2017 TCJA PROVISIONS and REAL PROPERTY TRADES & BUSINESSES ELECTING OUT OF THE BUSINESS INTEREST EXPENSE LIMITATIONS

While the Tax Cuts and Jobs Act of 2017 (TCJA) included many taxpayer-friendly provisions, some of the provisions could be negative for taxpayers. One such provision, the limitation on the deductibility of business interest expense under §163(j), has left practitioners searching for ways to reduce or eliminate its impact on their clients.

Fortunately, for taxpayers in real property trades/businesses (defined at §469(c)(7)(C) as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business), there is an election out of the business interest expense limitation that will allow for the full deductibility of business interest expense. See §163(j)(7)(A)(ii) & (B).

Note: Practitioners need to be aware that there is an anti-abuse rule for real property trades/businesses that lease at least 80% (determined by FMV) of their real property to other commonly controlled trades/businesses (generally, 50% of direct and indirect ownership of both businesses by related parties as defined under §267(b) and §707(b)). See Prop. Reg. §1.163(j)9(h).

To make the election, the taxpayer must attach an election statement to a timely filed original tax return (including extensions). [Be advised that because the election is a regulatory election due on the return due date including extensions, there should be an automatic 6-month extension to make it under Treas. Reg. §301.9100-2(b). Therefore, if you timely filed the original return, you can file an amended return to make the election so long as that is done by the extended due date of the original return.] Once the election is made, it is irrevocable. See the Instructions for Form 8990 and Prop. Reg. §1.163(j)-9 for the requirements of the election statement.

Unfortunately, when the IRS giveth, it also usually taketh away somewhere else, and this is no exception. The downside to the election is that the taxpayer is required to use ADS on any nonresidential real property, residential rental property, and qualified improvement property held during the election year or any subsequent year. See §168(g)(1)(F) & (8). Furthermore, Rev. Proc. 2019-8, Sec. 4.02(2)(a) makes it clear that this requirement applies to all such property held by the taxpayer regardless of the year it was placed in service.

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Finally, while not specifically stated in the Rev. Proc., Qualified Leasehold Improvement Property, Qualified Retail Improvement Property, and Qualified Restaurant Property are special types of nonresidential real property, even if they do not meet the definition of Qualified Improvement Property, and as such, are subject to the ADS requirement (39-yr ADS recovery period under former §168(g)).

Typically, the biggest disadvantage of mandatory ADS treatment is the ineligibility of the affected property to claim bonus depreciation. See §168(k)(2)(D). However, nonresidential real property, residential rental property, and, starting in 2018, qualified improvement property are not qualified property types for bonus depreciation, anyway. Therefore, the only downside for newly acquired property will be a switch from a 27.5-yr to 30-yr recovery period for residential rental property, or from a 39-yr to 40-yr recovery period for nonresidential real property and qualified improvement property.

Note: For residential rental property placed in service before 1/1/2018, the ADS recovery period was 40 years. Therefore, when switching to ADS (see below), practitioners will need to pay close attention so that they use the correct ADS recovery period. See Rev. Proc. 2019-8, Sec. 4.01(1).

Furthermore, through the use of a cost segregation study, a taxpayer will reduce the amount of nonresidential real property, residential rental property, and qualified improvement property on their books, further mitigating any negative effects of the election, and actually increasing the taxpayer's depreciation deduction.

The switch to ADS is a change in use, not a change in method of accounting (if the change is implemented in the election year). Practitioners will need to follow the procedures in Treas. Reg. §1.168(i)-4(d) for determining the depreciation for affected property in the election year and subsequent years. The change in use will not result in any recapture of prior depreciation claimed, to include any bonus depreciation properly claimed. See Treas. Reg. 1.168(k)-1(f)(6)(iv)(A).

As we have discussed, there is a valuable election available to many of your real estate clients, but there are downsides to be considered and pitfalls to be avoided. Let Scarpello Consulting assist you in your analysis.

Start your cost segregation study today
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