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Relief for taxpayers to correct, change QIP depreciation methods (Rev. Proc. 2020-25)

April 22, 2020

The IRS on April 17, 2020, issued **Rev. Proc. 2020-25** [PDF 125 KB] (28 pages) providing taxpayers the ability to amend tax returns and file accounting method changes to correct prior depreciation methods of so-called "qualified improvement property" (QIP) placed in service after 2017. The revenue procedure also provides taxpayers a broader opportunity to retroactively make, revoke or withdraw certain elections with respect to all classes of tangible depreciable property under section 168 on returns filed prior to April 18, 2020.

QIP generally is any improvement made by the taxpayer to the interior of a nonresidential building that is placed in service after the building's initial placed in service date. It does not include improvements related to elevators, escalators, building additions, or a building's internal structural framework.

Background

As a result of a drafting error to the 2017 tax law (Pub. L. No. 115-97, the law that is often referred to as the "Tax Cuts and Jobs Act" (TCJA)), qualified improvement property (QIP) placed in service after 2017 has generally been depreciated as 39-year non-residential real property and has not been eligible for the additional first-year depreciation deduction (bonus depreciation) of section 168(k). The CARES Act[1] includes a technical correction to the TCJA that corrects the drafting error by providing that QIP has a recovery period of 15 years for purposes of the general depreciation system (GDS) of section 168(a) and a recovery period of 20 years for purposes of the alternative depreciation system (ADS) of section 168(g). As property with a GDS recovery period of 20 years or less, QIP that is not required to be depreciated using ADS is eligible for bonus depreciation.

The technical correction is effective as if it had been included in the TCJA—i.e., for all QIP placed in service after 2017. As a result, all QIP placed in service on or after January 1, 2018, likely is being depreciated using a now impermissible depreciation method.

Rev. Proc. 2020-25

The revenue procedure provides guidance for correcting the depreciation of QIP placed in service after 2017. The revenue procedure also provides more broad-based relief by allowing taxpayers to retroactively make, revoke, or withdraw specified elections under section 168 with respect to all classes of eligible property under section 168, including QIP, on previously filed returns.

Correction of QIP depreciation

With respect to the correction of QIP depreciation, Rev. Proc. 2020-25 generally provides taxpayers with

[1] The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (Pub. L. No. 116-136) was signed into law on March 27, 2020.

a choice to either correct the impermissible depreciation method used for QIP placed in service after 2017 by filing an automatic accounting method change, or by amending the previously filed tax returns to correct the depreciation method. The revenue procedure defines an impermissible depreciation method for QIP to include both use of a recovery period other than 15 years under the GDS or 20 years under the ADS and failure to claim bonus depreciation for QIP that was eligible for bonus depreciation in the year it was placed in service.

The revenue procedure amends Rev. Proc. 2019-43 to include new section 6.19, which provides automatic change procedures for making an accounting method change for QIP depreciation. With certain exceptions, these procedures apply to any QIP that was placed in service after 2017, is owned by the taxpayer at the beginning of the tax year of change, and that has been depreciated using an impermissible method on one or more tax returns for tax years immediately preceding the year of change. The exceptions include QIP that was placed in service in a tax year for which the taxpayer made a late election or revoked a previously made election under section 163(j) in accordance with Rev. Proc. 2020-22. As provided in Rev. Proc. 2020-22,[2] the depreciation of such QIP may only be corrected via an amended return.

The new automatic change procedures also provide a temporary waiver of certain of the eligibility rules of Rev. Proc. 2015-13.[3] Specifically, taxpayers may use the new procedures to change the depreciation method of QIP placed in service after 2017 in a tax year ending in 2018, 2019 or 2020 even if the tax year of change is the taxpayer's final tax year or if the taxpayer had made another depreciation method change for the same asset during the five tax years ending with the tax year of change. This waiver only applies to accounting method changes filed for the first or second tax year after the QIP placed in service year or, if later, to accounting method changes made with a timely filed return between April 17, 2020 and October 15, 2021. The procedures for changing QIP also provide for streamlined filing requirements.

If a taxpayer prefers to correct the depreciation method for QIP by filing an amended return or administrative adjustment request (AAR), Rev. Proc. 2020-25 provides a limited window to do so. The amended return or AAR must be filed, for a tax year ending in 2018, 2019 or 2010, by the earlier of October 15, 2021, or the date the statute expires for the tax year being amended.

KPMG observation

The revenue procedure allows taxpayers to amend returns to correct an impermissible method of depreciation of QIP even if that impermissible method has been used on more than one return. While this flexibility is welcome, it is somewhat surprising as it departs from the accepted rules of establishing accounting methods as stated in Rev. Rul. 90-38.[4] Under these rules a permissible accounting method is established after it is used on a single tax return, while an impermissible method is established after use on two consecutive returns. Once established, an accounting method may only be corrected by the filing of an accounting method change request on Form 3115, absent administrative guidance providing otherwise.

[2] 2020-18 I.R.B. 745.
[3] 2015-5 I.R.B. 419.
[4] 1990-1 C.B. 57.

Revision of certain depreciation elections

Rev. Proc. 2020-25 allows taxpayers to revise specified depreciation elections for certain tax years for which a return was timely filed prior to April 18, 2020, as follows.

- **Section 168(k)(7) election out of bonus depreciation for one or more recovery classes of property.** For tax years that ended in 2018, 2019 or 2020, this election may be retroactively made or revoked by either amending the return for that tax year or by filing an automatic accounting method change.

- **Section 168(k)(5) election to claim bonus depreciation for specified plants in the year of planting or grafting.** For tax years that ended in 2018, 2019 or 2020, this election may be retroactively made or revoked by either amending the return for that tax year or by filing an automatic accounting method change.

- **Section 168(k)(10) election to use 50% in lieu of 100% bonus depreciation.** For the tax year that included September 27, 2017, taxpayers may retroactively make or revoke this election by either amending the return for that tax year or by filing an automatic accounting method change.

- **Section 168(g)(7) election to use the ADS for one or more recovery classes of property or for specific buildings.** For tax years that ended in 2018, 2019 or 2020, this election may be retroactively made by filing an amended return for that tax year or by filing an automatic accounting method change. It may be retroactively withdrawn only by filing an amended return for the tax year in which it was made.

Amended returns to make, revoke or withdraw the above elections are required to be filed prior to the expiration of the statute of limitations for the tax year or, if earlier, October 16, 2021. Accounting method changes to make or revoke elections, as described above, may be filed for the first or second tax years following the year of the election, or, if later, with a timely filed return filed after April 16, 2020 and before October 16, 2021.

Rev. Proc. 2020-25 revises Rev. Proc. 2019-43 by adding section 6.20 to the list of automatic accounting method changes. As with the change described above to correct an impermissible depreciation method for QIP, the new procedures waive the eligibility rules of Rev. Proc. 2015-13 that would otherwise prohibit the filing of an automatic method change for final year returns and for accounting methods that have been filed for the same item in the five tax years ending with the year of change.

Rev. Proc. 2020-25 allows both the QIP accounting method change and an accounting method change to revise one or more of the specified elections to be filed on the same Form 3115 along with a change made under section 6.01 of Rev. Proc. 2019-43 for certain changes from an impermissible to a permissible method of depreciation. Rev. Proc. 2020-25 also provides for streamlined filing of both newly created accounting method changes in that only limited sections of the Form 3115 are required to be completed.

KPMG observation

The election out of bonus under section 168(k)(7) is made by recovery class of property, and the election to use the ADS under section 168(g)(7) is made by recovery class except for 39-year or 27.5-year property, for which the election to use the ADS is made by building. QIP is part of the 15-

year recovery class for purposes of these elections. The ability to retroactively make, revoke or withdraw one of the specified elections, however, is not limited to QIP or even to 15-year property, but applies to any recovery class (or, for the section 168(g)(7) election, any building) of the taxpayer's choosing. This gives taxpayers significant flexibility in planning and can be particularly useful for taxpayers with net operating losses and credit carryforwards.

Other considerations

Impact of technical correction on qualified business asset investment under FDII/GILTI

Taxpayers eligible for the section 250 deduction for foreign-derived intangible income (FDII) or global intangible low-taxed income (GILTI) are required to calculate that deduction by subtracting 10% of the qualified business asset investment (QBAI) from certain intangible income. For this purpose, section 951A(d)(3) requires that QBAI be calculated by determining the tax basis of property as if the ADS method under section 168(g) applied but without regard to "any law enacted after December 22, 2017."

Both the use of the ADS and the disregard of after-enacted statutes also apply for FDII purposes because the QBAI definition is adopted via a cross-reference from section 250(b)(2)(B) to section 951A(d). The GILTI final regulations (section 1.951A-3(e)) and FDII proposed regulations (prop. section 1.250(b)-2(e)) each clarify both that the determination of QBAI is not an accounting method and that an after-enacted statute could have effect on these rules but only if that after-enacted statute were to specifically amend the QBAI definition for purposes of 951A (or, for FDII purposes, if it were to amend the definition for purposes of section 250 or section 951A(d)).

Section 2207 of the CARES Act amends section 168(g) for QIP as described above. However, there is no specific reference to QBAI, section 951A, or section 250 in section 2207. The applicability date in section 2207(b) states: "The amendments made by this section shall take effect as if included in section 13204 of Public Law 115–97." Based on the relevant statutory language, it appears that the revision to section 168(g) in the CARES Act is a later enacted law because, even though it becomes effective as if included in the TCJA, the CARES Act was enacted and became law in 2020. As a result, QIP depreciation for QBAI for GILTI and FDII purposes is still required to be based on an ADS recovery period of 40 years.

COVID-19 cash flow planning considerations

As discussed above, the guidance and ability to make retroactive changes, elections, and revocations for QIP and other depreciable assets provides a wide array of choices for taxpayers in the present tax return filing season. These options should all be considered in the light of their interplay with and impact on the taxpayer's other pre-existing tax attributes, other COVID-19-related provisions such as the NOL carryback and revised section 163(j) limitations, and tax planning in general. For example, a taxpayer who has not had net operating losses in the past, but expects to incur a net operating loss in 2020 that can be carried back to pre-2018 tax years would generate a permanent tax rate benefit by opting to correct its 2018 QIP additions through a method change filed for the 2020 tax year as opposed to amending its tax return for 2018, or making the accounting method change for 2019.

Conversely, a taxpayer that does not expect to generate net operating losses, may find the amended return option or 2019 method change more advantageous by accelerating the cash flow benefits of the accelerated timing of the bonus depreciation deduction.

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