



CARES Act Offers Real Estate Companies Multiple Tax Planning and Business Strategy Opportunities

Real estate companies, like companies in most other business sectors, have struggled to maintain operations and drive revenues during the coronavirus (COVID-19) pandemic. Thankfully, the \$2.2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES Act) contains changes to the 2017 Tax Cuts and Jobs Act (TCJA). Those changes, along with tax law changes and loan programs under the CARES Act, provide potential relief to companies in the real estate industry.

Provisions within the CARES Act can be impactful for tax and business continuity planning and are an important complement to other ongoing discussions related to SBA loan applications and subsequent loan forgiveness. A summary of relief highlights is included below.

TAX HIGHLIGHTS

Extended Return Filing And Payment Deadlines – 1031 Like-Kind Exchange And Qualified Opportunity Zones

New IRS guidance extends all IRS return filing and payment deadlines to July 15 that fall within the period beginning April 1, 2020, and ending July 14, 2020. This includes the first- and second-quarter estimated tax payments for 2020. The IRS released additional guidance that provides relief related to real estate investors by extending deadlines for 1031 Like-Kind Exchanges and Qualified Opportunity Zones to July 15.

Like-Kind Exchanges – Section 1031 allows a taxpayer to defer capital gains on the sale of real property by reinvesting the proceeds in like-kind property. The 1031 exchange rules require the taxpayer to identify the replacement property within 45 days of the sale of the real property and 180 days to acquire the replacement property. The IRS has extended these deadlines as follows: If the taxpayer's 45-day or 180-day identification period deadline falls between April 1, 2020, and July 14, 2020, then the identification period is extended to July 15.

Qualified Opportunity Zones – Section 1400Z-2 allows for deferral of capital gains when invested in a Qualified Opportunity Fund within a 180-day period. The IRS has extended the 180-day period for investors as follows: If the taxpayer's 180-day deadline falls between April 1, 2020, and July 14, 2020, then the 180-day period is extended to July 15.

BUSINESS INTEREST LIMITATIONS

The TCJA limited business interest expense for certain taxpayers that were highly leveraged, including real estate. The interest expense deduction is limited to 30% of adjusted taxable income (ATI), which is taxable income plus interest, depreciation and amortization. For tax years beginning in 2019 and 2020, the business interest expense limitation is increased from 30% of ATI to 50%. In expectation that ATI for 2020 will be less than that in 2019, the CARES Act allows a taxpayer to utilize the 2019 ATI in its computation of the business interest expense in 2020.

Please note that there are different rules depending on what type of legal entity the taxpayer is. The increase in limitation applies for 2019 and 2020 for S Corporations and for 2020 for partnerships. If you fall under the real property trade or business definition, which means development, construction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business, you may be able to elect out of the interest expense limitation rules. There is a cost to making the election, which is that the assets are placed in service over a slightly longer depreciable life, and bonus depreciation is not allowed. Since Qualified Improvement Property (QIP) was not allowed for 100% bonus depreciation prior to the Act, making the real property trade or business election for 2018 was not as costly. The Act has since changed the QIP rules, and QIP is now eligible for 100% bonus depreciation, which is discussed directly below.

QUALIFIED IMPROVEMENT PROPERTY (QIP)

QIP is any improvement made by the taxpayer to an interior portion of a building that is nonresidential real property. The TCJA made a drafting error regarding QIP. The error left QIP being depreciated over a 39-year life, which disqualifies QIP for 100% bonus depreciation. 100% bonus depreciation allows for 100% write-off. The CARES Act makes a technical correction to the TCJA, which changed the depreciable life of QIP over a 15-year period. QIP now qualifies for 100% bonus depreciation, allowing for 100% write-off starting in the 2018 tax year.

For taxpayers that capitalized QIP in 2018, there is a choice of whether to amend and claim the QIP as 100% bonus depreciation in the 2018 tax year or to file a change of accounting method in 2019 to take the deduction in the 2019 tax year, subject to certain limitations. Please note that if you made the real property trade or business election related to the business interest expense limitation, which is discussed above, you cannot take bonus depreciation.

There is relief provided for taxpayers that made a real property trade or business election in 2018. The relief provides the taxpayer the ability to revoke the election (which was previously irrevocable), and it also allows a late election for the 2018 tax year. Real estate companies may consider revoking the real property trade or business election made in the 2018 tax year if the 100% write-off for QIP results in a better tax outcome.

NET OPERATING LOSS CARRYBACK

The CARES Act allows for the carryback of net operating losses (NOL) to claim refunds for taxes paid in prior years. An NOL incurring in 2018, 2019 or 2020 can be carried back to each of the five years preceding the taxable year of such loss.

EXTENDED EXCESS BUSINESS LOSS LIMITATION

The TCJA contains a provision limiting ordinary business losses for individuals starting in the 2018 tax year. These ordinary business losses could only offset passive income and investment income to the extent of \$250,000 for single filers and \$500,000 for married filing joint filers, and the remaining losses were carried forward as a net operating loss to the following tax year subject to certain taxable income limits. The CARES Act suspends the excess business loss limitation until 2021. Real estate professionals generally receive large depreciation deductions, which can result in an overall ordinary business loss. Therefore, real estate professionals may have been limited by the excess business loss limitation in 2018, and there is an opportunity to

amend the 2018 tax return to remove the loss limitation to offset passive and investment income and potentially receive a tax refund.

SBA LOANS

Paycheck Protection Program (PPP)

Under the program, forgivable federal loans are available to qualified small businesses, as an incentive for employers to maintain payroll during the COVID-19 pandemic. The maximum loan size is \$10 million, and the loan term is two years with a 1% interest rate. The loan is calculated based on 2.5 times average monthly payroll. Loan forgiveness requirements include the following: at least 75% of the funds must be used for payroll costs (as defined in the regulations), salary levels and number of employees must be maintained and loan proceeds can be used to offset no more than eight weeks of eligible expenses. The PPP Loan program provides that certain businesses are ineligible. Passive businesses owned by developers and landlords that do not actively use or occupy the assets are not eligible for the PPP loan. Rental real estate is a passive activity by definition. Tenants may be eligible to apply for the PPP loan program, and note that 25% of eligible costs to be forgiven is rent expense. Real estate management companies are not considered passive and, therefore, are generally eligible for the PPP loan program.

The SBA has made exceptions to the eligibility of passive businesses. Generally, there are exceptions for what is known as an Eligible Passive Company. According to the SBA, an Eligible Passive Company (EPC) is an entity that leases property to one or more operating companies for conducting the operating company's business. If your customer leases space to operating companies that use it to conduct their businesses, they may qualify for the Paycheck Protection Program. However, the SBA has very narrow guidelines for which EPCs qualify for loans and how they may use loan proceeds.

Conditions for qualifying as an Eligible Passive Company:

- Lease to an operating company: The EPC must lease 100% of its real or personal property to an operating company (OC). The OC must also be an eligible small business.
- Lease term: The lease must have a term equal to or greater than the term of the loan. For example, if there is only one year left on the tenant's lease with no option to renew, the EPC won't be able to get a loan with a two-year term.
- Lease payments: The EPC can't make a profit on the lease payments from the OC. In other words, the lease payments can't be more than the loan payment plus a reasonable amount to cover the EPC's costs of owning the property, such as maintenance, property taxes and insurance.
- OC as co-borrower or guarantor: The OC must be a co-borrower on the loan if it receives any loan proceeds. Otherwise, each person with at least a 20% ownership stake in either the EPC or the OC must guarantee the loan.

All of these factors should be taken into consideration in determining if the real estate company qualifies for the PPP loan program.

MAIN STREET LENDING PROGRAM

The Federal Reserve is funding \$600 billion for the Main Street Lending Program, and real estate companies are eligible to participate. This program for small and mid-sized businesses offers 4-year non-forgivable loans to companies employing up to 15,000 workers or with revenues of less than \$5 billion for 2019. There are three different types of loans available under this program, ranging from a minimum loan amount of \$500,000 to a maximum of \$200 million. The loan amount is based upon a multiple of adjusted EBITDA. The interest rate terms are LIBOR plus 3%. Principal and interest payments will be deferred for one year, and there is no prepayment penalty. This lending program is not yet available, but the Federal Reserve said it will announce a start date "soon." Real estate companies should reach out to their lenders to discuss the lending program.

ECONOMIC INJURY DISASTER LOAN (EIDL)

The SBA will begin accepting new Economic Injury Disaster Loan (EIDL) and EIDL Advance applications on a limited basis only, to provide relief to U.S. agricultural businesses. Therefore, this loan program currently does not apply to real estate companies.

Questions about CARES Act relief for real estate businesses, or other tax matters? Please contact Mitchell Hagen by phone 402.980.4651 or by email at mhagen@fzacpa.com.