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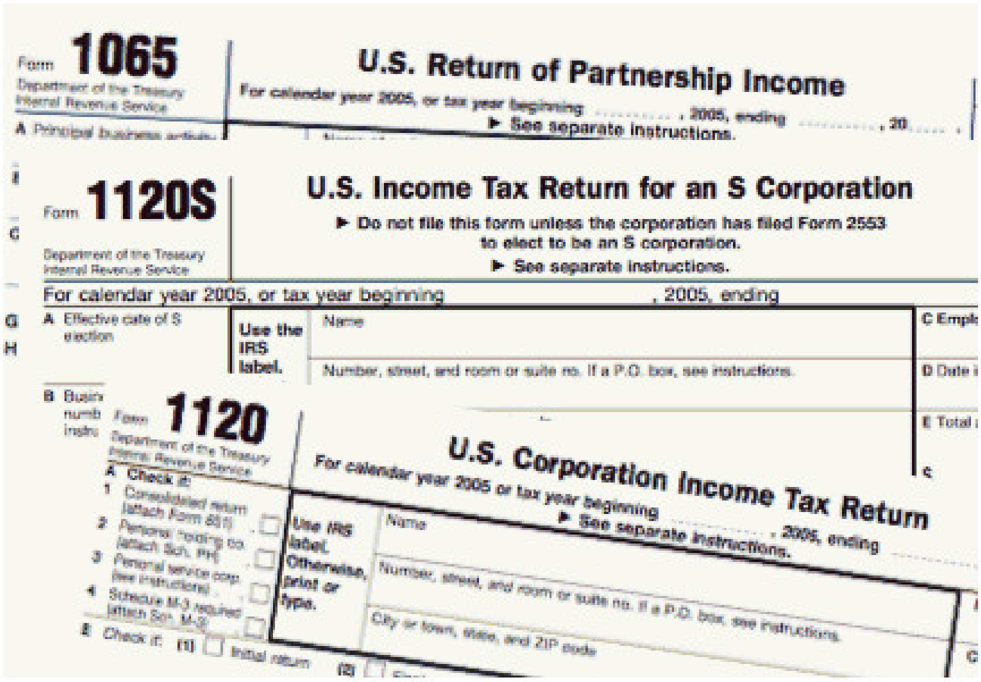

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Now that we are more than halfway through the current year, tax strategy and planning should be at the top of tax and accounting executives' minds. This is especially true in the post-COVID-19 era, when taxation rules and regulations continue to be in flux. One change that could potentially save companies millions of tax dollars involves depreciation of qualified improvement property (QIP).

CARES Act Remedies QIP Mistake

Primarily intended to provide relief from economic hardship caused by the COVID-19

the three pre-TCJA categories of improvement property, which had been assigned a depreciation class life of 15 years, and created a single category of QIP, to which it also intended to assign a 15-year depreciation class life so that QIP would be eligible for 100 percent bonus depreciation. However, due to an unintended omission, the new QIP category was not assigned a depreciation class life. Without a specific assignment, QIP placed in service after 2017 was generally characterized as nonresidential real property, which has a depreciation class life of 39 years. As such, QIP was ineligible for bonus depreciation, which generally requires property to have a depreciation class life of 20 years or less.

But on March 27, 2020, the error was corrected retroactively. Under the CARES Act, QIP is depreciated over 15 years under the MACRS general depreciation system (20 years under the MACRS alternative depreciation system or ADS). This means that many businesses can claim 100 percent bonus depreciation for QIP placed in service in 2018 and later.

In addition, for a limited time, Rev. Proc. 2020-22 allows electing real property businesses and electing farming businesses to withdraw the IRC Sec. 163(j)(7) election, thus enabling them to take advantage of the CARES Act change. Without this change, those businesses would be required to depreciate QIP using the straight-line method over 20 years under the MACRS alternative depreciation system (ADS).

Writing off QIP placed in service in 2018 and/or 2019 is a boon for businesses because it can create a multimillion-dollar bonus depreciation deduction for that year, potentially generating an immediate tax refund and a net operating loss that can be carried back for five tax years, thus possibly generating additional refunds for those carryback years as well.

Formulating a Tax Strategy

For not-yet-filed tax returns, you can simply elect to apply the favorable treatment

3. The Form 3115, Application for Change in Accounting Method, to change your depreciation of QIP placed in service in 2018 or later, in your tax year ending in 2018, 2019, or 2020.

The automatic accounting method change available to change your depreciation method for QIP is available both for taxpayers that have adopted a method of accounting for QIP (i.e., taxpayers that have used an impermissible method for at least two consecutive tax years), and also for taxpayers that have not yet adopted a method for QIP, having applied the impermissible method for only one year. Rev. Proc. 2020-25 provides the procedures and time limits for retroactively changing the depreciation of QIP. However, there are certain limitations on a taxpayer's ability to avail itself of these options. For example, if a taxpayer placed in service QIP after 2017, but made a late election, or withdrew an election, to be an electing real property trade or business or an electing farming trade or business, then any changes to depreciation for such property must be made in accordance with Rev. Proc. 2020-22.

If deducting QIP expense results in a loss, the taxpayer can receive a refund for the year of deduction and can leverage temporary net operating loss (NOL) amendments — also included in the CARES Act — to potentially generate refunds for prior years. In the case of corporate taxpayers, this creates a tax rate arbitrage opportunity. Under the CARES Act, NOLs arising in tax years beginning in 2018, 2019, and 2020, can be carried back to each of the five tax years preceding the tax year of the loss (REITs are not permitted to carry back NOLs). As an example, if you retroactively deduct bonus deprecation for QIP placed in service in 2018 and it creates a large NOL, that NOL could potentially be carried back to offset income in 2013, 2014, 2015, 2015, and 2017, when the corporate tax rate was 35 percent (compared to the 21 percent tax rate applicable to tax years to which NOLs otherwise would have been carried forward), possibly generating refunds of previously paid federal income taxes. A few caveats to keep in mind:

- NOLs are first carried back to the earliest tax year of the 5-year carryback period,

service in an earlier year really depends on its unique business situation. However, a company that meets the following criteria should consider amending its prior year return immediately:

- Company placed in service QIP after December 31, 2017;
- Company filed federal income tax returns treating QIP as nonresidential real property (depreciable over 39 years, ineligible for bonus depreciation);
- Company paid tax (i.e., had taxable income) on that prior year tax return; and
- Company has a current need for cash.

At first glance, taking accelerated depreciation for QIP, creating an NOL and getting a potential cash tax refund seems like a prudent strategy; however, this strategy is not always beneficial. Taxpayers, especially multinational corporations, must consider how carrying back losses to more profitable years will impact their overall U.S. tax bill for the carryback years.

Carrying back losses to earlier years may reduce or eliminate other deductions taken in the carryback year due to lower taxable income resulting from the loss carryback. For example, an NOL carryback to 2018 would result in lower 2018 taxable income, which may reduce or eliminate the 2018 GILTI/FDII deduction, the 2018 business interest expense deduction, and the 2018 charitable contributions deduction, among others. Reduction in taxable income because of an NOL carryback may also reduce the amount of IRC Sec. 960 foreign tax credit (FTC), among other credits, available in the carryback year.

The bottom line is that accelerating QIP depreciation to create an NOL may or may not be beneficial. In light of post-COVID-19 taxation rules and regulation changes, forecasting, modeling, and tax planning is more important than ever to determine the most beneficial tax strategy.