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Depreciation, Bonus Depreciation and Other Changes of Interest for Real Estate Owners Under 2017 Tax Reform

Tax Reform Update

We wrote an [article explaining new IRC 199A](#) — the flow through deduction that will materially benefit many owners of real estate — at least until the benefits of the lower tax rate are factored into the values paid for new acquisitions. By necessity, that article was limited to IRC 199A and thus short-changed three key changes that affect real estate ownership: the new rules for depreciation as they apply to real estate, the limitation on deductibility of business interest, and the changes to like-kind exchanges. We dive into those below.

Cost Recovery for Real Estate

One cannot understand the present without some basic history.

1. Standard Depreciation Rules Applicable to Real Estate — Simplified

Under prior law, the cost recovery periods for most nonresidential real property other than land was 39 years — until 2015 when the PATH Act allowed 15 year recovery period for (A) qualified leasehold improvement property (which was defined to be an interior building improvement to

nonresidential real property by a landlord, or tenant that was placed in service more than three years after the building was first placed into service that met other requirements), (B) qualified restaurant property (which was defined as either a building improvement in a building in which more than 50 percent of the building's square footage was devoted to the preparation of, and seating for, on-premises consumption of prepared meals (the more-than-50-percent test), or a building that passed the more-than-50-percent test), and (C) qualified retail improvement property (which was defined as an interior improvement to retail space that was placed in service more than three years after the date the building was first placed in service and that met other requirements.)

1. Bonus Depreciation for Some Real Estate Improvements

Bonus depreciation allows a percentage of a capital expenditure to be deducted in the current year. Prior to 2015, except for certain qualified leasehold improvements placed in service for leased property three years after a building was placed in service, owners of real estate generally missed out on bonus depreciation. In 2015, bonus depreciation allowed a deduction in the first year equal to 50 percent of the qualifying expense. The percentage of capital expense eligible for bonus depreciation fluctuated in prior years from a low of 30 percent and high of 100 percent, and absent passage of the new tax rules in December 2017, the percentage was scheduled to drop to 40 percent in 2018 and to drop further in future years.^[1] Tax basis in the asset was, of course, reduced by the amount of any current year tax deduction and the balance of the tax basis was recovered over the normal depreciation period for the asset class — as long as 39 years.

In 2015, the PATH Act also materially expanded the ability to deduct first-year 50 percent bonus depreciation for “qualified improvement property” — a vastly more expansive category than “qualified leasehold improvement property.” Qualified improvement property was defined as any improvement to an interior portion of a building that was nonresidential real property if the improvement was placed in-service after the date the building was first placed into service. It did not include any improvement for which the expense is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. Further, qualifying property

improvements were allowed for bonus depreciation even if the property wasn't leased, was no longer limited to improvements placed in service three years after the building was first placed in service, and no longer excluded structural components of a building which benefited a common area.

Qualified improvement property as defined above for bonus depreciation did not necessarily qualify for 15-year recovery unless it also met the more stringent tests of qualified leasehold improvement property or qualified retail improvement property.

1. Summary of History From 2015 Through September 27, 2017

Thus, following the PATH Act in 2015, tax law was pretty favorable to real estate, and very favorable to tax advisors and cost-segregation experts who could help owners of real estate navigate these rules. Query of course whether the complexity undermined some of the incentive to remodel/repair/improve or develop real estate.

Now that we have finished the history lesson, we can turn to new law.

1. Bonus Depreciation Expanded

The new law — aka H.R. 1, sometimes (and incorrectly) referred to as the Tax Cuts and Jobs Act (TCJA) — now allows taxpayers to claim a 100 percent^[2] first-year bonus deduction for the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023.^[3]

2. IRC Section 179 Expanded

We noted above that IRC 179 was of limited value in the real estate industry because of the relatively low-dollar thresholds and limitations that precluded use for many real property capital expenditures. No more.

For property placed in service in tax years beginning after December 31, 2017, the maximum amount a taxpayer may expense under IRC 179 is

increased to \$1 million, and the phase-out threshold amount for taxpayers with too much income is increased to \$2.5 million. For tax years beginning after 2018, these amounts (as well as the \$25,000 sport utility vehicle limitation) are indexed for inflation.

The definition of IRC 179 property is expanded to include certain personal property even though it is used predominantly to furnish lodging or in connection with furnishing lodging. The definition of qualified real property eligible for IRC expensing is also expanded to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems. Also any other building improvements to nonresidential real property that aren't elevators or escalators, building enlargements or attributable to internal structural framework are now eligible for IRC 179 expensing.

1. Recovery Period for Real Property Shortened

The TCJA eliminates the separate definitions of qualified leasehold improvement, qualified restaurant and qualified retail improvement property for property placed in service after December 31, 2017. Instead, a general 15-year recovery period and straight-line depreciation applies to qualified improvement property. Qualified improvement property is defined as any improvement to an interior portion of a building that is nonresidential real property, excluding any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. Thus, qualified improvement property placed in service after December 31, 2017 is generally depreciable over 15 years using the straight-line method (with the half-year convention), without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building.

Limits on Interest Deductibility

Under prior law, business interest generally was deductible when computing taxable income (subject to a number of limitations). Under the TCJA, for tax years beginning after December 31, 2017 the deduction for

net interest expense is limited to 30 percent of the taxpayer's adjusted taxable income (not below zero and subject to certain exceptions). The net interest expense disallowance is normally determined at the tax-filer level but there is a special rule applicable to pass-through entities that requires the determination to be made at the entity level. Thus, the computation and disallowance can apply at the partnership level instead of at the partner level.

Significantly, taxpayers (other than tax shelters) are exempt from this rule if their average annual gross receipts for the three-tax-year period, ending with the prior tax year, is less than \$25 million. Also exempted from this new limitation are certain regulated public utilities and electric cooperatives. Real property trades or businesses can elect out of the provision if they use ADS to depreciate applicable real property used in a trade or business. Finally, interest paid on floor plan financing is effectively excluded.

From 2018 to 2021, adjusted taxable income is computed without regard to deductions allowable for depreciation and amortization. For these purposes, adjusted taxable income should be roughly equivalent to EBITDA.

Any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Disallowed business interest may be carried forward indefinitely.

This change will obviously influence a business's leverage and could reduce the benefits of debt financing vis-a-vis equity. As long as interest rates remain relatively low, most real-estate operations will not be adversely affected by this new limitation, but it is easy to imagine a delay of interest deductions when interest rates rise.

Like-Kind Exchanges

Prior to the TCJA, the IRC 1031 like-kind exchange rules provided that no gain or loss was recognized to the extent that property — which included a wide range of property from real estate to tangible personal property — held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that

also is held for productive use in a trade or business or for investment.

Under the TCJA, the rule allowing the deferral of gain on like-kind exchanges is modified to allow for like-kind exchanges only with respect to real property, effective for transfers after December 31, 2017. However, under a transition rule, the pre-Act like-kind exchange rules apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

Further, the TCJA now expressly excludes from IRC 1031 any property not held primarily for sale, but most tax practitioners see that as a mere clarification.

Changes to Credits

The TCJA changes credits of common value in the real estate industry (e.g., for Low-Income Housing Tax Credit, New Markets Tax Credit, Rehabilitation), both directly and indirectly. The indirect change may be the most significant. Most — but by no means all — credit “purchasers” are corporations. The reduced corporate tax rate materially reduces the value of all credit carry forwards as well as the amount they are willing to pay for such credits.

More directly, the TCJA also modified the rehabilitation credit for qualified rehabilitation expenditures paid or incurred starting in 2018 by eliminating the 10 percent credit for expenditures for qualified rehabilitation buildings placed in service before 1936, and retaining the 20 percent credit for expenditures for certified historic structures, but reducing its value by requiring taxpayers to take the credit ratably over five years starting with the date the structure is placed in service. Formerly, a taxpayer could take the entire credit in the year the structure was placed in service. A transition rule is also provided for certain buildings owned or leased at all times on and after January 1, 2018.

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If you have any questions regarding the new tax law, please don't hesitate to contact a member of our Tax Team.

[1] Amounts not deductible in the current year as bonus depreciation could, in some cases, be currently deducted under the special IRC 179 expensing provision. However, IRC 179 has historically had limited value in the real estate context because it was not available for many real property capital expenditures and contained relatively low dollar limits that limited usefulness in the real estate context.

[2] For the first tax year ending after September 27, 2017, a taxpayer can elect to claim 50 percent bonus first-year depreciation (instead of claiming a 100 percent first-year depreciation allowance).

[3] First-year bonus depreciation deduction is scheduled to phase down to 80 percent for property placed in service after December 31, 2022 and before January 1, 2024, and to continue to phase down 20 percent every two years until it sunsets for property placed in service after December 31, 2027 (subject to exceptions that slow down the phase down for long-production-period property). Query whether Congress will ever be able to get this particular genie back in its bottle.