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Real Estate Owners—All You Need to Know About the Depreciation Rules Under TCJA

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Rental real estate owners and operators can use tax depreciation to reduce (if not eliminate) taxable income, while still generating positive cash flow. Through the years there have been many important cases and tax law changes that have spurred real estate ownership and ultimately higher tax depreciation deductions. The author of this article discusses the current depreciation rules.

Tax depreciation deductions have always been an important, if not essential, aspect of rental real estate ownership. Rental real estate owners and operators can use tax depreciation to reduce (if not wipe out) taxable income, while still generating positive cash flow. Through the years there have been many important cases and tax law changes that have spurred real estate ownership and ultimately higher tax depreciation deductions. Around the turn of the century, the ability to segregate a building into shorter lived assets became commonplace with the landmark 1997 tax court case, *Hospital Corporation of America v. Commissioner*. Following the decision in that case, the Internal Revenue Service ("IRS") made it much easier to make changes to all previously-held real estate assets in one fell swoop, which ultimately was a boon for cost segregation studies. Then, starting in 2002, legislation was passed to introduce bonus depreciation on certain assets which would allow real estate owners and operators to recover the cost of capital acquisitions more quickly to stimulate the economy. Since then, there have been several iterations of bonus depreciation and it lives on, stronger than ever, with the Tax Cuts and Jobs Act ("TCJA") of 2017.

Background

Leading up to the TCJA, there were several proposals for tax reform that included major changes that would ultimately accelerate tax depreciation. One of the most aggressive proposals would have provided taxpayers the ability to write-off 100 percent of buildings and other capital improvements upon acquisition. While the TCJA did not go that far, there were several changes to tax depreciation that will greatly benefit rental real estate owners. As most taxpayers are in the midst of the first fil-

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ing season under the TCJA, it has become apparent that there is much to consider not only from a tax depreciation perspective, but also the interplay between tax depreciation and some of the other changes of the TCJA, including the interest deduction limitation and the new net operating loss ("NOLs") rules for corporations.

Bonus Depreciation

The TCJA changed bonus depreciation from 50 percent to 100 percent for qualified property. Qualified property is defined in Internal Revenue Code ("IRC") § 168(k) as assets which have a recover period of 20 years or less. While non-residential buildings have a depreciable life of 39 years and residential buildings have a depreciable life of 27.5 years, each of these types of buildings may have several components that could be broken out into shorter lived assets. The percentage of a building that is represented by such assets will vary greatly depending upon the type of asset. For example, a state-of-the-art Class A office building may yield a much larger amount of qualified property than a no thrills industrial building.

Doubling bonus depreciation is in and of itself a very taxpayer friendly change; however together with the TCJA change to allow bonus depreciation on both used and new qualified property, it is a bit of a game changer. Previously, only owners and investors who constructed or purchased new property were able to benefit from bonus depreciation. Now, a taxpayer could purchase a 30-year-old office building and conceivably break out the purchase price to include a large amount of qualified property that would be eligible for 100 percent bonus depreciation. This certainly does not rise to the level of depreciating an entire building immediately as was seen in previous proposals, but there is still a great benefit to taxpayers made by this change. Ultimately, taxpayers will most likely see this as an opportunity to perform more cost segregation studies on their acquisitions.

One-hundred percent bonus depreciation will apply to qualified property placed in service before January 1, 2023. The applicable bonus depreciation percentage will reduce 20 percent each year thereafter culminating in no bonus depreciation for assets placed in service after 2026. There certainly will be tax planning around these dates — when to buy an asset, construction schedules, etc. But at least for the time being, the expectation is that many tax payers will benefit from the full write-off. Think about a real estate owner who constructs significant improvements to a commercial building that yields a large amount of write-offs. That taxpayer gets an ordinary deduction off the top and then when the property is sold two years later, any gain will be taxed at a lower capital gains rate (as an aside the depreciation will be recaptured at a 25 percent rate, however still lower than ordinary income tax rates). A person who acquires the building after construction is completed is now able to theoretically take the same write-offs on qualified property.

Deduction of Business Interest

Another change made by the TCJA is the potential limitation on the deduction of business interest. IRC § 163(j) provides that the amount of business interest allowed as a deduction shall not exceed a taxpayer's business interest income for the year plus 30 percent of the adjusted taxable income of such

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taxpayer for such taxable year. There are two important depreciation considerations to be made with regards to § 163(j). First, a real property trade or business can make an election ("RPTOB") out of the limitation. If such election is made, the "penalty" for doing so is that the taxpayer must depreciate "real property" using the alternative depreciation system ("ADS") rather than the general depreciation system ("GDS"). First, the change from GDS to ADS on a non-residential building is 39 years to 40 years, hardly a large determinant. The change on residential buildings is from 27.5 years for GDS to 30 years for ADS — this includes another change made by TCJA which made the ADS life for residential buildings 30 years instead of 40 years under pre-TCJA law. Second, the requirement to use ADS only applies to real estate, thus taxpayers would still be able to use GDS for personal property. Personal property could include regular furniture and fixtures or, as detailed above, property that has a life of 20 years or less that may be broken out by a cost segregation study (for example, electronic systems, wiring, etc.). The ability to use GDS on personal property is an important distinction for purposes of bonus depreciation. Bonus depreciation is not allowed on assets that are required to be depreciated using ADS. Since personal property is not required to be depreciated using ADS, a taxpayer could make the RPTOB election and still get the benefit of bonus depreciation.

The second depreciation consideration is in the calculation of adjusted taxable income for purposes of § 163(j). The calculation of adjusted taxable income is made without regard to any depreciation or amortization deduction. Therefore, if subject to the § 163(j) limitation, a taxpayer can addback depreciation and amortization before calculating the 30 percent limitation. This is available only for taxable years before 2022 (2018–2021). Again, there are planning opportunities around these dates. For example, taking advantage of bonus depreciation by making large personal property expenditures before 2022 would allow the taxpayer to deduct more interest than they would if they made the expenditures a year later (a hotel's purchase of furniture, fixtures and equipment ("FF&E") is an example that comes to mind).

Qualified Improvement Property

There was a technical glitch in the TCJA which inadvertently resulted in certain assets not being subject to bonus depreciation. Qualified Improvement Property ("QIP"), which includes tenant and leasehold improvements, was eligible for bonus depreciation under pre-TCJA law because it had a class life of 15 years. However, because of a drafting error, the QIP now must be written off over 39 years. Accordingly, such assets do not have a class life of 20 years or less and are not eligible for bonus depreciation. There have been proposals to provide a legislative fix, but there has not been one to date. Note that if these assets ultimately are eligible for bonus depreciation, bonus depreciation will not be available to those taxpayers who make the RPTOB election since these would be considered "real property."

Net Operating Losses

Another change made by the TCJA is to limit a corporation's use of post-2017 NOLs to 80 percent of the taxpayer's taxable income. This may impact a corporation's decision in taking

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bonus depreciation and in making a RPTOB election. For example, if bonus depreciation would only increase an operating loss, a corporation may not want to create a larger NOL that may be limited in the future. Furthermore, a corporation may also not mind if interest is limited for the same reason. Ultimately, there may be many other factors in play for a corporation, but nevertheless, there is an opportunity for corporations to plan for the future use of depreciation and interest deductions.

Depreciable Business Assets

Finally, one additional change made by the TCJA was to IRC § 179, which allows for an election to expense certain depreciable business assets. The TCJA raised the maximum amount a taxpayer may now expense to $1 million per business asset. Additionally, the overall deduction does not get phased out until the taxpayer reaches $2.5 million of business asset purchases in a taxable year. Finally, and probably more importantly, IRC § 179 definition of qualified real property was expanded and now includes any improvement to a building's interior; unless, improvements are attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. Such definition does include roofs, HVAC, fire protection, alarm systems, and security systems. Thus, this includes assets that may not be subject to bonus depreciation.

Conclusion

Depreciation deductions are an essential part to rental real estate ownership. Cost recovery, in general, is not only a focus of owners, but something that they can use as a planning tool. In the recent past, the repair regulations shined a light on the idea of assets as a betterment and immediate write-offs and now the TCJA is providing more tools for real estate owners to get upfront deductions. This is an area where taxpayers can really benefit from proper planning. Taxpayers should use the opportunity to investigate the use of cost segregation studies and repair deduction studies to provide the most bang for their buck.

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