CARES Act Qualified Improvement Property Fix and Related Guidance

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act (CARES Act, Public Law 116-136). The CARES Act includes, among its many provisions, taxpayer-favorable changes to the 2017 Tax Cuts and Jobs Act (TCJA), including TCJA technical corrections that have been long anticipated.

The CARES Act makes significant changes to one tax provision that is discussed throughout the Federal Depreciation Handbook, 2020 edition (Handbook)—the tax treatment of qualified improvement property (QIP). QIP is discussed in the following chapters of the Handbook: 3, 4, 5, 6, 7, 9, and 10, and in the Handbook’s 2019 Developments Summary.

TCJA Background

The TCJA amended IRC Sec. 168 to allow 100% bonus depreciation for certain qualified property. The TCJA eliminated preexisting definitions for (1) qualified leasehold improvement property, (2) qualified restaurant property, and (3) qualified retail improvement property. It replaced those definitions with one category called qualified improvement property (QIP). A general 15-year recovery period was intended to have been provided for QIP. However, that specific recovery period failed to be reflected in the statutory text of the TCJA. Thus, under the TCJA, QIP fell into the 39-year recovery period for nonresidential real property, which made QIP ineligible for 100% bonus depreciation. The TCJA's failure to assign QIP a 15-year recovery period is often referred to as the retail glitch because retailers tend to make significant (and sometimes frequent) building improvements that fall into the definition of QIP. However, nonretail businesses also were affected by the retail glitch.

Qualified Improvement Property

QIP is generally a combination (with some exceptions) of three types of property that existed before, and were eliminated by, the TCJA—qualified retail improvement property, qualified restaurant property, and qualified leasehold improvement property. Specifically, QIP (for property placed in service after 2017) is any improvement that is Section 1250 property made by the taxpayer to an interior portion of a nonresidential building that is placed in service after the date the building is first placed in service [IRC Sec. 168(e)(6)]. However, expenditures attributable to enlarging a building, any elevator or escalator, or the building's internal structural framework are not QIP.

After much speculation about whether or when a technical correction would happen, the CARES Act assigned QIP a 15-year [20-year for the alternative depreciation system (ADS)] recovery period, as if such provision had been included in the TCJA. Therefore, provided it meets either the original use or the acquisition test for used property, QIP placed in service after 2017 can qualify for bonus depreciation. If bonus depreciation does not apply (because, for example, the taxpayer elects out), QIP is depreciated straight-line over a 15-year recovery period.

Observation: The CARES Act also made a technical correction to the definition of QIP to clarify that it only includes improvements to a building that the taxpayer makes. Taxpayers cannot acquire a building and treat any cost assigned to improvements made by a previous owner as QIP.

Rev. Proc. 2020-25 provides guidance on how taxpayers that placed QIP in service after 2017 (when such property was assigned a 39-year recovery period) can take advantage of the technical correction. Also, apparently recognizing that this retroactive reclassification may affect depreciation-related elections that taxpayers made (or failed to make) in prior years, the IRS is extending the period for making elections and allowing taxpayers to revoke elections they have previously made.
Claiming Bonus Depreciation on QIP

Planning considerations. While claiming 100% bonus depreciation on QIP will often be beneficial, there are some situations where depreciating QIP straight-line over 15 years may make more sense:

- 100% bonus depreciation is recaptured as ordinary income if the property is sold at a gain, while straight-line depreciation gives rise to unrecaptured Section 1250 gain subject to a maximum 25% tax rate. Thus, claiming 100% bonus depreciation for QIP expenditures can cause a higher tax rate on part of the gain when the property is sold. However, if the taxpayer anticipates holding the property for many years, this tax rate differential issue is less important.

- When a taxpayer claims 100% bonus depreciation for QIP expenditures, depreciation deductions for future years are reduced by the bonus depreciation amount. If tax rates increase in future years, the taxpayer has effectively traded potentially more valuable future-year depreciation write-offs for a less-valuable first-year 100% bonus depreciation deduction.

- An individual taxpayer can claim a federal income tax deduction of up to 20% of qualified business income (QBI) from an unincorporated business activity. However, the QBI deduction from an activity cannot exceed 20% of net income from that activity for the year, calculated before the QBI deduction.
  - Net income from the activity of renting out nonresidential property will usually count as QBI (that is, the activity will generally be considered a trade or business). However, claiming 100% first-year bonus depreciation for QIP expenditures for the property will lower the net income and potentially result in a lower QBI deduction.
  - The QBI deduction for a year cannot exceed 20% of the excess of taxable income for that year over net capital gain (net long-term capital gains in excess of net short-term capital losses, plus qualified dividends). So, reducing taxable income by claiming 100% first-year bonus depreciation for QIP expenditures also can have the adverse side effect of reducing the QBI deduction.
  - The QBI deduction may be a use-it-or-lose-it proposition because it is scheduled to expire after 2025. It could disappear sooner, depending on legislation. If a taxpayer forgoes bonus depreciation, his QBI deduction may be higher. Also, the foregone depreciation is not lost—it is deducted in later years when depreciation write-offs might be more valuable if tax rates are higher.

Net operating loss (NOL) carrybacks. The TCJA generally eliminated the ability to carry NOLs back to prior tax years. However, this treatment is modified by the CARES Act, which allows taxpayers to carry back NOLs arising in a tax year beginning in 2018, 2019, or 2020 to the prior five tax years. Amending a 2018 or 2019 return to claim 100% bonus depreciation for QIP placed in service in those years may result in an NOL that can be carried back to a prior tax year. So, claiming 100% bonus depreciation may be extremely beneficial for a cash-strapped taxpayer that could benefit from an NOL carryback and the resulting tax refund, especially if the taxpayer was subject to higher tax rates in the carryback year(s).

Accounting Method Changes and Amended Returns

Rev. Proc. 2020-25, Secs. 2 and 3 provide that taxpayers that placed QIP in service after 2017 in tax years ending in 2018, 2019, or 2020 (their 2018, 2019, or 2020 tax years) depreciate such property straight-line over a 15-year recovery period and, provided all requirements are met, can claim bonus depreciation. A change to either depreciating QIP straight-line over 15 years or claiming 100% bonus depreciation is a change from an impermissible accounting method to a permissible one.
The change to a permissible method can be made by filing an amended return for the placed-in-service year and any affected succeeding years on or before October 15, 2021 (or, if sooner, before the statute of limitations for that year expires). Or, a taxpayer can file a Form 3115 (Application for Change in Accounting Method) to request an automatic accounting method change under Rev. Proc. 2015-13. The Form 3115 is filed with a timely-filed income tax return for the year of change. See Sec. 6.03(1) of Rev. Proc. 2020-25 for details on requesting this accounting method change (designated automatic accounting method change number “244”), including relaxation of the rule prohibiting changes to the same accounting method more than once in a five-year period, a reduced filing requirement, and rules for making concurrent method changes. The negative Section 481(a) adjustment resulting from claiming more depreciation in the affected years than claimed under the impermissible method is taken into account in the year of change.

**Caution:** Rev. Proc. 2020-25 does not apply to QIP if the taxpayer deducted its cost as an expense. Also, *real property trades or businesses and farming businesses* can elect out of the Section 163(j) limit on business interest expense [that is, make a Section 163(j)(7) election]. However, if they do so, they must use ADS to depreciate certain assets used in those businesses, including QIP. Rev. Proc. 2020-22 allows real property trades or businesses and farming businesses to retroactively make or revoke their Section 163(j)(7) election for certain years. Any change in depreciating QIP due to making or withdrawing a Section 163(j)(7) election is made under Rev. Proc. 2020-22, not under Rev. Proc. 2020-25.

Generally, an accounting method is not adopted until a taxpayer has used it for at least two years. However, taxpayers that only claimed impermissible depreciation on QIP for a single year can include that depreciation in an accounting method change. Or, they can correct the depreciation for so-called *one-year property* by filing an amended return.

**Strategy:** Requesting an accounting method change on Form 3115 may be less time-consuming than filing amended returns for several years. Even if QIP was only placed in service during a single prior year, amended returns must be filed for the placed-in-service year, as well as any succeeding years, to take into account the change in depreciation for each of those years. However, a request for an accounting method change is filed on Form 3115, which must be attached to the taxpayer’s timely-filed original return for the year the change is requested [Rev. Proc. 2015-13, Sec. 6.03(1)]. For taxpayers that have already filed their 2019 returns, a Form 3115 to change the depreciation method for QIP cannot be filed until the 2020 return is filed, which means that the tax benefit will not be realized until after that. For these taxpayers, filing amended returns for prior years will generally allow the tax benefit to be received much sooner.

**Observation:** While Rev. Proc. 2020-25 provides taxpayers a great deal of flexibility for correcting depreciation on QIP, it does not allow taxpayers to take no action. Under Rev. Proc. 2020-25, treating QIP placed in service after 2017 as 39-year property (even if that was the proper treatment when the return was filed) is an impermissible depreciation method. Some taxpayers might prefer to just keep depreciating the QIP over 39 years. This might be an attractive option for taxpayers that placed a relatively small amount of QIP in service and would like to avoid the cost and administrative burden of filing amended returns or a Form 3115. This could be especially true for tiered partnership situations. The IRS has informally indicated that continuing to treat QIP placed in service in 2018 or 2019 as 39-year property is an impermissible method. In that case, the IRS can argue that the property's basis is reduced by depreciation allowable using 15-year straight-line, or if the property was eligible and the taxpayer failed to elect out, 100% bonus depreciation, regardless of the depreciation actually claimed. This seems inequitable since a taxpayer that used the 39-year recovery period in 2018 and 2019 was complying with the law in effect at that time. Practitioners should be alert for additional guidance.
Extended Time Period for Making Certain Depreciation-related Elections

In general, taxpayers must make the following depreciation-related elections on a timely-filed return for the year the property is placed in service:

1) Election to use ADS [IRC Sec. 168(g)(7)].

2) Election to treat certain plants as placed in service (for bonus depreciation) in the year they are planted or grafted (rather than in the later year they become productive) [IRC Sec. 168(k)(5)].

3) Election out of bonus depreciation [IRC Sec. 168(k)(7)].

4) Election to apply a 50% (rather than 100%) bonus depreciation rate to certain property placed in service in the taxpayer's first tax year ending after September 27, 2017 [IRC Sec. 168(k)(10)].

Rev. Proc. 2020-25, Sec. 4.02 extends the deadline for taxpayers that place depreciable property in service in their 2018, 2019, or 2020 tax years; timely file their returns for the placed-in-service year; and want to make an election described in item 1, 2, or 3 in the preceding list. Likewise, taxpayers that timely filed their return for their tax year that includes September 28, 2017 and that want to make the election described in item 4 can make a late election. Late elections are made by filing amended returns for the placed-in-service year and any affected succeeding tax years by October 15, 2021 (or, if earlier, before the statute of limitations expires).

Alternatively, a late election can be made by filing a Form 3115 with the taxpayer's timely-filed original return for either (1) the first or second tax year after the year the property is placed in service or (2) that is filed on or after April 17, 2020 and on or before October 15, 2021. See Rev. Proc. 2020-25, Sec. 6.03(2) for details on requesting this automatic accounting method change (designated automatic accounting method change number "245"). Normally, making a late depreciation election or revoking a timely valid election is not an accounting method change [Reg. 1.446-1(e)(2)(iii)(d)(iii)]. However, for the limited timeframe provided by Rev. Proc. 2020-25, the effect of these late elections and election revocations can be treated as an accounting method change, which means that a Section 481(a) adjustment is available.

Caution: Taxpayers that revoke an existing election under Sec. 5.02 of Rev. Proc. 2020-25 cannot later elect back in using Rev. Proc. 2020-25, Sec. 4.02.

The Section 168(k)(7) election out of bonus depreciation is made with respect to a class (or classes) of assets and applies to all assets in that class placed in service during the tax year for which the election is made. QIP placed in service after 2017 is in the 15-year property class and is not a separate class of property, unlike QIP placed in service before 2018, which is a separate class of property [Reg. 1.168(k)-2(f)(1)(ii)(D)]. So, for QIP placed in service after 2017, an election out of bonus depreciation applies to all 15-year property (not just the QIP) placed in service that year.

Observation: Rev. Proc. 2019-33 provided guidance for taxpayers to make late elections under IRC Sec. 168(k)(5), 168(k)(7), and 168(k)(10). Rev. Proc. 2020-25 further extends the time for making such elections.

Certain Irrevocable Depreciation Elections Can Be Revoked or Withdrawn

Generally, the elections described in items 2, 3, and 4 in the preceding list at Extended Time Period for Making Certain Depreciation-related Elections cannot be revoked without IRS permission. Rev. Proc. 2020-25, Sec. 5.02(2) allows taxpayers that placed depreciable property in service during their 2018, 2019, or 2020 tax years
and that made the Section 168(k)(5) election for specified plants or the election out of bonus depreciation under IRC Sec. 168(k)(7) on a timely-filed original return filed on or before April 17, 2020 (or that made a late election under Rev. Proc. 2019-33 before that date) to revoke those elections. Similarly, taxpayers that made a Section 168(k)(10) election to use the 50% bonus depreciation rate for certain assets for their tax year including September 28, 2017 on a timely-filed original return filed on or before April 17, 2020 (or that made a late election under Rev. Proc. 2019-33 before that date) may revoke that election.

The elections are revoked by filing amended returns for the placed-in-service year and any affected succeeding years on or before October 15, 2021 (or, if earlier, before the statute of limitations expires). Or, the elections can be revoked by filing a Form 3115 to request an automatic accounting method change (designated automatic accounting method change number "245"). See Sec. 6.03(2) of Rev. Proc. 2020-25 for details on filing Form 3115.

The election to use the ADS is irrevocable. However, under Rev. Proc. 2020-25, Sec. 5.02(3), taxpayers that elected to use the ADS for assets placed in service during their 2018, 2019, or 2020 tax years may withdraw that election by filing amended returns for the placed-in-service year and any affected succeeding years. Note that unlike the elections discussed in the preceding paragraphs, withdrawing the election to use the ADS cannot be treated as an accounting method change, so no Section 481(a) adjustment is available.

**Special Rules for Partnerships**

Partnerships subject to the centralized audit regime generally cannot file amended returns. [These partnerships are referred to as BBA partnerships because the centralized audit regime was enacted by the 2015 Bipartisan Budget Act (BBA).] The centralized audit regime generally applies to returns filed for tax years beginning after 2017, and partnerships are subject to it unless they are eligible to elect out and do so.

Rev. Proc. 2020-23 allows certain BBA partnerships to file amended returns for their tax years beginning in 2018 and 2019 to take tax law changes under the CARES Act into consideration. BBA partnerships that filed Form 1065 and furnished Schedules K-1 to their partners for their tax years beginning in 2018 or 2019 before April 8, 2020 can take advantage of Rev. Proc. 2020-23. Therefore, they can file amended returns under Rev. Proc. 2020-25 (to adopt a permissible accounting method for QIP or make or revoke certain depreciation-related elections) for their tax years beginning in 2018 and 2019.

BBA partnerships that choose not to file amended returns as permitted under Rev. Proc. 2020-23, or that cannot file amended returns because the placed-in-service year for the QIP is not within the scope of Rev. Proc. 2020-23, can file an Administrative Adjustment Request (AAR) for the QIP’s placed-in-service year and any affected succeeding years on or before October 15, 2021 (or, if earlier, the date the statute of limitations expires).