MEMORANDUM

DATE: April 21, 2020
TO: All
FROM: Wendy J. Manson, CPA and William J. Palazzolo, Esq.
RE: CARES Act – Real Estate and Other Important Updates

The CARES Act (the "Act") is a $2.2 trillion stimulus package that was passed by Congress and signed into law on March 27, 2020. The Act includes provisions that help the real estate industry with the fallout from combatting the Coronavirus. The important aspects of these provisions and implications for landlords are as follows:

Qualified Improvement Property

The Act corrects a drafting error in the 2017 Tax Cuts and Jobs Act ("TCJA"), which unintentionally resulted in "qualified improvement property" being classified as 39-year property and therefore not qualifying for bonus depreciation. Qualified improvement property generally is any improvement to an interior portion of a building that is nonresidential real property provided such improvement is placed in service after the date the building was first placed in service (excluding expenses for enlargement of the building, any elevator or escalator or the internal structural framework of the building).

As corrected by the Act, qualified improvement property is treated as 15-year property, and, therefore, eligible for bonus depreciation. The change is retroactive and is effective for property placed in service after December 31, 2017.

Suspension of Loss Limitation

TCJA contained a provision (IRC Sec. 461(l)) for tax years beginning after December 31, 2017 that limited the deductibility of current-year business losses for pass-through businesses and sole proprietorships. The limitation was $500,000 on a joint tax return and $250,000 for all other filers. A business loss in excess of these amounts was disallowed in the year in which it was incurred and was converted into a net operating loss ("NOL") that could be utilized in a future tax year.

The Act suspends the implementation of IRC Sec. 461(l) until tax years beginning after December 31, 2020, thus allowing non-corporate taxpayers to deduct excess business losses arising in 2018, 2019 and 2020.

Real estate properties typically receive large depreciation deductions, including bonus depreciation. Prior to the enactment of IRC Sec. 461(l) in the TCJA, taxpayers qualifying as real estate professionals were able to utilize their business losses to offset their other types of income, such as portfolio and investment income. The loss limitation put in place by the TCJA eliminated the ability for taxpayers to fully utilize their business losses to offset their other income and it ensured that they would pay income taxes on other non-business income in excess of the loss limitation threshold.

As a result, the loss limitation was particularly onerous to taxpayers in the real estate industry who were residents of New York State. The starting point for computing New York State taxable income for a New York resident is federal adjusted gross income, which did not include a deduction for the excess business losses noted above. A taxpayer was then required to adjust federal income by certain items, one of which is bonus depreciation deductions. This adjustment was made whether the business loss was limited by the thresholds noted above or not. A taxpayer could have potentially been required to add back a deduction that was actually not deducted for federal tax purposes as a result of the limitations.

The Act temporarily eliminates this problem. Impacted taxpayers may be able to file amended tax returns and receive refunds paid as a result of the delayed implementation of IRC Sec 461(l).

Implications for Landlords

Due to the eviction moratoriums presently in place, landlords who experience significant revenue declines may need to make use of forbearance options or negotiate loan modifications or extensions with creditors. Landlords will likely need to negotiate with both their tenants and their lenders. In the current crisis, being proactive and initiating conversations could lead to a better outcome than a "wait and see" approach.

Borrowers should review their loan covenants (particularly for any material adverse changes, or force majeure and similar clauses), test any cash flow or financial covenants, and review any limitations on their ability to modify, cancel or amend leases, property management agreements or other key contracts.

Commercial leases should be reviewed to determine whether the COVID-19 crisis qualifies as a force majeure event or triggers common law doctrines of impossibility, impracticability, and/or frustration of purpose which may be applicable depending on the jurisdiction.

Co-tenancy, continuous operations, access, exclusive and other use restrictions may also be impacted as a result of State or local restrictions and orders in effect, for example allowing dine-in restaurant tenants to convert to take-out only service.

IRC Sec. 1031 Exchanges

The safe harbor timelines that are generally followed for 1031 exchanges are:

- Within 45 days of the sale of relinquished property, identify replacement property.
- Within 180 days of the sale of relinquished property, acquire replacement property.

The IRS issued Notice 2020-23 on April 9, 2020 which grants relief with respect to specified time-sensitive actions. This Notice extends the 45-day identification period and the 180-day exchange period by providing an automatic extension until July 15, 2020, but only if your exchange deadlines were in the period April 1, 2020 through July 15, 2020. Unfortunately, this notice does not help if the deadlines were in February and March.

Other Important Updates

Guaranteed Payments - Partners who provide services to their partnerships generally cannot be employees of partnerships, so instead of receiving regular Form W-2 wages, they receive guaranteed payments. The Act defines payroll costs broadly and the definition includes "payments of any compensation to or income of a sole proprietor or independent contractor that is a wage, commission, net earnings from self-employment, or similar compensation." Thus, it is logical to conclude that, although guaranteed payments are not explicitly stated by the Act, Congress's broad definition of payroll costs was intended to include guaranteed payments.

NOL - Under the Act, an NOL arising in a tax year beginning in 2018, 2019 or 2020 can be carried back for five years. It also allows NOLs arising before January 1, 2021 to fully offset income. Thus, the Act temporarily removes limitations put in place by the TCJA where, for taxable years beginning after December 31, 2017, NOLs were limited to 80% of taxable income and could not be carried back.