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SPECIAL FEATURE

Limited Time Offer–Bonus Depreciation Yield Enhancer

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On Dec. 18, 2015, President Barack Obama signed the Consolidated Appropriations Act, 2016. In addition to the five-year extension of the new markets tax credit (NMTC) and the permanent extension of the 9 percent floor for the applicable percentage for low-income housing tax credit (LIHTC) developments, tucked into the law is an extension of yield-enhancing bonus depreciation through 2019. The following paragraphs will examine what bonus depreciation is and how it can impact current and future real estate projects.

Bonus depreciation under Internal Revenue Code (IRC) Section 168(k) allows a project to expense up to 50 percent of certain new assets when they are placed in service. This can significantly accelerate the losses generated by a project. Increased losses result in a better yield for investors and can therefore allow for better equity pricing.

Personal Property and Site Improvements

Personal property and site improvements are the primary assets to get bonus depreciation. Generally, bonus depreciation only applies to property that has a life of 20 years or less, based on IRC Section 168(k)(2)(A)(i)(I). For affordable housing and community developments, that will mostly mean bonus depreciation is limited to new personal property (including qualifying energy property) and site improvements. However, see the last section of this article for the availability of bonus depreciation on interior building costs for properties with substantial commercial components.

Impact of Bonus Depreciation

Fifty percent of the costs of qualifying assets are depreciated in the year placed in service with the remaining 50 percent depreciated as normal. For example, site improvements are normally depreciated on an accelerated basis over 15 years and get a 5 percent depreciation deduction in the first year. With bonus depreciation, 50 percent of the site improvements would be deducted in the first year with the remaining 50 percent using the regular 15-year schedule, resulting in a combined 52.5 percent deduction in the first year. Similarly, personal property has a five-year accelerated depreciation schedule with a 20 percent deduction in the first year. With 50 percent bonus depreciation, the combined first-year deduction would be 60 percent.

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Good Things Don't Last Forever–Phase Out

The 50 percent bonus depreciation is set to phase out. The full 50 percent deduction is available for property placed in service before the end of 2017. For property placed in service in 2018, the deduction is reduced to 40 percent, then drops to 30 percent in 2019. Bonus depreciation is not available for property placed in service after 2019, except in the case of certain long production property where an additional year may be available, based on IRC Section 168(k)(2)(B).

While it is unfortunate that bonus depreciation will phase out, this is an improvement to the prior situation. Recently bonus depreciation expired every year, only to be re-enacted at the very end of the year. Because of the uncertainty of re-enactment, investors would not underwrite bonus depreciation when closing deals and equity pricing did not reflect the benefits of bonus depreciation. With bonus depreciation now firmly available through 2019, investors can underwrite the faster depreciation resulting in improved equity pricing.

Off-Site Dedicated Improvements—Good for Basis, but No Bonus Depreciation

When a partnership pays to build property off-site and dedicates it to the government, if certain requirements are met it is possible to get such costs into LIHTC eligible basis and depreciable basis. (See PLR 200916007 and Treas. Reg. Section 1.263(a)-4(d)(8)(iv)). For example, building the roads next to the project and dedicating them to a city usually qualifies. Such off-site improvements are deemed an indirect cost of the building. Accordingly, dedicated improvements are not considered site improvements and do not qualify for bonus depreciation.

Capital Accounts Problems from Site Improvement Bonus Depreciation

Bonus depreciation on site improvements can sometimes create capital account problems. LIHTCs are allocated to the partner that is allocated depreciation. It is critical that a LIHTC investor's capital account stay positive for the 10- or 11-year credit delivery period. Taking bonus depreciation on a large amount of site improvements might cause an investor to run out of capital too early, because it will accelerate half of the depreciation into the first year that would have otherwise been taken over 15 years. In such cases, it may be desirable to make an affirmative election not to take bonus depreciation. Because of the lesser amount of equity in a tax-exempt bond project, such developments are especially likely to run into capital account problems and to need to elect out of bonus depreciation.

Note that personal property's normal accelerated depreciation schedule results in such assets being fully depreciated after six years. Because most developments do not have capital account problems during the first six years, applying bonus depreciation to personal property is not usually a problem.

Recent Projects Might Want to Avoid Bonus Depreciation

As discussed above, developments that were underwritten before the re-enactment of bonus depreciation likely were underwritten without modeling the impact of bonus depreciation. Developments with tight capital accounts (e.g., bond projects) should be reviewed to determine whether it may be desirable to elect out of bonus depreciation.

Electing Out of Bonus Depreciation

To solve capital account problems, it is possible to elect out of bonus depreciation on site improvements, but keep it on personal property. Bonus depreciation applies by default, unless an election is made on the tax return to not take it, according to IRC Section 168(k)(7). The election is made for a specific class of property and would apply to all property of a class placed in service that year. Thus it is possible to keep bonus depreciation

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on personal property (good for yield) while electing not to take it on-site improvements.

Caution with Tax-Exempt Entities

Bonus depreciation is generally not available for property that is required to use the slower alternative depreciation schedules. For housing and community development projects, this most commonly arises if projects have tax-exempt entities in the ownership structure or if there are leases to tax-exempt entities. It is often possible to carefully structure projects to avoid the tax-exempt use rules, but such a discussion is beyond the scope of this article.

Can Cost Segregation Studies Help?

In an effort to generate more bonus depreciation and a higher credit price, it might be tempting to get a cost segregation study from an accounting firm. Such studies scrutinize projects to identify assets that can be depreciated more quickly rather than being lumped into the slow-depreciation building category. As a result, such studies could identify substantially more assets that qualify for bonus depreciation. However, such studies have sometimes been aggressive and the IRS has audited projects with cost segregation studies. Because investors do not want a substantial portion of their yield to depend on whether or not a cost segregation study would prevail, a number of investors will not use cost segregation studies.

Treatment of Improvements to LIHTC and HTC Buildings

Can you get bonus depreciation on improvements to a LIHTC building? What about an historic tax credit (HTC) commercial building? The answer is maybe and yes.

In general, bonus depreciation is unavailable for improvements that are capitalized as part of the building. However, in a new broadening of bonus depreciation, certain “qualified improvement property” can qualify, based on IRC Section168 (k)(2)(A)(i)(IV). Qualified improvement property is certain internal improvements to “nonresidential real property” placed in service after Dec. 31, 2015. For this purpose, nonresidential real property is defined as property with less than 80 percent of gross rent from dwelling units. As a result, a building not used for housing could qualify. Additionally, an apartment building (including a LIHTC building) can qualify if it has commercial rent that is more than 20 percent of all rent received from the building. Traditionally it has been undesirable to have a LIHTC building classified as nonresidential rental property, because such classification would require the building to be depreciated over 39 years rather than 27.5 years. However, under the new bonus depreciation statute, such a building can now claim an immediate 50 percent deduction for qualifying costs. In the right situation, this could be a significant enhancement to a project’s yield and LIHTC credit pricing.

However, Congress did not open the spigot too far. Bonus depreciation on nonresidential real property is only for internal building costs and also does not apply to costs of building enlargements, elevators/escalators or internal structural framework. Thus, qualifying expenses could include costs such as non-loadbearing walls, doors, flooring, plumbing, HVAC and other items that are determined to be non-structural framework.

The availability of bonus depreciation for improvements to a building that qualifies for HTCs at first seems a good improvement. However, a technical requirement to qualify for HTCs is that the expense used to create the HTC must use straight-line depreciation. The one-year deduction for bonus depreciation conflicts with the ban on accelerated depreciation. If a project takes bonus depreciation on qualified improvements, then HTCs would only be available on the remaining 50 percent of the project’s depreciable basis, based on Treas. Reg. Sections 1.48-12(c)(8 and 1.168(k)-1(f)(10). Thus in order to maximize HTCs for historic projects, one must make an election not to take bonus depreciation

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on qualified improvement property. However, because personal property and site work don't qualify for HTCs, a HTC project can still take the bonus depreciation on those assets.

Conclusion

The re-enactment of bonus depreciation by Congress is a very helpful tool. Equity pricing should benefit from this tax benefit. However, with its phase out and other technical complexities, care needs to be used in determining what amount of bonus depreciation will be available.❖

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