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CARES Act Provisions May Benefit Real Estate Owners

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On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law. The Act includes many provisions aimed at mitigating the economic impact of the coronavirus outbreak, such as cash rebates to individuals and loans and tax credits to businesses. However, the Act also contains several modifications and technical corrections to the 2017 Tax Cuts and Jobs Act that could significantly benefit real estate owners.

Background

Many rental properties generate losses for federal income tax purposes. Prior to 2018, as long as an individual owner of rental real estate was treated as a real estate professional for purposes of the passive loss limitations, the owner was free to use such losses to shelter portfolio income such as interest, dividends, and capital gains. However, as part of the 2017 Tax Cuts and Jobs Act, Congress enacted Section 461(*l*) of the Internal Revenue Code. Section 461(*l*) generally provided that, for years 2018 through 2025, deductions from trades or businesses could only be used to offset (1) income attributable to trades or businesses and (2) $250,000 of other income for single taxpayers and $500,000 for married couples filing jointly (subject to annual inflation adjustments). Any deductions in excess of these limitations (so-called "excess business losses") were disallowed and carried over to the following year. Section 461(*l*) did not apply to C corporations.

In addition to the loss limitations of Section 461(*l*), if a taxpayer had a net operating loss (NOL) that arose in 2018 or later, the NOL could not be carried back to prior years. The NOL could be carried forward to future years, but could only offset up to 80% of the taxpayer's taxable income in a future year.

Separately, the 2017 Tax Cuts and Jobs Act created a new category of depreciable property called "qualified improvement property," which was generally defined to include most interior improvements to an existing nonresidential building. Congress intended for qualified improvement property to be generally depreciable over a 15-year period and eligible for 100% bonus depreciation through 2022 (which would phase out from 2023 through 2026). However, due to a drafting error, the statute had actually provided that this type of property was depreciable over 39 years and was not eligible for bonus depreciation.

The CARES Act

The CARES Act contained significant changes to these provisions. The Act repealed the loss limitations of Section 461(*l*) for the years 2018 through 2020. Any taxpayers that were subject to these limitations may amend previously filed returns to claim the benefit of these losses. In addition, although the loss limitations of Section 461(*l*) continue to apply to years 2021 through 2026, the Act clarifies that any excess business loss that is disallowed under Section 461(*l*) for a given year will become an NOL carryforward in subsequent years that is no longer subject to Section 461(*l*). This results in the bizarre outcome that an excess business loss cannot offset portfolio income for the year in which it was incurred, but *can* offset portfolio income in subsequent years. Although this may result in timing issues for some taxpayers, this is a much more taxpayer-favorable rule than some interpretations of prior law.

The CARES Act also significantly changed the NOL carryback and carryforward provisions. The Act permits an NOL arising in 2018, 2019, or 2020 to be carried back up to five years and permits NOLs carried forward to 2019 or 2020 to offset 100% of taxable income rather than 80% of taxable income. Taxpayers may file amended returns to take advantage of these provisions. The five-year carryback is particularly advantageous to taxpayers because tax rates were higher than current rates in years prior to 2018.

In addition, the CARES Act retroactively fixed the drafting error in the Tax Cuts and Jobs Act with respect to qualified improvement property. Qualified improvement property is now generally depreciable over 15 years, and now qualifies for 100% bonus depreciation through 2022 (followed by a phase out of bonus depreciation for years 2023 through 2026). This is a major benefit to real estate owners given that qualified improvement property can encompass

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many real estate improvements that otherwise would have had to have been depreciated over 39 years.

However, if a taxpayer that is in a real estate business previously made an election not to apply the new interest deduction limitations of the Tax Cuts and Jobs Act, then the taxpayer must depreciate this type of property over 20 years rather than 15 years, and the property is not eligible for bonus depreciation. As some taxpayers made these elections on prior tax returns before this statutory change, the IRS recently issued guidance effectively allowing such taxpayers to retroactively revoke these elections.

Conclusion

Because the operation of many rental properties results in losses for income tax purposes, the provisions of the CARES Act that relaxed the limitations on the use of losses could result in significant benefits to rental property owners and may even result in refunds for prior years. Moreover, the qualified improvement property provisions may result in much larger depreciation deductions to taxpayers that have recently made interior improvements to nonresidential properties. As always, taxpayers will need to plan carefully to ensure that they obtain the maximum benefit of these provisions.