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Real Estate Methods and Credits: A Summary of Recent Developments and Strategies (PowerPoint)

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Real Estate Methods and Credits

A summary of recent
developments and strategies



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Purpose

Consider key developments related to real estate investment credits and recovery of the basis of real property.

- Review legislative, regulatory, and administrative developments in the areas of the new markets tax credit, depreciation, repairs versus capitalization, among others.
- Consider practical strategies and impacts

Background on Capitalization Rules and Federal Credits

- Introduction to Federal capitalization and depreciation principles
 - IRC §§ 263(a) and 263A for capitalization rules
 - IRC §§ 167 and 168 for depreciation rules
- Introduction to Federal credits
 - IRC § 42 for low-income housing tax credit
 - IRC § 45D for new markets tax credit
 - IRC § 47 for historic rehabilitation tax credit

Legislative Developments

- PATH Act (December 2015)
 - Extended § 179 expensing
 - Extended 15-year recovery of:
 - qualified leasehold improvement property (QLIP)
 - Qualified restaurant property (QRP)
 - Qualified retail improvement property (QRIP)
 - Extended and modified bonus depreciation
 - Extended low income housing tax credit (LIHTC)
 - Extended new markets tax credit (NMTC)

PATH Act – § 179 Property

- Extended § 179 expensing
 - Made permanent with limit at \$500,000 with phaseout at \$2,000,000, inflation adjusted after 2015
 - Made permanent § 179(f) real property rule

PATH Act – 15-year Depreciation

- Extended 15-year recovery of:
 - Qualified leasehold improvement property (QLIP)
 - Qualified restaurant property (QRP)
 - Qualified retail improvement property (QRIP)

PATH Act - § 168(k) Bonus Depreciation

- Extended and modified bonus depreciation
 - Extended 50% bonus depreciation through 2015
 - Eliminated “acquisition” rules for qualified property beginning in 2016
 - Expanded bonus depreciation to include Qualified Improvement Property (QIP)
 - Phased out extension through 2020
 - 50% in 2016 and 2017, 40% in 2018, and 30% in 2019
 - Extended placed-in-service rules permit 1-year extension for certain property
 - Extended and modified § 168(k)(4) provision for increased use of AMT credits in lieu of bonus

PATH Act – Bonus Depreciation (cont'd)

- Bonus depreciation – 2015
 - Follows same general provisions as pre-2015 years:
 - Qualified property =
 - MACRS property with recovery period of 20 years or less
 - Computer software
 - Water utility property
 - Qualified leasehold improvement property
 - Original use commences with taxpayer after 31 December 2007
 - Acquired after 31 December 2007 and after 1 January 2016
 - Placed in service before 1 January 2016 (1 January 2017 for long production period property and certain aircraft)

PATH Act – Bonus Depreciation (cont'd)

- Bonus depreciation – 2016–2019
 - Modified provisions:
 - Qualified property =
 - MACRS property with recovery period of 20 years or less
 - Computer software
 - Water utility property
 - Original use commences with taxpayer
 - (No acquisition date component)
 - Placed in service before 1 January 2020 (1 January 2021 for long production period property and certain aircraft)

PATH Act – Bonus Depreciation (cont'd)

- Bonus depreciation 2015 vs. 2016 – QLIP vs. QIP definition:
 - 2015 = QLIP:
 - Improvement to an interior portion of a building that is nonresidential real property if:
 - Such improvement is made pursuant to a lease by lessee or lessor
 - Such improvement is occupied exclusively by lessee
 - Such improvement is PIS more than 3 years after building is PIS
 - Does not include improvements attributable to:
 - Enlargement of the building
 - Any escalator or elevator
 - Any structural component benefiting a common area
 - The internal structural framework of the building

PATH Act – Bonus Depreciation (cont'd)

- Bonus depreciation 2015 vs. 2016 – QLIP vs. QIP definition:
 - 2016 = QIP:
 - Improvement to an interior portion of a building that is nonresidential real property if such improvement is made after the building is first placed in service
 - Does not include improvements attributable to:
 - Enlargement of the building
 - Any escalator or elevator
 - The internal structural framework of the building
 - Less rigid requirements for bonus depreciation (e.g., no lease requirement, no requirement that building be placed in service more than 3 years before improvement made, etc.)
 - Conclusion – certain 39-year property is eligible for bonus depreciation

PATH Act – Bonus Depreciation (cont'd)

- Bonus depreciation – election out of bonus
 - 2 elections:
 - Section 168(k)(7) – elect not to utilize bonus depreciation and instead utilize normal MACRS depreciation
 - Done on a class of property basis
 - Section 168(k)(4) – elect to utilize straight-line depreciation and monetize a portion of AMT credit carryforwards
 - Done for all bonus eligible assets
 - If a taxpayer makes both elections, then (k)(7) trumps (k)(4) with respect to all classes of property to which the (k)(7) election pertains

Capitalization and cost recovery (cont.)

- Election out of bonus – Section 168(k)(4) – 2015 vs. 2016
 - The §168(k)(4) election is substantially modified for 2016 and future years in comparison to its operation in 2015
 - 2015 §168(k)(4) election:
 - Utilize straight-line depreciation on all bonus eligible assets
 - Compute “bonus depreciation amount” = 20% X (MACRS with bonus – MACRS without bonus)
 - AMT credit to be monetized = lesser of bonus depreciation amount, \$30 million, or 6% of pre-2006 AMT credits
 - 2016 §168(k)(4) election:
 - Same initial 2 rules, but AMT credit to be monetized is capped at lesser of bonus depreciation amount, 50% of pre-2016 AMT credits, or AMT credit available for current year (utilizing only AMT credits generated before 2016)

PATH Act – Bonus Depreciation (cont'd)

- Election out of bonus – Section 168(k)(4) – 2015 vs. 2016.
 - Sample fact pattern: Taxpayer has \$250 million in pre-2006 AMT credits, \$250 million in AMT credits applicable for 2016, and a “bonus depreciation amount” (as defined above) of \$300 million in both years. In this scenario, should the taxpayer elect to utilize §168(k)(4) – difference in amount taxpayer would get paid (2015 vs. 2016):
 - 2015: \$300 million, capped at the lesser of (a) \$30 million or (b) 6% of pre-2006 AMT credits carried forward (\$15 million). Thus, in this scenario, the taxpayer may monetize \$15 million in AMT credits.
 - 2016: \$300 million, capped at the lesser of (a) 50% of \$250 million, or (b) \$250 million. Thus, in this scenario, the taxpayer may monetize \$125 million in AMT credits.
 - Thus, by utilizing §168(k)(4) in 2016, taxpayer acquires \$110 million more in cash compared to utilizing §168(k)(4) in 2015.

PATH Act – Extension of Credits

- Permanently extended low income housing tax credit (LIHTC)
- Extended new markets tax credit (NMTC)
 - 5-year extension (through 2019)
 - \$3.5 billion allocation

Legislative Developments

- Wyden Depreciation Pooling Proposal (April 2016)
 - The proposal would replace the current depreciation schedules with six pools of recovery rates
 - The purpose of pooling is to simplify depreciation by not requiring taxpayers to track individual assets, which is currently only possible by electing to use general asset accounts (GAAs)

Current Depreciation vs. Wyden Proposal

- Under the current depreciation rules, an asset's depreciation schedule generally depends on its:
 - Recovery period (as determined under Rev. Proc. 87-56 and Section 168),
 - Method (straight line, 200% declining balance, etc.), and
 - Placed-in-service convention (half-year, mid-quarter, mid-month)
- Senator Wyden's proposed legislation would take existing asset classes in Rev. Proc. 87-56 and Section 168 that are not straight-line property and condense them into six pools roughly based on their current class lives

Current Depreciation vs. Wyden Proposal

- The proposed pooling method for tangible assets (and computer software) does away with the half-year and mid-quarter conventions and allows a taxpayer to claim a full first-year depreciation deduction
 - As straight-line property continues to be depreciated ratably, the mid-month convention remains for those assets
- The current Regulations allow taxpayers to place assets in GAAs, but the GAA rules contain strict grouping rules and may defer basis recovery on certain asset dispositions

Current Depreciation vs. Wyden Proposal

- The six pools are each assigned one of six recovery rates:

Current Recovery			Proposed Recovery	
Class Life (Years)	MACRS Recovery		Pools	Recovery Rates
4 or fewer	3	→	Pool 1	49%
5 to 9	5	→	Pool 2	34%
10 to 15	7	→	Pool 3	25%
16 to 19	10	→	Pool 4	18%
20 to 24	15	→	Pool 5	11%
25 or more	20	→	Pool 6	8%

- Straight-line property continues to be depreciated on a straight-line basis

Wyden - Pooling Mechanics

- Taxpayers would transition to the new system by transferring the remaining adjusted bases of applicable capital assets into each of the six pools
- The pools' balances are increased by the assets placed in service that tax year and reduced by proceeds of asset dispositions in such year
- At tax year end, each pool balance is multiplied by its recovery rate (see table in previous slide) to determine the year's depreciation deductions

Wyden - Special Rules

- As foreign assets must be pooled separately from domestic assets, a business could have two of each pool
- The increase in pool balance may not exceed \$45,000 for a passenger automobile (which are in Pool 2)
- Negative pool balances at year-end give rise to Section 1245 gain, and the gain recognized is added to the pool balance to restore it to zero
- If no assets remain in a pool at year-end, any positive balance may be deducted as a terminal loss
 - A taxpayer may also deduct any year-end pool balance of \$1,000 or less, which is considered a de minimis balance

Wyden - Special Rules (cont'd)

- If an asset is used in a trade or business less than 50% of the time, the depreciation deduction for the pool must be calculated pursuant to a formula that essentially disallows a deduction for the personal use portion of the asset
- If there is a like-kind exchange or involuntary conversion of pooled property where the replacement property is in a different pool from the relinquished property, the pool of the relinquished property is reduced by the lesser of the FMV of that property on date of exchange or the positive balance in the pool
 - The pool of the replacement property increases by the same amount

Current Depreciation vs. Wyden Proposal

Property	Classification	MACRS Recovery Period	Pool	Recovery Rate
Information Systems; Data handling	00.12 & 00.13	5 years	#2	34%
Distributive trades or services	57.0	5 years	#2	34%
Office FFE	00.11	7 years	#3	25%
Mfg Consumer Products (non-food)	20.4→31.0	5-7 years	#3	25%
Land Improvements	00.3	15 years	#5	11%
QLIP, QRIP & QRP	168(e)(6-8)	15 years	Straight-Line	39 years
Nonresidential Real Property	168(i)(5)	39 years	Straight-Line	39 years

Wyden - NPV comparison

	Current 3.50%	Proposed 3.50%	Current 5.50%	Proposed 5.50%	Current 7.50%	Proposed 7.50%
5-yr w/bonus	\$ 97,060	\$ 96,933	\$ 95,549	\$ 95,421	\$ 94,146	\$ 94,053
5-yr no bonus	\$ 94,120	\$ 93,867	\$ 91,098	\$ 90,843	\$ 88,293	\$ 88,106
00.3 w/bonus	\$ 89,984	\$ 89,164	\$ 85,665	\$ 85,127	\$ 82,096	\$ 81,942
00.3 no bonus	\$ 79,969	\$ 78,329	\$ 71,331	\$ 70,255	\$ 64,192	\$ 63,885
QLIP w/bonus	\$ 89,063	\$ 55,608	\$ 84,378	\$ 42,621	\$ 80,527	\$ 34,060
QLIP no bonus	\$ 78,126	\$ 55,608	\$ 68,757	\$ 42,621	\$ 61,054	\$ 34,060
39-year property	\$ 55,608	\$ 55,608	\$ 42,621	\$ 42,621	\$ 34,060	\$ 34,060

Wyden - Status

- The proposed change in calculating depreciation of tangible assets, if enacted, would apply to tax years beginning after December 31, 2016
- The Joint Committee on Taxation estimates that this proposal would be revenue-neutral
- It is Senator Wyden's belief that this overhaul of Section 168 would simplify depreciation of capital assets which in turn would benefit both small businesses and larger industries, specifically those negatively impacted by outdated depreciation lives
- Senator Wyden has asked for comments on this proposal

Regulatory and Administrative Developments

- Low Income Housing Tax Credit
 - Final regulations on renewable energy and maximum gross rent under § 42
 - Proposed and temporary regulations published 3/3/16
 - Final regulations on compliance monitoring (see Notice 2012-18) for § 42
 - Proposed and temporary regulations published 2/25/16
 - Guidance on right of first refusal under § 42(i)(7)
- New Markets Tax Credit
 - Final regulations on recapture and other issues
 - Proposed and temporary regulations published 8/11/08

Regulatory and Administrative Developments

- Depreciation
 - Guidance under §§ 168 and 179 required as a result of the PATH Act
 - Rev. Proc. 2016-48 published 8/2016
 - Further guidance on §§ 168 bonus depreciation phase-out and § 168(k)(4)

Regulatory and Administrative Developments

- Capitalization
 - Rev. Proc. 2015-56 for retailers, restaurants, and their landlords for deducting remodel/refresh costs
 - Follow-on FAQs clarify
 - Updates affecting implementation of Tangible Property Regulations (TPR) and
 - Treas. Reg. §§ 1.263(a)-1, -2, -3 (capitalization); 1.168(i)-1, -8 (dispositions)
 - Rev. Proc. 2016-29 – procedural extension of transition rules

Reminder of TPR framework

- ▶ The regulations affect all taxpayers with tangible property and require compliance via Form 3115 or annual elections
- ▶ Generally effective for tax years beginning on or after 1 January 2014 (optional early adoption for 2012 and/or 2013 years)

Materials and supplies (M&S)	Acquisitions	Improvements	GAA and dispositions
§ 1.162-3	§§ 1.263(a)-1 and -2	§ 1.263(a)-3	§§ 1.168(i)-1, -8
<ul style="list-style-type: none"> ▶ Definition of M&S <ul style="list-style-type: none"> ▶ A unit of property ≤ \$200 ▶ Used or consumed in 12 months or less ▶ Replacement parts ▶ Fuel, lubricants, etc. or ▶ Identified as M&S in other IRS guidance ▶ M&S Types and Timing <ul style="list-style-type: none"> ▶ Incidentals (no record of consumption or physical inventory) when acquired ▶ Non-incidentals (including emergency spare parts) when consumed ▶ Rotable and temporary spare part when disposed ▶ Limited <i>annual election</i> to capitalize M&S ▶ Interaction with <i>de minimis</i> safe harbor 	<ul style="list-style-type: none"> ▶ <i>De minimis</i> safe harbor - <i>annual election</i> to follow book expense policy <ul style="list-style-type: none"> ▶ If have AFS, no more than \$5,000 per invoice or item ▶ If no AFS, no more than \$500 per invoice or item ▶ If written book policy in place at beginning of year ▶ Capitalize costs that facilitate acquisitions <ul style="list-style-type: none"> ▶ 11 inherently facilitative costs ▶ Safe harbor <i>annual election</i> to expense <ul style="list-style-type: none"> ▶ Employee compensation and overhead ▶ Investigatory costs for real property 	<ul style="list-style-type: none"> ▶ Unit of Property (“UOP”) definition - <i>functional interdependence property</i> except for <ul style="list-style-type: none"> ▶ Buildings ▶ Plant property ▶ Leased property ▶ Network assets ▶ Improvement defined <ul style="list-style-type: none"> ▶ Betterment ▶ Restoration ▶ New or different use ▶ Safe harbor to expense routine maintenance <ul style="list-style-type: none"> ▶ Buildings: if more than once over 10-year period ▶ Non-Buildings: if more than once over class life ▶ <i>Annual election</i> to follow book by capitalizing repairs 	<ul style="list-style-type: none"> ▶ General Asset Accounts (GAA) <ul style="list-style-type: none"> ▶ Establish GAAs with assets of similar depreciation methods ▶ Qualifying dispositions do not include partial dispositions (e.g., structural components of a building) ▶ Dispositions (not in GAA) <ul style="list-style-type: none"> ▶ Optional <i>annual election</i> to recognize partial dispositions (e.g., building structural components) ▶ Reasonable valuation method to determine disposition gain or loss ▶ Coordination of dispositions with IRS examination of repairs