas Reg §§1.1400Z2(d)–1(d)(3)(v)(D), 1.1400Z2(f)–1(b)(2). In the opinion of the Opportunity Zones Working Group (a consortium of interested parties who work together to make technical recommendations), as stated in an April 7, 2020, letter to the Treasury Department, "this regulatory relief is automatic, meaning QOFs and QOZBs [qualified opportunity zone businesses] are not required to request such relief." However, this interpretation is not obvious. The regulations say only that projects "may receive up to an additional" 12 or 24 months. Treasury should clarify.

In its April 7, 2020, letter, the Opportunity Zones Working Group also requested several other extensions and clarifications, including:

- Currently, a taxpayer has 180 days from recognizing a gain to make an investment in a QOF. The Working Group requested a 6-month extension in cases when the last day would otherwise fall after the January 20, 2020, disaster declaration.
- Currently, when property is contributed to a QOF, the QOF has a limited time to convert the property into qualifying property before it counts toward the "90% standard" and potentially incurs a penalty. The Working Group requested a 6-month extension.
- Currently, when a QOF or subsidiary acquires real property, it has 30 months to "substantially improve" that property. The Working Group requested a 12-month extension, for a total of 42 months.

The Service ultimately issued Rev Proc 2020–23, 2020–18 Int Rev Bull 749, but it fell far short of these requests. It addressed only the first item (the 180-day investment window); extended only deadlines that would otherwise expire on or after April 1, 2020; and only extended them through July 15, 2020.

Deadlines for Like-Kind Exchanges (IRC §1031)

Within 45 days of selling relinquished property in a deferred exchange, the taxpayer must narrow the list of possible replacement properties (the "identification period"). Then, within 180 days of the sale, the taxpayer must buy one or more properties on that list (the "exchange period"). See IRC §1031(a)(3); Treas Reg §1.1031(k)–1. Similar deadlines apply for reverse exchanges. See Rev Proc 2000–37, 2000–2 Cum Bull 308, as modified by Rev Proc 2004–51, 2004–2 Cum Bull 294.

To the extent any of these deadlines falls on or after April 1, 2020, Notice 2020–23 grants an extension to July 15, 2020. However, it is also important to understand what the Notice does not do:

- It does not protect a taxpayer who fails to observe any of the other requirements of a §1031 exchange (for example, by taking receipt of the sales proceeds).
- It does not modify the written contract that prevents the taxpayer from withdrawing cash from the Qualified

Intermediary during the 180-day exchange period.

- Additional guidance might be needed to explain how taxpayers can avoid being in "constructive receipt" of the sales proceeds between the end of the original exchange period (as reflected in the contract) and the end of the extended exchange period (under Notice 2020–23).
- It does not appear to incorporate the additional extensions described in §17 of Rev Proc 2018–58, 2018–50 Int Rev Bull 990 (*i.e.,* a flat 120-day extension for all taxpayers whose deadlines fall after the January 20, 2020, disaster date). The text here is not perfectly clear; the IRS should clarify its position.

Deadlines for Involuntary Conversions (IRC §1033)

No special extension has been announced for IRC §1033 property conversions. If taxpayers anticipate missing their year-end deadlines, they should seek an extension under existing procedures.

Generally, tax is imposed on the receipt of compensation for the "involuntary conversion" of property, meaning its destruction, theft, seizure, requisition, or condemnation. Under IRC §1033, this tax may be avoided by acquiring property that is "similar or related in service or use" to the converted property by the last day of the year 2 years after the year of conversion. For example, for calendar year taxpayers whose property was converted at any time in 2018, the replacement property must be purchased by December 31, 2020. Unlike §1031 exchanges (and like QOZs), the taxpayer can spend the conversion proceeds on something else in the meantime. Come December, these taxpayers will need an extension.

Although IRS Notice 2020–23 does not address these deadlines, a case-by-case procedure for requesting extensions already exists. See IRC §1033(a)(2)(B)(ii); Treas Reg §1.1033(a)–2(c). Extensions are generally for a period not exceeding 1 year and require reasonable cause. Unless Treasury issues specific guidance, taxpayers should at least be prepared to describe an economic hardship traceable to the disaster.

Deadlines for Low-Income Housing Tax Credits (LIHTC)

Many jurisdictions have temporarily delayed eviction of tenants during lockdown periods. When evictions resume, COVID–19 will have a devastating impact on housing insecurity. See *Coronavirus and Housing/Homeless* at https://nlihc.org/ for updates and recommendations.

For the low-income housing tax credit (LIHTC), guidance appears at Rev Proc 2014–49, 2014–37 Int Rev Bull 535, and Rev Proc 2014–50, 2014–37 Int Rev Bull 540 (private activity bonds). A disaster declaration is generally not sufficient to trigger relief; these decisions are now in the hands of the appropriate state agency. In an April 8, 2020, letter, the National Association of Home Builders wrote to Treasury requesting a variety of extensions. Treasury has yet to respond.