



TaxNewsFlash

United States



No. 2020-233
April 17, 2020

KPMG report: Relief to make or withdraw a real property trade or business or farming business election and certain other elections related to the CARES Act changes to section 163(j)

The IRS on April 10, 2020, released an advance version of Rev. Proc. 2020-22 providing taxpayers with:

- The ability to withdraw prior elections to be an electing real property trade or business under section 163(j)(7)(B) or an electing farming business under section 163(j)(7)(C)—referred to as an “Excepted Business Election”
- The ability to make a late Excepted Business Election
- Guidance on making certain elections related to changes made to section 163(j) under the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act)

Read [Rev. Proc. 2020-22](#) [PDF 22 KB]

The following discussion provides initial impressions of the guidance provided by the revenue procedure.

Section 163(j) and “Excepted Business Elections” — in general

Section 163(j) generally provides that, in any given tax year, a taxpayer can deduct business interest only up to the sum of:

- The taxpayer’s business interest income for the tax year,
- 30% of the taxpayer’s adjusted taxable income (“ATI”) for the tax year (the “30% ATI Rule”), plus
- The taxpayer’s floor plan financing interest for the tax year.

However, a real property trade or business (within the meaning of section 469(c)(7)(C)) or a farming business (within the meaning of section 263A(e)(4)) owned by a taxpayer is not subject to the section 163(j) limitation to the extent the taxpayer makes an Excepted Business Election. Under section 163(j)(7)(B) and (C)—as well as the proposed regulations under section 163(j) issued on December 28, 2018 (the “Proposed Regulations”)—an Excepted Business Election is irrevocable.

A real property trade or business that makes an Excepted Business Election is required to depreciate its non-residential real property, residential rental property, and qualified improvement property (“QIP”) using the alternative depreciation system (ADS”) of section 168(g) rather than the general depreciation system (“GDS”) of section 168(a). A farming business that makes an Excepted Business Election is required to depreciate any assets with a recovery period of 10 years or more using ADS.

CARES Act changes to section 163(j) and qualified improvement property

The CARES Act makes significant changes to the business interest expense limitation rules under section 163(j).

In particular, for 2019 and 2020 tax years, taxpayers may compute their section 163(j) limitation based on 50% of ATI—rather than 30% of ATI—the “50% ATI Rule”) unless a taxpayer elects not to apply the 50% ATI Rule.

Unlike other taxpayers, partnerships must continue to compute their section 163(j) limitation based on 30% of ATI for the 2019 tax year and can only compute apply the 50% ATI Rule for their 2020 tax year. However, partners are permitted to treat 50% of their allocable share of a partnership’s 2019 excess business interest expense (“EBIE”) as paid or accrued in 2020 and such business interest expense is not subject to any further section 163(j) limitation at the partner level (the “50% EBIE Rule”). Lastly, taxpayers (including partnerships) can elect to apply their 2019 ATI to compute their 2020 section 163(j) limitation.

Read a more detailed discussion of the CARES Act in general and changes made to section 163(j): [**KPMG report: Tax provisions in the CARES Act \(COVID-19 “phase 3” response\): Preliminary analysis and observations**](#) [PDF 3.1 MB]

In addition to the changes to section 163(j), the CARES Act made a technical correction to the 2017 tax law known as the *Tax Cut and Jobs Act* (TCJA) (Pub. L. No. 115-07, 131 Stat. 2054) with respect to QIP. The technical correction retroactively, provides a 15-year recovery period to QIP for purposes of the general depreciation system of section 168(a) and a 20-year recovery period for purposes of the alternative depreciation system under section 168(g) for assets placed in service after December 31, 2017.

Generally, QIP is any improvement made by the taxpayer to the interior of a non-residential building that is placed in service after the date the building was initially placed in service.

Reason for Rev. Proc. 2020-22

The IRS released Rev. Proc. 2020-22 to provide immediate guidance under section 163(j) to taxpayers who may be impacted by the changes made in the CARES Act. Importantly, the revenue procedure allows an automatic extension of time for certain taxpayers to make an Excepted Business Election or to retroactively withdraw a timely filed Excepted Business Election.

In addition, Rev. Proc. 2020-22 addresses how taxpayers can (1) elect out of the 50% ATI Rule for their 2019 or 2020 tax year, (2) elect to use 2019 tax year ATI to calculate a 2020 tax year section 163(j) limitation, and (3) elect out of the 50% EBIE Rule.

KPMG observation

In evaluating the impact of any elections available under section 163(j), taxpayers need to consider the net impact of the technical corrections to QIP, business interest expense, and any other collateral adjustments. If an increase to a taxpayer's deduction for business interest expense would result in negative tax consequences under another tax provision, such as section 59A (the base erosion and anti-abuse tax), Rev. Proc. 2020-22 provides a great deal of flexibility for a taxpayer to revisit applicable section 163(j) elections, as noted below. In the partnership context, the partnership and its partners may have competing goals, interests, and tax sensitivities. As a result, modeling will be extremely important.

KPMG observation

The IRS has not yet issued guidance under section 168(k)(7) related to the ability to change a previous election out of bonus depreciation for a recovery class of property for a tax year. Such an election is irrevocable without the consent of the IRS. As such, guidance may be needed for taxpayers that made an election out of bonus for eligible property that would include QIP placed in service in a tax year for which the taxpayer now wishes to revoke an Excepted Business Election.

Late or withdrawal of "Excepted Business Election"

Rev. Proc. 2020-22 allows late elections for taxpayers, including partnerships that did not file an Excepted Business Election with their timely filed original tax return, including extensions, for their 2018, 2019 or 2020 tax years (or withdrew an Excepted Business Election under Rev. Proc. 2020-22).

Despite the fact that an Excepted Business Election is generally irrevocable under the statute and the Proposed Regulations, Rev. Proc. 2020-22 provides relief to taxpayers—including partnerships—that made an Excepted Business Election on a timely filed original tax return for the 2018, 2019, or 2020 tax years, including extensions (or timely made the election under Rev. Proc. 2020-22) but now wishes to retroactively withdraw such election.

Rev. Proc. 2020-22 provides that both the late Excepted Business Election and a retroactive withdrawal of a timely Excepted Business Election may be made by filing an amended return, an amended Form 1065 (in certain circumstances) or an administrative adjustment request ("AAR"). Partnerships subject to the Bipartisan Budget Act of 2015 ("BBA Partnerships") are generally prohibited from filing an amended Form 1065.

Rev. Proc. 2020-22, however, incorporates the provisions of Rev. Proc. 2020-23 and allows BBA Partnerships that filed their 2018 or 2019 tax year returns prior to April 8, 2020, to file an amended Form 1065 before September 30, 2020. Read [TaxNewsFlash](#)

With respect to a late Excepted Business Election, the amended return, amended Form 1065 or AAR, as applicable, must include an election statement—titled "Revenue Procedure 2020-22 Late Election Statement"—and must include the adjustment to taxable income for the late election and any collateral adjustments (such as depreciation allowed or allowable) to taxable income or to tax liability.

In addition, collateral adjustments must be made on amended returns, amended Forms 1065 or AARs, as appropriate, for any affected succeeding tax year. The election statement must include the taxpayer's name, address, and employer identification number ("EIN"). It must also describe the electing trade or business, including its principal business activity code, and state that that taxpayer is making an election under section 163(j)(7)(B) or (C), as applicable.

With respect to a withdrawal of a timely filed Excepted Business Election, the amended return, amended Form 1065 or AAR, as appropriate, must include a withdrawal statement—titled "Revenue Procedure 2020-22 Section 163(j) Election Withdrawal"—and an adjustment to taxable income for the

withdrawn Excepted Business Election and any collateral adjustments to taxable income or tax, including an adjustments under section 481.

The taxpayer must also file amended tax returns, amended Forms 1065 or AARs, as applicable, including any collateral adjustments, for any affected succeeding tax year. An example of such collateral adjustments would be to adjust the amount of depreciation allowed or allowable for the property to which the withdrawn election applies.

The election withdrawal statement must include the taxpayer's name, address, and EIN, and must state that the taxpayer is withdrawing its election under section 163(j)(7)(B) or (C), as applicable.

KPMG observation

Taxpayers that own a real property trade or business need to analyze, and potentially reassess, whether to make an Excepted Business Election in a current or previous tax year, or withdraw a previously made Excepted Business Election, in light of the technical correction to the depreciation of QIP and potential increased business interest expense limitation under the CARES Act changes to section 163(j).

To the extent relevant, corporations (including REITs) and partnerships may also want to consider the impact of making or withdrawing an Excepted Business Election on any direct or indirect shareholder or partner that allocated all or a portion of the shareholder's or partner's business interest expense to the applicable real property trade or business or farming business under the Proposed Regulations. Partnerships also need to consider the implications on their direct or indirect partners if the partnership files an amended return or AAR, including the tax year in which any additional tax deductions are taken into account as well as compliance complexities.

Election out of 50% ATI Rule

Rev. Proc. 2020-22 provides that a taxpayer may elect out of applying the 50% ATI Rule—and instead compute the section 163(j) limitation based on 30% of the taxpayer's ATI—by timely filing a tax return or Form 1065, an amended tax return for non-BBA partnership taxpayers (a BBA Partnership is not permitted to file an amended Form 1065 for a 2020 tax year), or an AAR (in the case of BBA Partnerships) by computing the taxpayer's section 163(j) limitation based on 30% of the taxpayer's ATI. No other formal statement is needed.

If a taxpayer elects out of the 50% ATI Rule, the taxpayer may subsequently revoke the election out by applying the 50% ATI Rule on an amended tax return or AAR, as applicable.

KPMG observation

As noted above, taxpayers may wish to elect out of the 50% ATI Rule or the 50% EBIE Rule (discussed below) in circumstances where an increased limitation would result in adverse tax consequences. It was not clear under new section 163(j)(10)(A)(iii) whether a taxpayer can elect out of the 50% ATI Rule for only one tax year as opposed to electing out for both the 2019 and 2020 tax years. Rev. Proc. 2020-22 clarifies that a taxpayer may elect out of the 50% ATI Rule for a single tax year.

Election to use 2019 ATI in 2020

Rev. Proc. 2020-22 provides that a taxpayer may elect to apply the taxpayer's 2019 ATI to compute the taxpayer's 2020 section 163(j) limitation by timely filing, including extensions, a 2020 tax return or Form 1065, an amended tax return for non-BBA partnership taxpayers, or an AAR (in the case of BBA Partnerships), as applicable, and computing the 2020 section 163(j) limitation based on the taxpayer's 2020 ATI. A taxpayer may revoke this election by timely filing an amended return or AAR, as

applicable, and computing the taxpayer's section 163(j) limitation based on the taxpayer's 2020 ATI. No formal statement is required to either make or revoke this election.

KPMG observation

Tax professionals believe that the application of a taxpayer's 2019 ATI to compute a 2020 section 163(j) limitation is likely to produce a higher section 163(j) limitation. A partnership that applies this rule will need to consider how the application of its 2019 ATI will impact the allocation of 2020 deductible business interest expense, excess business interest expense or excess taxable income among its partners. Partnerships will need to take into account differences between the 2019 tax year and 2020 tax year, including the identity of partners, partners' varying interests, cash flow entitlements, and actual items of income, gain, loss and deduction that may not correspond to the items that comprise 2019 ATI. These computations affect partners' current estimated taxes. Treasury may provide additional guidance on these issues in forthcoming regulations.

Partner election out of 50% EBIE Rule

A partner may elect not to apply the 50% EBIE Rule by timely filing a 2020 tax return including extensions, amended return, or AAR, as applicable, without deducting such amount of EBIE.

A partner may revoke the election to not apply the 50% EBIE Rule by filing an amended 2020 return or AAR, as applicable, and by deducting 50% of the taxpayer's 2019 EBIE. No formal statement is required to make or revoke the election.

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