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JANUARY 21, 2021

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Residential rental property businesses may be eligible for 2018 and 2019 income tax refunds

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Headnote

Many large residential real property (RRP) rental businesses have been hurt by the business interest deduction disallowance enacted in the 2017 Tax Cuts and Jobs Act (TCJA). Previously, it has been too costly for them to make the TCJA election to slow their depreciation and earn an exemption from the interest deduction limitation. The Consolidated Appropriations Act, 2021 (CAA) might enable them to file refund claims for 2018 and 2019 and avoid losing future interest deductions.

Details

The TCJA imposed new limitations beginning in 2018 on the deduction for business interest expense for large taxpayers (those with annual gross receipts exceeding $25 million). Businesses could choose either to carry over the excess interest expense or elect, under Sec. 163(j)(7) (the election), to ignore the new limitations in exchange for depreciating their residential and nonresidential real property and their qualified improvement property under the slower Alternative Depreciation System (ADS) rules. The TCJA rule required a 40-year depreciation schedule for existing property in exchange for waiving the interest deduction limitation. Only projects placed in service after 2017 were eligible for the shorter 30-year schedule.

The depreciation price tag for making the election was too much for many RRP rental businesses, so they accepted the interest deduction limitations instead. Congress has now reduced the price and allowed businesses to reconsider, retroactively to January 1, 2018.

The CAA, which was signed by the president on December 27, 2020, changed the ADS rules, effective as of the same date it introduced the interest deduction limitation, January 1, 2018. Now, all rental RRP existing and in-service before 2018 need only change from 27 ½-year straight-line depreciation to 30-years.

This will make the election more cost-effective for RRP rental businesses that had substantial portfolios of property in service on December 31, 2017. If the election now makes sense at this reduced price, the CAA permits late elections back to 2018 so that taxpayers can claim refunds. (The Joint Committee estimated the federal budget impact of this change to be over $1.2 billion in

2021 alone; presumably, most of this amount would come from amended-return-refunds paid to RRP rental businesses.)

This is good news for large RRP rental owners. Here is what we know now:

- Businesses that made the election for 2018 or 2019 but were forced to use the 40-year life for existing projects can now amend their returns for 2018 and 2019 to claim refunds for the additional depreciation.
  - Because the CAA change is a technical correction to the ADS depreciation law, it is neither a change in use of the property nor a change in accounting method.
  - Note that this shorter life is not available to RRP rental businesses that were already using the ADS system for this class of property before 2018, nor is it available to property financed by the use of tax-exempt bonds.
- Businesses that did not make the election previously and that would like to do so now can amend their 2018 and 2019 returns and claim immediate refunds.
  - Once made, the election is irrevocable and will apply to all of this class of depreciable property. (Remember that the election only applies to real property and not personal property, like appliances and furniture.)
  - Making the election triggers a "change in use" for the affected existing property. Therefore, the change to conform to ADS depreciation rules is not a change-of-accounting method, which would require IRS permission. The applicable rules are Treas. Reg. 1.168(i)-4(d) and Section 4.02(2)(b) of Rev. Proc. 2019-8.
  - The amended returns, which claim the previously-deferred interest expense, must also adjust the previously-claimed depreciation, presumably to claim a net refund.
- Both of these groups of businesses will implement the ADS 30-year lives for existing property by taking straight-line depreciation of the adjusted tax basis that remained on December 31, 2017, over the number of years that would remain if the property had originally been placed in service with a 30-year useful life.
- The state and local tax impact of this change adds a layer of complexity on to an already difficult compliance task.
  - At this date, it's likely that only states with so-called "rolling conformity" to federal tax law and those with fixed-date conformity to a date after January 1, 2018, will conform to this technical correction.
  - Other state legislatures would have to take action to make the 30-year life available for property placed in service before 2018.
- To determine the economic impact of this retroactive technical correction on partnerships whose partners have changed during the period, it's necessary to review the transfer documents to determine:
  - Who is entitled to the additional interest deductions and who bears the reduction in depreciation; and
  - What secondary effects result from the changes, such as adjustments to the partners' tax basis, which would, in turn, affect their gain recognition in a subsequent sale.

Low-income housing tax credit (LIHTC) projects and others owned by partnerships should carefully consider:

- The difference between 30-year and 40-year useful lives can affect partners' capital accounts, which might, in turn, impact the allocation of tax credits; and
- The election must also be applied to all nonresidential real property and all qualified improvement property of the electing trade-or-business and is irrevocable.
- Therefore, LIHTC investors and others who must carefully monitor capital accounts may not find this new retroactive benefit attractive.

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