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Tax Notes

Impact of CARES Act on Partnerships

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The recently passed Coronavirus Aid, Relief, and Economic Security (CARES) Act provides assistance to businesses through the modification of rules related to net operating losses (NOLs), interest expense deductions, alternative minimum tax credits and trade or business losses of non-corporate taxpayers. Many of these modifications are designed to provide critical cash flow and liquidity to businesses during these turbulent times.

The Act has given businesses and their owners several tools to improve cash flow, claim tax refunds, and reduce or defer upcoming tax payments. Certain modifications make corrections to items that were originally omitted by the 2017 Tax Cuts and Jobs Act (TCJA). This article focuses on the impact of certain federal income tax provisions of the CARES Act on partnerships and partners; namely:

- Business Interest Deductions
- Suspension of Non-Corporate Loss Limitation
- Qualified Improvement Property
- Interplay between Partnership Audit Rules and CARES Act Retroactive Changes

Business Interest Deductions

The CARES Act includes several temporary changes to IRC §163(j). It primarily increases the interest expense limitation from 30% to 50% of Adjusted Taxable Income (ATI) for 2019 and 2020 tax years.

The TCJA revamped IRC §163(j) to include all taxpayers as opposed to only corporate taxpayers. Under the TCJA revisions, interest expense was generally limited to 30% of the ATI of such taxpayer for such taxable year. For tax years before 2022, ATI is computed in a manner similar to EBITDA, and, for years after 2021, it is computed in a manner similar to EBIT computation.

The CARES Act includes several temporary changes to §163(j). These changes apply to tax years beginning in 2019 and 2020. For these tax years only, the limitation to 30% of ATI is increased to 50%. The expanded 50% limit does not apply to a partnership tax year beginning in 2019, but (unless a partner otherwise elects out) for any of the partnership's 2019 excess business interest expense that is allocated to a partner:

- 50% of that excess business interest expense will be treated as business interest that is paid or accrued by the partner in its tax year beginning in 2020 and will not be subject to the limits of §163(j) and (subject to any other applicable limitations) should be deductible in such tax year, and
- The other 50% will be subject to the limitations of §163(j)(4)(B)(ii) in the same manner as any other excess business interest expense.

These complex partnership-specific rules are intended to allow partners to realize some benefit of the changes without adjusting the calculation of the 2019 limitation at the partnership level. Since many 2019

partnership tax returns may have been filed prior to the passage of the CARES Act, the rules provided the same benefit of increased interest expense deductions to all partners regardless of when the partnership files its 2019 return.

As an example, assume that a partnership has $300 of ATI and $150 of business interest expense in 2019. $90 of interest expense (30% of $300) would be deductible by the partnership and $60 would be excess business interest expense. $30 of the excess business interest expense may be deductible by the partners in 2020 regardless of the partnership's 2020 activity. The remaining $30 would remain disallowed at the partner level unless sufficient additional income is earned by the partnership in the future.

This example reveals that the increased interest expense available for partners attributable to 2019 partnership income does not match the full deduction made available to other taxpayers, in amount or in time. Note that if the entity was a corporation rather than a partnership, all $150 of the interest expense would be deductible immediately in 2019 as it does not exceed 50% of ATI. Rather, in the partnership example, partners may be limited to only deduct a total of $120 over two years.

Another favorable CARES Act provision permits taxpayers to elect to use their ATI in 2019 in place of their 2020 ATI for purposes of determining the deductibility of their business interest expense for 2020, which would increase their deductible business interest expense if 2019 ATI is greater than 2020 ATI.

Suspension of Non-Corporate Loss Limitation

For the 2018, 2019 and 2020 tax years, the CARES Act removes the limitation on excess business losses for non-corporate taxpayers that originally went into effect in 2018 as a result of the TCJA. These rules are now postponed until 2021 and will apply for the taxable years 2021 through 2026.

The TCJA introduced new IRC §461(l), which disallows the deduction of "excess business losses" by a non-corporate taxpayer during taxable years 2018 through 2026. Nondeductible excess business losses are defined as net business losses (that is, business losses and deductions in excess of business income and gains) in excess of $250,000 ($500,000 for taxpayers filing jointly). Excess business losses are carried forward as net operating losses.

The CARES Act removes this limitation entirely for 2018, 2019, and 2020. It will instead apply for taxable years 2021 through 2026. The CARES Act also makes technical corrections to the excess business loss provisions to clarify that net operating losses and the qualified business income deduction under §199A are not included in calculating an excess business loss; and the extent to which capital gains are taken into account in determining the amount of an excess business loss. These changes may enable partners to claim additional losses in 2018 by filing amended returns, but there should generally be no material impact to partnerships themselves, since §461(l) applies only at the partner, and not the partnership, level.

Qualified Improvement Property

As a technical correction to the TCJA, the CARES Act expands the bonus depreciation rules to allow an immediate 100% write-off for qualified improvement property (QIP), retroactive to the beginning of 2018.

The CARES Act includes a welcome technical correction to the TCJA with respect to QIP. In a legislative drafting error, the TCJA eliminated bonus depreciation on QIP by erroneously removing such property from the list of 15-year recovery period assets. The CARES Act corrects this error, by classifying QIP as having a 15-year recovery period and thereby making such property eligible for immediate bonus depreciation.

QIP is defined as any improvement made by the taxpayer to the interior of a non-residential building that is placed in service after the building's initial placed in service date. QIP excludes improvements attributable to elevators, escalators, building enlargements or the building's internal structural framework. As noted above, because of the CARES Act changes, QIP is now eligible for the additional first-year depreciation

deduction ("bonus depreciation") under §168(k). The provision is effective for assets placed in service after 2017, as if it had been originally included in the TCJA. Accordingly, to comply with this provision, taxpayers are required to change the depreciation methods of qualified improvement property placed in service after 2017 that had been depreciated as 39-year building property.

Interplay between Partnership Audit Rules and CARES Act Retroactive Changes

The Bipartisan Budget Act of 2015 (BBA) replaced the previous partnership audit and litigation rules with a new Centralized Partnership Audit Regime (CPAR). The CPAR assesses and collects tax at the partnership level. The CPAR rules first became effective with the 2018 tax year. These rules were designed to ameliorate some of the difficulties that the IRS faced when auditing partnerships. In particular, the CPAR rules were intended to make it easier for the IRS to collect taxes, by allowing the IRS to assess and collect underpaid taxes, interest and penalties directly at the partnership level rather than through the ultimate owners of the audited partnership.

There are exceptions to CPAR for certain small partnerships if they elect out of CPAR rules. The election is an annual election. If an eligible partnership validly elects out of the CPAR, that partnership is allowed to file an amended return. However, partnerships that are subject to CPAR rules (BBA partnerships) are generally not allowed to amend their returns after the returns are filed. Instead, such partnerships generally would need to file an Administrative Adjustment Request (AAR) and the impacted partners will determine the potential benefit of the adjustment and will reflect that benefit against their tax liability in the year of change.

In light of the CARES Act retroactive changes, the IRS released Rev. Proc. 2020-23, which allows BBA partnerships to file amended returns for taxable years beginning in 2018 and 2019. Permitting these amended returns allows for quicker relief from CARES Act provisions for partners. Under AARs, these benefits could have been delayed until 2021.

Eligible returns include 2018 tax returns and 2019 tax returns which were filed prior to the issuance of Rev. Proc. 2020-23. The amended returns must be filed by September 30, 2020 (electronically or by mail) and include, "Filed pursuant to Rev Proc 2020-23" along the top of page 1 and with each amended Schedule K-1. The amended returns may include changes enacted by the CARES Act as well as any other tax attributes entitled by law.

Partnerships that are under examinations can still take advantage of the provisions in this revenue procedure, but must send written notice to the revenue agent coordinating the examination along with a copy of the amended return. Additionally, partnerships which have already filed an AAR are eligible to file amended returns and should use the items adjusted in the AAR as the originally reported amounts, where applicable.

Any partnerships that relied on the proposed GILTI regulations, such partnership may continue to apply the rules of the proposed regulations. If a partnership applies the final GILTI regulations, any amended Schedule K-1s issued under this revenue procedure must be consistent with those final regulations.

All discussions of the CARES Act above are with regard to U.S. federal income tax consequences; any non-income tax consequences, or any state, local or foreign income tax consequences have not been discussed in this newsletter.

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