Depreciation and Expensing: New Rules and Limits Under Current Tax Law

TUESDAY, JULY 24, 2018, 1:00-2:50 pm Eastern

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Depreciation and Expensing: New Rules and Limits Under Current Tax Law

TUESDAY, JULY 24, 2018

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John Napoli

Agenda

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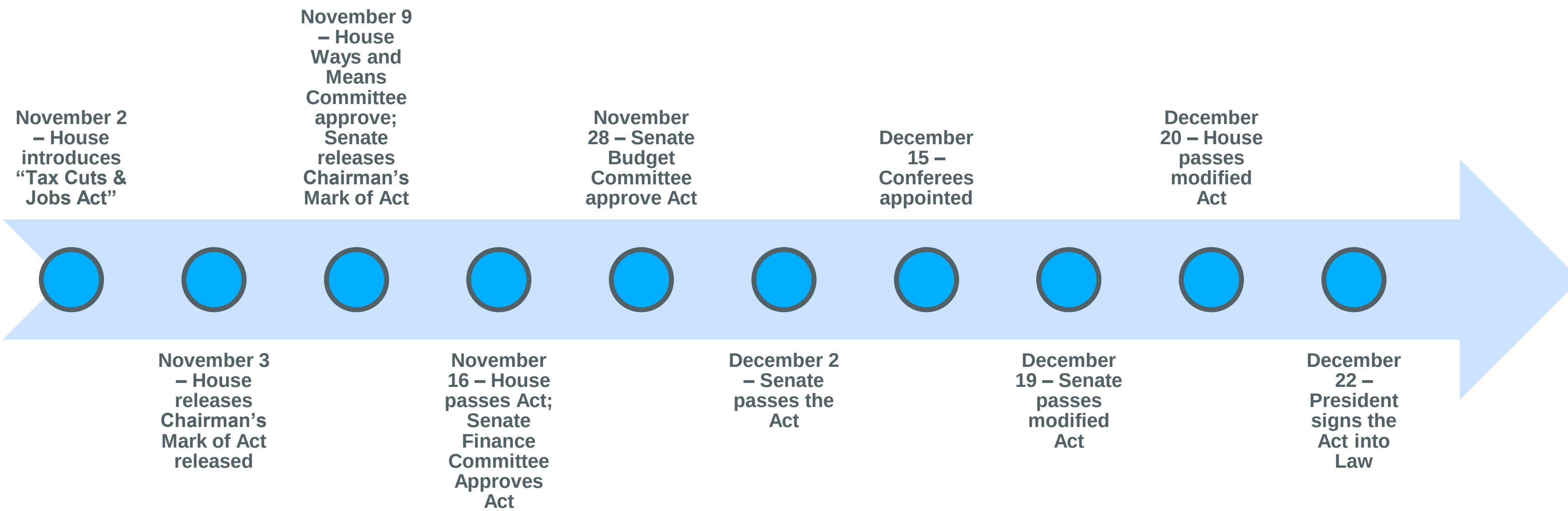
- **How we'll proceed:**
  - After a little background and an overview of tax reform and prior cost recovery system, we'll cover the changes to sections 168(k) and 179
  - We'll discuss the provisions and some other special considerations
  - We'll discuss tax planning considerations for choosing between the provisions and other long-term strategies
  - We will answer questions at the end

Background

Depreciation and Expensing: New Rules and Limits Under Current Tax Law

- Brief Introduction to New Tax Act
- Introduction to Depreciation

Background: Timing of tax law changes



- Tax Cuts & Jobs Act
  - **50 Days** (November 2nd to December 22nd)
- Tax Reform Act of 1986
  - **323 Days** (December 3, 1985 to October 22, 1986)

Overview: What has changed and what stayed the same

- **Changed:**
  - Individual rates down 39% to 37%, but SALT deduction restricted
  - Corporate rates down 35% to 21%
  - New deduction that will reduce tax on income from pass-through businesses
  - Business interest deduction has been limited (for non-real estate; there is a special rule for real estate)
  - Increased cost recovery/bonus depreciation (for non-real estate and, in some circumstances, real estate)

Overview: What has changed and what stayed the same

- **Did not change:**
  - Business interest deduction (for real estate)
  - Cost recovery/bonus depreciation (for real estate)
  - 1031 Exchanges survived for real estate
  - Most of the rules related to carried interests
  - SALT deduction (for businesses)

Depreciation 101

<u>Three events when we deal with depreciation</u>

1. Initial acquisition / placed in service
2. Subsequent improvements / additions
3. Recapture at disposition

Depreciation 101

<u>Tax planning challenges with depreciation</u>

1. Multiple ways to accelerate or slow down depreciation
2. Maximizing depreciation is not always desirable:
   - deductions may be limited
   - deductions may be inefficient (AGI, NOL)
   - exit strategies may factor in
   - non-tax reasons (lenders, shareholders)

Depreciation 101

<u>Approaches to accelerating depreciation</u>

1. Choosing a faster allowable method
2. Cost segregation aka asset segregation aka component depreciation
3. Section 179 expensing
4. Bonus depreciation
5. Special categories: qualified leasehold, restaurant and retail improvements property plus qualified improvement property

New Depreciation and Expensing Rules

Depreciation and Expensing: New Rules and Limits Under Current Tax Law

- Section 179 Expensing
- ADS changes
- Section 168(k) Bonus Depreciation
- Qualified Property
- Business Interest Deduction Limitation

Section 179 changes

1. Annual max doubled from $510,000 (2017) to $1,000,000 (2018)
2. Phaseout threshold slightly increased, from $2,030,000 (2017) to $2,500,000 (2018)
3. Both numbers indexed for inflation from 2019
4. Added: certain depreciable tangible property used in connection with lodging
5. Added: certain improvements to non-residential real property
6. Revised: qualified improvement property

Section 179 changes

Tangible property used in connection with lodging.

Translation: residential rental properties.

Previously specifically excluded, other than for short-term rentals, i.e. hotels and AirBnB.

Now, all personal property could be expensed: appliances, carpets, equipment, vehicles (!).

Cost segregation studies received a boost!

<u>Caveat:</u> must qualify as *trade or business*

Section 179 changes

Specific improvements to *non-residential* real property are now eligible:

- Roofs
- Heating, ventilation, and air-conditioning
- Fire protection and alarm systems
- Security systems

Notice: this used to be 39-yr property not eligible for any accelerated depreciation, incl. Sec. 179!

Section 179 changes

Qualified improvement property.

Replaced references to Sec. 168(e)(3): qualified leasehold, restaurant and retail improvements with Sec. 168(e)(6) – *qualified improvement property:*

1. made to an interior portion of a building which is nonresidential real property, and
2. be placed in service after the date the building is first placed in service.
3. not attributable to the enlargement of the building, an elevator or escalator, or the internal structural framework of the building.

Section 179 changes

Important distinctions:

1. Does not need to be made pursuant to a lease, unlike the old leasehold improvements
2. No need to wait 3 years, unlike the old leasehold and retail improvements
3. Limited to interior improvements, unlike the old restaurant property
4. No specific use requirements, unlike retail trade under retail improvements or 50% of the square footage for food prep under the old restaurant property

Note: still waiting for the technical correction!

Changes to ADS lives

	MACRS	ADS old	ADS new
Residential property	27.5	40	30
Non-residential property	39	40	40
Qualified improvement property	15	39	20*

*still waiting for the technical correction!

Who cares? Large (>$25 mil) “real property trade or business” electing out of the net interest expense limitation

Section 168(k) Bonus Depreciation

- Taxpayer may depreciate 100% of the cost basis of qualified property, placed in service after September 27, 2017 and before January 1, 2023
  - The bonus depreciation percentage is phased-down after 2022
- The Act removes the requirement that the original use of qualified property must commence with the taxpayer
  - Thus, immediate expensing applies to both new and used properties placed into service See Sec. 168(k)(2)(E)

Qualified Property

- Qualified Property under Section 168(k)(2) includes property with a recovery period of 20 years or less, computer software, water utility property, qualified film or TV production, qualified live theatrical production
  - Must be original use or acquisition property (no history of prior use by taxpayer)
  - Includes property with longer production period
- Qualified Improvement Property no longer included in definition of qualified properties, however the intent was for qualified improvement property to fall under property with a 20-year recovery period
  - Qualified Improvement Property definition expanded to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property
- **Drafting Error:** Qualified Improvement Property is no longer eligible for bonus depreciation, because improvement property does not have a recovery period of 15 years

Special Considerations: Business interest deduction limitation

- **Business interest deduction (Generally):**
  - New Code Section 163(j): for most taxpayers, the Act disallows the deductibility of business interest to the extent that net interest expense exceeds 30% of EBITDA (2018 through 2022) or EBIT (beginning in 2022)
  - The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely
  - This provision applies to existing debt and applies at the entity level
  - **Exception:** The limitation does not apply to taxpayers whose average annual gross receipts for the three-tax-year period ending with the prior tax period does not exceed $25 million

Business Interest Deduction Limitation

- **Business interest deduction (Real Estate):**
  - A real property trade or business can elect out of the new business interest disallowance regime.
    - Any business engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business
  - The real estate exception extends to
    - (1) the activities of corporations and REITs, and
    - (2) the operation or management of a hotel.
  - The election out is irrevocable

Real Estate Businesses and Business Interest Deduction Limitation

- **Cost recovery (Real Estate):**
  - Taxpayers that elect to use the business interest real estate exception will be permitted to expense, under section 179, tangible, personal property used in their real property trade or business
  - However, such taxpayers must depreciate real property using ADS under slightly longer recovery periods: 40 years for nonresidential property, 30 years for residential rental property, and 20 years for qualified improvement property (interior)
  - The switch to ADS applies to all nonresidential rental property, residential rental property, and qualified improvement property, not just property placed in service beginning in 2018
  - The Act <u>did not</u> adopt the Senate proposal to reduce the MACRS depreciable lives on residential and nonresidential depreciable property

Business Interest Deduction Example

- **Example 1:**
  - In 2018, Jim’s Business, LLC paid $2,000,000 in net interest expense that is properly allocable to its trade or business to Lender
  - In 2018, Jim’s Business, LLC’s EBITDA is $5,000,000
  - The business interest expense limitation is $1,500,000 (30% of $5,000,000)
  - Jim’s Business, LLC can only deduct $1,500,000 in business interest in 2018
  - Jim’s Business, LLC can carry forward the $500,000 in disallowed business interest indefinitely

- **Variation: What if Jim’s Business, LLC was a real property trade or business and elected out?**

Cost Recovery Example

- **Example 2:**
  - In 2018, Jim’s Business, LLC did not elect out of the business interest deduction limitation, and purchases equipment (either new or used) for $1,000,000 and places the equipment into service the same year
  - Jim’s Business, LLC can deduct its full $1,000,000 basis in the equipment in 2018
- **Example 3:**
  - Same as Example 3, except Jim’s Business, LLC elected out of the business interest deduction limitation
  - Jim’s Business, LLC cannot fully expense its equipment in 2018

Implications: Business Interest Deduction Limitation

– Real estate trades and businesses will need to decide which is more important to their business
  - Companies that rely heavily on leverage, may choose to elect out of the business interest deduction limitation
  - Companies that do not rely heavily on leverage may find that the shorter depreciable lives of real property (and expensing for qualified improvement property) may outweigh any detriment from the limitation on interest deductions
  - The interest limitation will be less onerous initially because adjusted taxable income will not include deductions for depreciation, amortization, or depletion until to 2022. This may mean that the depreciation and expensing benefits could justify deferring the election for exemption from the interest limitation until 2022

SEYFARTH SHAW

Relevant Provisions and Accelerated Depreciation

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- Section 199A Qualified Business Income
- Section 1031 Like-Kind Exchanges
- Section 280F Passenger Automobiles

Section 199A Qualified Business Income

- Generally, allows the taxpayer to take a 20% deduction on certain **qualified business income** earned in a **qualified trade or business**
  - Qualified Trade/Business is all trades and businesses, except service businesses
  - Must be a domestic pass-through business
- The deduction will expire after 2025
- Deduction permitted is the greater of
  - 50% of W-2 Wages or
  - 25% of W-2 wages plus 2.5% of unadjusted basis immediately after acquisition of all qualified property
- Deduction cannot exceed a certain percentage, which is determined by the taxable income over net capital gain plus aggregate qualified cooperative dividends

Section 199A and Accelerated Depreciation

- Section 199A(b) Limitation – the deduction is limited, in part, to 2.5% of the unadjusted basis of qualified property
  - What is the basis of real property that has been received through a like-kind exchange and previously depreciated?
- When the taxpayer fully depreciates qualified property, it will reduce the Qualified Business Income

Sec. 1031 Like-Kind Exchanges

- Under prior law, both real property and personal property held for investment or productive use in a trade or business could be exchanged for like-kind property under 1031 to defer gain for the taxpayer
- Under the new law, the Act permits taxpayers to continue to defer gain on *only* real estate like-kind exchanges.
- Improved real estate and unimproved real estate will continue to be considered property of a like kind.
- However, the portion of any exchange that includes personal property will no longer qualify for tax deferred treatment under Code Section 1031
- **General Implications:** This is very good for real estate because it will continue to generate interest in real estate investments
  - Not a significant change from current law
- **Cost Segregation Implications**

Sec. 1031 Like-Kind Exchanges

- Personal property no longer permitted tax deferred gain on like-kind exchanges, but can offset recognized income through the depreciation/expense deductions under with section 168(k) or 179

Depreciation of automobiles

Passenger automobiles (< 6,000 lbs) – Sec. 280F

Old maximum:

$11,160 1st yr. ($3,160 + $8,000 bonus or Sec. 179);

$5,100 2nd yr.

New maximum:

$18,000 1st yr. ($10,000 + $8,000 bonus or Sec. 179);

$16,100* 2nd yr.

*In reality, 2nd and future years may have much less, due to a weird quirk – *see Tony Nitti's blog @ Forbes, Jan 2, 2018*

Depreciation of automobiles

Heavy SUVs (> 6,000 lbs)

Old maximum:

$25,000 under Sec. 179;

plus 50% bonus depreciation

plus 20% 1st year of the remainder

New maximum:

$25,000 under Sec. 179;

OR 100% bonus depreciation !!! (from Sept 27, 2017)

Depreciation of automobiles

Disposition issues:

- All depreciation, including Sec. 179 and 100% bonus, reduces the vehicle’s basis – possibly to zero.
- Section 1031 has been revised to cover real property only. Auto trade-ins are no longer like-kind exchanges.
- Result: taxable gain on many trade-ins!

Tax Planning

Depreciation and Expensing: New Rules and Limits Under Current Tax Law

- Selecting between Section 179 and Section 168(k)
- Long-Term Planning

Section 179 v. Section 168(k)

Applicability	Section 179	100% bonus
Asset classes	3-10 yrs	3-20 yrs
Business use requirement	50%	n/a
Applies to used property	Yes	Yes (!)
Applies to ADS property	Yes	No (!)
Applies to residential rentals	Yes (!)	Yes

Section 179 v. Section 168(k)

Tax planning	Section 179	100% bonus
Limited to business income	Yes	No
Can generate NOL	No	Yes
Limited on entity level	Yes	No
Recapture if below 50% use	Yes	No
Can be applied selectively	Per asset	Per class
Effective date for changes	1/1/2018	9/27/2017

Tax planning A: Max depreciation

- More property is eligible
- 100% bonus replaced 50% bonus
- Alternative approaches have to be compared.
  Example: appliances for an apartment complex
  - expensed under de minimis safe harbor
  - expensed under Section 179
  - depreciated under 100% bonus
  - depreciated with electing out of the bonus

Tax planning B: Section 199A

- All depreciation reduces QBI and consequently the 20% deduction
- What is a "trade or business"? Section 162? Does it apply to rental operations?
- What is "per business"? Multiple Schedules C? Multiple disregarded entity LLCs? Splitting multiple lines of business? Common control issues?

Tax planning C: NOL

- Section 179 does not create a NOL, but Section 168(k) does.
- Limited Section 179 deduction carries forward, as does NOL.
- NOL is no longer carried back.
- NOL is now limited to 80% of taxable income.

Tax planning D: Dispositions

- Section 1031 like-kind exchanges are now limited to real property.
- Other property (ex.: automobiles) can trigger taxable gains where it was exchange-eligible in the past.
- Asset segregation allows partial dispositions. (Ex.: replaced HVAC)

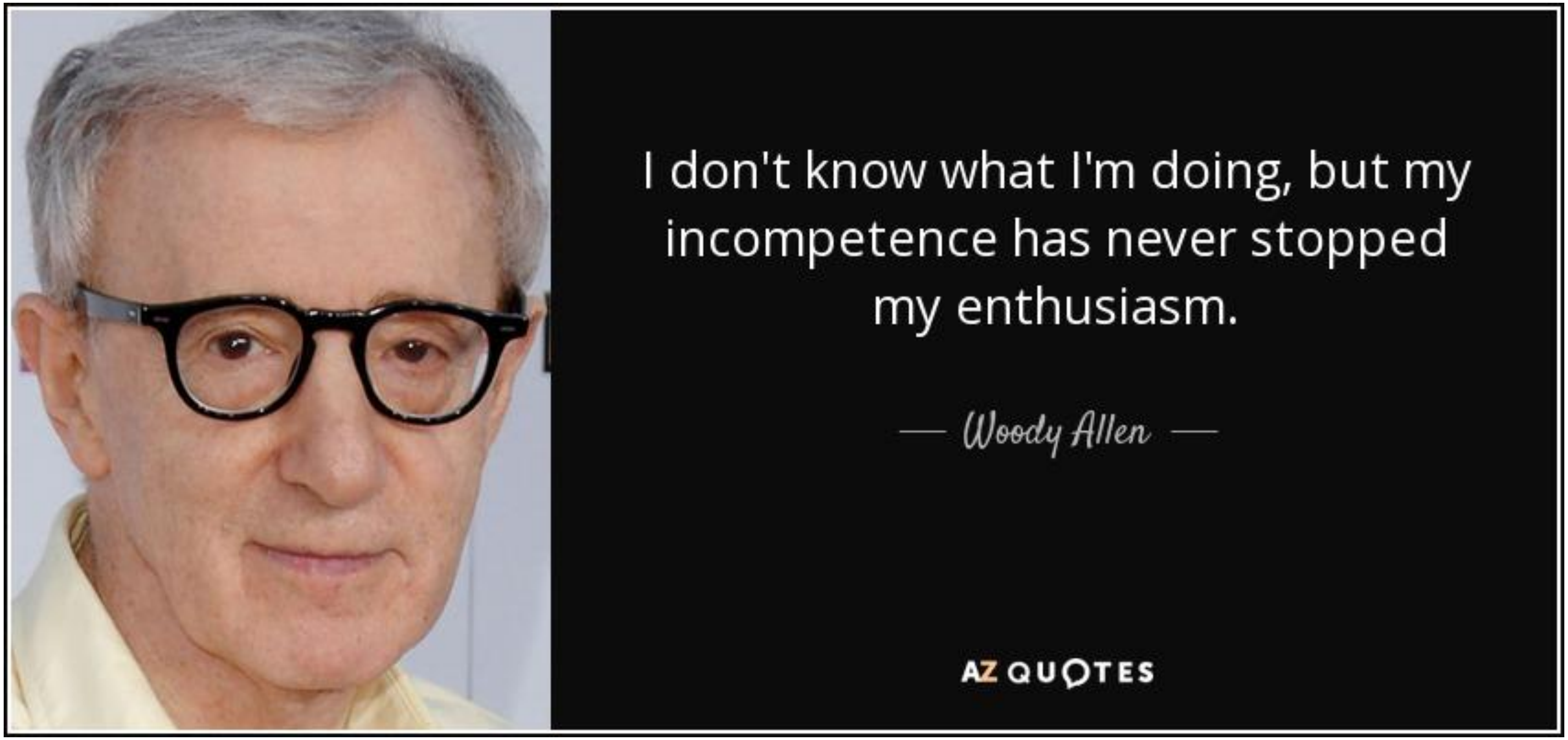
Non-Tax planning E: Lending

- Most lenders add back depreciation for income eligibility.
- How will they treat the beefed-up depreciation?
- Depreciation via Sec. 179 or 100% bonus may look better than expensing, despite identical tax results.
- How will they interpret the Balance Sheet?
- How will they interpret carryforward losses, including Sec. 179, PAL and NOL?

Long-Term Tax Planning Considerations for Accelerated Depreciation

- Most benefit of the bonus depreciation will occur in the earlier years
  - Plan purchases/acquisitions before 2023
- Real estate businesses will need to choose between avoiding the new business interest deduction limitation or enjoying the new full and immediate bonus depreciation
  - May cause a shift away from debt financing towards equity financing

Q&A Disclaimer:



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