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Tax News and Developments

North America

Client Alert

April 3, 2020

CARES Act Tax Provisions Impacting the Real Estate Industry

On Friday March 27, the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") became law as P.L. 116-136. The CARES Act and recently issued guidance contain the following tax provisions of particular interest to the real estate industry:

- NOL Carryback. Allow 2018, 2019, and 2020 net operating losses to be used without being subject to the 80% income cap enacted as part of the Tax Cuts and Jobs Act ("TCJA") and to be carried back 5 years.
- Section 461(l) Excess Business Losses. Effectively repeal the 2018 Section 461(l) excess business loss rules for 2018, 2019, and 2020 such that real estate professionals can use excess real estate losses against unrelated income (such as investment income).
- Section 163(j) Interest Expense Limitations. Increase the Section 163(j) "interest stripping" limitation on business interest expense from 30% to 50% of adjusted taxable income (e.g., EBITDA) and allow taxpayers to use 2019 ATI amounts in calculating the 2020 limitation.
- Qualified Improvement Property. Incorporate technical correction to allow 15-year depreciation for qualified improvement property (primarily tenant improvements) back to 2018, allowing for immediate expensing.
- Employer-Payroll Tax Delay. Delayed due date for employer-side payroll taxes for wages paid from enactment until December 31, 2020. 50% of these taxes will be due on December 31, 2021, and the other 50%, on December 31, 2022.
- Forbearance of Residential Mortgage Loan Payments. Provide up to 90 days of forbearance for multifamily borrowers with a federally backed multifamily mortgage loan who have experienced a financial hardship. Borrowers receiving forbearance may not evict or charge late fees to tenants for the duration of the forbearance period.
- Tax Filing and Payment Delay Until July 15, 2020. Taxpayers, such as individuals, who were otherwise required to file tax returns or extensions on April 15, 2020 now have until July 15, 2020 to file such returns and make corresponding payments (no extension is required to be filed on April 15, 2020).

- Other Non-Tax Benefits. For a discussion of small business loans[1], employee retention credits, and the new $500 billion government "bailout" fund, see Baker & McKenzie Client Alert, "*Senate Passes Coronavirus Bill Containing Tax Provisions, House of Representatives to Vote Soon.*"

Detailed Real Estate Provisions

As part of the COVID-19 crisis, real estate businesses may be facing a liquidity problem in light of the partial or total suspension of business activities, reduction in consumption, and workforce disruption, among other issues. In response to these challenges, many real estate businesses have or are contemplating cutting costs and expenses. A primary objective of the tax measures in the CARES Act is to limit employee job loss by increasing real estate business liquidity by offering taxpayers the possibility of using certain tax attributes, deductions and credits that previously were not available or deferred.

Relaxed Limitations on Net Operating Losses

The CARES Act generally permits real estate businesses to carry back NOLs up to 5 years, and allows them to use their NOLs without the 80% limit imposed by the TCJA. This rule generally applies to NOLs generated in tax years beginning in calendar years 2018, 2019, and 2020. Real estate businesses utilizing NOLs generally will be permitted to amend prior year tax returns, which should provide critical cash flow and liquidity during the COVID-19 crisis. The provision does include a restriction on the carry back of losses by real estate investment trusts ("REITs"). NOLs generated during a taxable year in which a corporation elected to be taxed as a REIT may not be carried back. Further, NOLs generated during a taxable year in which a corporation did not elect to be taxed as a REIT may not be carried back to any preceding taxable year in which the corporation elected to be taxed as a REIT.

Elimination of Excess Business Loss Limitations

Code Section 461(l), enacted as part of the TCJA, denied certain investors a deduction for "excess business losses." Code Section 461(l) defines an "excess business loss" as the excess of an investor's deductions from all trades or businesses over aggregate gross income from the taxpayer's trades or businesses plus $250,000 (or $500,000 if a joint return is filed). Under the TCJA the excess business loss limitation rule applies for tax years beginning after December 31, 2017, and before January 1, 2026. The CARES Act suspends the application of the limitation on excess business losses for tax years beginning in 2018, 2019, and 2020. The allowed business losses may result in an NOL that could then be carried back under the procedures discussed above.

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[1] Note that SBA "ineligible types of business" restrictions preclude certain "passive businesses" relating to real estate.

Relaxed Interest Deduction Limitations

The CARES Act liberalizes the limitation on the deductibility of business interest in 2019 and 2020. The TCJA limited the amount of business interest deductible for tax purposes to no more than 30% of the real estate business's adjusted taxable income ("ATI"). The TCJA allows real estate businesses to elect out of the limitation. However, some real estate businesses continue to operate under the 30% limitation because the real estate exception lengthens the cost recovery period for real property and property improvements and denies immediate expensing (e.g., "bonus depreciation"). For these businesses, The CARES Act increases the amount of the interest expense deduction limitation under Code Section 163(j) from 30% of a real estate business's ATI to 50% of ATI for tax years beginning in 2019 and 2020. A real estate business may elect not to have the increased 50% ATI threshold apply to any tax year, which election is irrevocable without the U.S. Treasury Secretary's consent. In addition, a real estate business may elect to substitute its ATI from its 2019 tax year for its ATI in 2020, thereby allowing the substitution of its (presumably higher) 2019 ATI for its 2020 ATI. This should increase the amount of the real estate business's interest deduction, thereby increasing its liquidity. We expect the IRS to issue guidance as to whether taxpayers will receive a second chance to make decisions about whether they want to retain their Section 163(j) "electing real property trade or business" election for 2018 or 2019 since the new CARES Act rules change the baseline for such decisions.

With respect to partnerships, the increase to 50% of ATI is limited to the 2020 taxable year, however a similar benefit is given for the 2019 taxable year directly at the partner level (apparently with an intent of avoiding the need to otherwise amend the partnership's 2019 tax return). For 2019, with respect to any excess business interest of the partnership allocated to the partner—(i) 50 percent is treated as business interest paid or accrued by the partner in the partner's first taxable year beginning in 2020 and which is not subject to the ATI limitations, and (ii) 50 percent is subject to the regular limitations of excess business interest allocated to the partner. The partner can elect not to have this special rule to apply and be subject to the pre-CARES Act rules for 2019. Note that to the extent that the partnership has made the real property election out of the Section 163(j) limitations, these CARES Act changes would not appear to affect such interest expense (although this interaction is not directly addressed in the CARES Act). We expect U.S. Treasury guidance on the changes to Code Section 163(j), and we understand that the U.S. Treasury has placed a high priority on this item.

Qualified Improvement Property Technical Correction

The TCJA eliminated the separate definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, and provided a general definition of qualified improvement property ("QIP"). Congress intended QIP to be depreciable property with a recovery period of 15 years. By having an applicable recovery period of 20 years or less, QIP would be "qualified property" under Code Section 168(k) and thus taxpayers could immediately expense the cost of QIP through their 2022 tax year. The TCJA defined QIP, but failed to include the 15-year recovery period for it. As a result, immediate expensing was not available.

The CARES Act contains three technical corrections and its effective date is retroactive to the date Congress enacted the TCJA. The CARES Act includes the 15-year recovery period for QIP, and clarifies the definition of QIP to limit QIP so that it only includes improvements made by the taxpayer. Finally, for purposes of the alternative depreciation system, QIP is given a class life of 20 years. We expect the IRS to issue guidance on whether streamlined procedures will be available for the change in method of accounting that may be needed to apply the QIP technical corrections for property placed in service for tax returns already filed for the 2018 or 2019 tax years.

Employer Payroll Tax Payment Delay

The CARES Act delays the payment due date for the employer share of social security taxes (the 6.2% tax borne by employers on wages up to the social security wage base) and railroad retirement act taxes, for the period from enactment until December 31, 2020. 50% of these taxes will be due on December 31, 2021, and the other 50%, on December 31, 2022.

Forbearance of Residential Mortgage Loan Payments

The CARES Act provides that multifamily borrowers with federally-backed mortgage loans for residential multifamily properties principally designed for the occupancy of five or more families, who are experiencing financial hardship due to COVID-19, can request to receive a loan payment forbearance. Upon receipt of a forbearance request by a multifamily borrower, the mortgage servicer must document the financial hardship and provide up to a 30-day forbearance period. The multifamily borrower can request and receive two additional 30-day forbearance periods, provided that it makes the request at least 15 days prior to the end of the forbearance period, and the request is made before the earlier of (i) the termination of the President's COVID-19 national emergency declaration and (ii) December 31, 2020. The multifamily borrower may choose to terminate the forbearance at any time. Loans for temporary financing such as a construction loans are not eligible for forbearance.

Multifamily borrowers receiving forbearance on its loan payments may not (i) evict or initiate the eviction of a tenant solely for nonpayment of rent or other fees; (ii) charge any late fees, penalties or other charges to a tenant because of a late rent payment; or (iii) require a tenant to vacate on fewer than 30 days' notice. Furthermore, such notice may not be issued during the forbearance period.

Tax Filing and Payment Extension

In IRS Notice 2020-18, the IRS postponed the due date for filing U.S. federal income tax returns and making U.S. federal income tax payments from April 15, 2020, to July 15, 2020. This relief generally applies to individuals, trusts, estates, partnerships and corporations with an April 15 filing deadline (calendar year partnerships had a March 15 filing deadline that did not benefit from this extension although the April 15 estimated taxes due by the partners of such partnerships would benefit). The period beginning on April 15, 2020, and ending on July 15, 2020, will be disregarded in the calculation of any interest, penalty, or addition to tax for failure to file such income tax returns or to pay such income taxes. Interest, penalties, and additions to tax with respect to such postponed income tax filings and payments will begin to accrue on July 16, 2020.

We note that the state and local tax authorities have not taken a uniform approach to tax filing and payment extension measures. As such, clients should consult with their tax advisers on the state and local tax relief available in their

Conclusion

We expect that the U.S. Treasury and Internal Revenue Service will be releasing guidance on the interpretation and application of the above CARES Act tax measures in short order. Real estate industry members and investors should continue to monitor and discuss with tax counsel the progress of such guidance to assess the best path forward in maximizing liquidity and value, and optimizing tax structuring. Real estate industry members and investors that are interested in the content of this guidance should contact the authors of this alert to discuss fund structuring and operational considerations in connection with the tax

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provisions in the CARES Act as well as the application of the tax measures described above to their specific facts and circumstances.

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