Klein Hornig LLP Client Alert

March 2019

IRS Guidance for Electing Real Property Trade or Business

By Steven L. Paul, Kathryn G. Day, Rebecca Melaas and Matthew Woodbury

While the Tax Cuts and Jobs Act greatly restricts business interest deductions under section 163(j), it provides an exemption for an "electing real property trade or business." In the last two months of 2018, the IRS published significant guidance addressing how to make the election and the impact of the election on property required, as a result, to use the Alternative Depreciation System.

Introduction

The Tax Cuts and Jobs Act ("TCJA" or the "Act") included an amendment to section 163(j) of the Internal Revenue Code significantly reducing the ability of businesses to deduct interest expenses. Congress did, however, provide certain exceptions, and those in the affordable housing and community development industry will be most interested in the exception for an "electing real property trade or business,"[1] which we refer to below as an "electing business." We refer to the election to become an electing business as the "election."

An electing business includes any real property development, redevelopment, construction, reconstruction, acquisition, rental, operation, management, leasing, or brokerage trade or business that makes an election using the procedure described in recent IRS guidance and summarized below.

Most LIHTC partnerships will qualify to make the election, but, because the election comes with the cost of having to use the Alternative Depreciation System (ADS), and its longer recovery periods, for

[1] Most LIHTC partnerships will not qualify for the separate exemption for small businesses because, although their gross receipts generally do not exceed the disqualifying threshold, allocation of losses to limited partners renders them disqualified "tax shelters" (as defined in the "electing real property trade or business" provision).

nonresidential real property, residential rental property, and "qualified improvement property" (QIP),[2] the analysis of whether to make the election requires a cost/benefit analysis.[3]

The IRS also published guidance regarding use of ADS by an electing business, addressing, among other things, the recovery period for property placed in service before 2018 which is switched to ADS in 2018 or after due to the making of the election.

How to make the election

Section 1.163(j)-9 of the Proposed Regulations published in November includes guidance regarding the mechanics of the election, rules to prevent businesses from avoiding the irrevocability of the election, and an anti-abuse rule to prevent artificial combining of separate businesses in order to obtain deductions for interest expenses with respect to property held by an ineligible business.

The Proposed Regulations generally provide that the election (i) is irrevocable and must be made separately with respect each trade or business of the taxpayer and (ii) applies to each such trade or business for the taxable year in which the election is made and generally for all subsequent taxable years.

To make the election, a taxpayer must attach an election statement to its timely filed (including extensions) original federal income tax return for the first tax year in which the election is to be effective. If the taxpayer has multiple businesses, elections may be made for any number of them on a single statement. An election statement must contain the following information:

- The taxpayer's name;
- The taxpayer's address;
- The taxpayer's social security number (SSN) or employer identification number (EIN);
- A description of each electing business, including its principal business activity code, so that the IRS can identify the trade or business and distinguish it from the taxpayer's other trades and businesses; and
- A statement that the taxpayer is making an election under section 163(j)(7)(B).

Note that in case of a business conducted by a partnership, the election must be made on the partnership's return and does not apply to any business conducted by a partner outside the partnership.

Because the election automatically terminates if a taxpayer ceases to engage in the electing business (for instance, by reason of a sale of the business assets) or if the taxpayer ceases to exist, the IRS was concerned about taxpayers manipulating the termination rules in order to sidestep the irrevocability

[2] QIP is any improvement to an interior portion of a building on nonresidential real property, if placed in service after the date the building was first placed in service, excluding, however, any expenditure related to the enlargement of the building, an elevator or escalator, or the internal structural framework of the building. See I.R.C. § 168(e)(6).

[3] Depreciation of other property, including personal property and site work, is not affected by the election.

requirement. One possible way of doing this might have been to engage in an ostensible sale of business assets, only later to reacquire them for use in the former activity, purportedly as a non-electing business. To prevent avoidance of the irrevocability requirement, the Proposed Regulations provide that a sale constitutes ceasing to engage in an electing business only upon a sale or transfer of substantially all the assets of the business to an *unrelated* acquirer in a *taxable* asset transfer, and not in a sale or transfer to a related person or in a transfer with a carryover basis, such as a tax-free reorganization or a gift. For purposes of this rule, generally entities under common ownership (50 percent or more) are related to each other. In addition, no termination occurs if a taxpayer reacquires substantially all of the assets that had been transferred or sold (or substantially similar assets) within 60 months and resumes conduct of the business.

Lastly, the Proposed Regulations include a special anti-abuse rule providing that a real property business is not eligible to make the election if 80 percent or more of its real property is leased to a trade or business and it and the lessee are under common control (i.e., owned 50 percent or more by related parties). This last rule is designed to prevent artificial combining of assets of the lessor- and lessee-businesses in order to obtain interest expense deductions for the lessor-business's property.

The effect of the election on depreciation

Revenue Procedure 2019-08 (December 21, 2018) provides guidance, useful to electing businesses, with regard to use of the alternative depreciation system (ADS) and the applicable recovery period. As noted above, ADS is required to be used for nonresidential real property, residential rental property, and QIP owned by an electing business. While ADS has longer depreciation periods, because these differences are relatively small (see Table below), in order to determine whether to make the election, LIHTC businesses must weigh the cost of the ADS requirement against the benefit of interest expense deductions. The Revenue Procedure fills in some gaps left by the TCJA, allowing LIHTC partnerships to engage in better analyses.

First, the Revenue Procedure addresses how the ADS requirement will affect property placed in service *before* 2018 by a business making the election in 2018 or thereafter. It makes clear that the ADS recovery period for residential real property placed in service before 2018 is 40 years, and that the new 30-year ADS recovery period for residential real property applies only to property placed in service in 2018 or after.

In addition, because the TCJA had left unclear how an electing real property business should make the change to ADS for affected property, the Revenue Procedure provides that for existing property a change in use occurs and that depreciation must be determined in accordance with existing change-in-use rules in section 1.168(I)-4(d) of the Treasury Regulations. For newly acquired property, ADS is required to be used in the placed-in-service year and all subsequent years.

Because ADS property is *not* eligible for bonus depreciation, an electing business that acquires any property in 2018 or any following year which is required to be depreciated using ADS will not be able to

take bonus depreciation for that newly acquired property.[4] However, the Revenue Procedure makes clear that an electing business's change to ADS for nonresidential and residential real property and QIP does *not require* a redetermination of otherwise valid bonus depreciation deductions taken with respect to such property in previous tax years.

Please contact your Klein Hornig attorney or accountant for more information about the impact of this guidance and of the TCJA on your business.

	General Depreciation System Period	ADS Period	
		Placed in service before 1/1/2018	Placed in service after 12/31/2017
Nonresidential real property	39 years	40 years (1-year difference) for either placement in service date	
Residential real property	27.5 years	40 years (12.5-year difference)	30 years (2.5-year difference)
QIP	39 years	40 years (1-year difference) for either placement in service date	

Table: Comparison of Pre- and Post-TCJA Depreciation Recovery Periods under GDS and ADS

[4] Note that a LIHTC partnership that makes the election generally may claim bonus depreciation with respect to personal property and site work, since making the election does not impact depreciation for such property.