**Historic Tax Credit**
**<u>Coalition</u>**

**Qualified Leasehold**
**<u>Improvement Property</u>**

**September 9, 2016**

## 1. <u>Introduction</u>

Section 168 of the Internal Revenue Code contains a series of rules relating to depreciation and cost recovery. These provisions include the assignment of cost recovery periods to specific categories of property, as well as special rules providing for additional depreciation deductions to incentivize investment in certain types of property. The rehabilitation tax credit described in Code § 47 (the "<u>HTC</u>") is available for both nonresidential and (in the case of certified historic structures) residential property. The normal cost recovery periods for nonresidential and residential rental property are 39 years and 27.5 years, respectively. However, participants in an HTC transaction should be aware of certain special depreciation rules that can affect (i) the availability of the HTC, (ii) the period over which rehabilitation improvements must be depreciated, and (iii) in a master lease transaction involving an election under Code § 50(d), the period over which any so-called "50(d) income" must be realized by the lessee (or its partners or members).

These provisions, which will be discussed in detail in Section 2 of this Memorandum, include (i) a requirement that qualified leasehold improvement property ("<u>QLIP</u>"), as well as certain other categories of <u>nonresidential</u> property, be depreciated over a 15-year recovery period rather than the normal 39-year period applicable to such property, unless an election is made to use the alternative depreciation system ("<u>ADS</u>"), and (ii) a requirement that QLIP, as well as certain other categories of so-called "qualified property," are subject to additional "bonus" depreciation unless an affirmative election is made <u>not</u> to claim such additional depreciation. This is of critical importance in an HTC transaction because qualified rehabilitation expenditures eligible for the HTC ("<u>QREs</u>") include only expenditures for which straight-line depreciation is used. As a result, the HTC may not be claimed with respect to QLIP or other qualified property <u>unless</u> the election <u>out</u> of additional depreciation is made.

Finally, Code § 50(d)(5) provides that "rules similar to" the old section 48(d) rules in effect in 1990 apply under current law to an HTC master lease transaction. The old section 48(d) rules provided that the lessee of property eligible or an investment credit such as the HTC for which a pass-through election was made must recognize income equal to the amount of the credit over the shortest cost recovery period that could apply to the property. The IRS has issued guidance that, in the case of property eligible for bonus depreciation, the shortest recovery period is the stated recovery period for such class of property in Code § 168(c). In the case of QLIP, this period is 15 years even though the normal recovery period for commercial property is 39 years and the ADS recovery period for both nonresidential and residential rental property is 40 years. As a result, it appears that 50(d) income attributable to QLIP (or other 15-year property) must be recognized over a 15-year period while 50(d) income attributable to nonresidential property that does not constitute QLIP (or another category of 15-year property) must be recognized over a 39-year period.

The terminology used in the Code to describe these rules is extremely confusing. The term "qualified leasehold improvement property" (or QLIP) is defined in Code §168(e) and a 15-year cost recovery period for such property is prescribed in Code § 168(c). Property eligible for bonus depreciation, or "qualified property," is described in Code § 168(k). One of the categories of qualified property eligible for bonus depreciation is "qualified improvement property" (or "QIP"), which includes QLIP but also includes other categories of property not covered by the QLIP definition such as improvements that are not made pursuant to a lease, property leased to a related party, common areas, and improvements to buildings that are less than three years old. In short, QLIP always will be QIP eligible for bonus depreciation but the term "qualified property" (including QIP) also includes other categories of property. Conversely, although QIP always qualifies for bonus depreciation, not all QIP (or other types of qualified property) must be depreciated over a 15-year period.

The next section of this Memorandum contains a description and technical analysis of the foregoing rules and their application in an HTC transaction.

## 2. Statutory Framework and Technical Analysis

### 2.1 Eligibility for HTC

The HTC is available only for costs that constitute QREs. Code § 47(c)(2)(B) provides that QREs do not include:

> Any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under subsection (c) or (g) of section 168. The preceding sentence shall not apply to any expenditure to the extent the alternative depreciation system of section 168(g) applies to such expenditure by reason of subparagraph (B) or (C) of section 168(g)(1).

Treas. Reg. §1.48-12(c)(8) provides:

> (8) Requirement to use straight line depreciation—(i) Property placed in service after December 31, 1986. The requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section to use straight line cost recovery does not apply to any expenditure to the extent that the alternative depreciation system of section 168(g) applies to such expenditure by reason of section 168(g)(1)(B) or (C). In addition, the requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section applies only to the depreciation of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. However, see §1.168(k)-l(f)(10) if the qualified rehabilitation expenditures are qualified property or 50-percent bonus depreciation property under section 168(k) and see §1.1400L(b)-l(f)(9) if the qualified rehabilitation expenditures are qualified New York Liberty Zone property under section 1400L(b).

Code § 168(g)(1), as currently in effect, provides:

(i) In general,

In the case of —

(A) any tangible property which during the taxable year is used predominantly outside the United States,

(B) any tax-exempt use property,

(C) any tax-exempt bond financed property,

(D) any imported property covered by an executive order under paragraph (6), and

(E) any property to which an election under paragraph (7) applies,

the depreciation deduction provided by Section 167(c) shall be determined under the alternative depreciation system.

To summarize, the straight line depreciation requirement does not apply to property that is subject to ADS because it is tax-exempt use property or tax-exempt bond financed property. However, this is somewhat moot in an HTC transaction where, for example, tax-exempt use property would not qualify for the HTC in any event.

The treasury regulations specifically address the interaction between the HTC provisions and the bonus depreciation provisions. Treas. Reg. §1.168(k)-1(f)(10) provides:

(10) *Coordination with section 47*

(i) In general.— If qualified rehabilitation expenditures (as defined in section 47(c)(2) and §1.48-12(c)) incurred by a taxpayer with respect to a qualified rehabilitated building (as defined in section 47(c)(1) and §1.48-12(b)) are qualified property or 50-percent bonus depreciation property, the taxpayer may claim the rehabilitation credit provided by section 47(a) (provided the requirements of section 47 are met)—

(A) With respect to the portion of the basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer makes the applicable election under paragraph (e)(1)(i) or (e)(1)(ii)(B) of this section not to deduct any additional first year depreciation for the class of property that includes the qualified rehabilitation expenditures; or

(B) With respect to the portion of the remaining rehabilitated basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer claims the additional first year depreciation deduction on the unadjusted depreciable basis (as defined in paragraph (a)(2)(iii) of this section but before the reduction in basis for the amount of the rehabilitation credit) of the qualified rehabilitation expenditures and the taxpayer depreciates the remaining adjusted depreciable basis (as defined in paragraph (d)(2)(i) of this section) of such expenditures using straight line cost recovery in accordance with section 47(c)(2)(B)(i) and §1.48-12(c)(7)(i). For purposes of this paragraph (f)(10)(i)(B), the remaining rehabilitated basis is equal to the unadjusted depreciable basis (as defined in paragraph (a)(2)(iii) of this section but before the reduction in basis for the amount of the rehabilitation credit) of the qualified rehabilitation expenditures that are qualified property or 50-percent bonus depreciation property reduced by the additional first year depreciation allowed or allowable, whichever is greater.

(ii) Example.— The application of this paragraph (f)(10) is illustrated by the following example.

*Example*, (i) Between February 8, 2004, and June 4, 2004, UU, a calendar-year taxpayer, incurred qualified rehabilitation expenditures of $200,000 with respect to a qualified rehabilitated building that is nonresidential real property under section 168(e). These qualified rehabilitation expenditures are 50-percent bonus depreciation property and qualify for the 10-percent rehabilitation credit under section 47(a)(1). UU's basis in the qualified rehabilitated building is zero before incurring the qualified rehabilitation expenditures and UU placed the qualified rehabilitated building in service in July 2004. UU depreciates its nonresidential real property placed in service in 2004 under the general depreciation system of section 168(a) by using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. UU elected to use the optional depreciation tables to compute the depreciation allowance for its depreciable property placed in service in 2004. Further, for 2004, UU did not make any election under paragraph (e) of this section.

(ii) Because UU did not make any election under paragraph (e) of this section, UU is allowed a 50-percent additional first year depreciation deduction of $100,000 for the qualified rehabilitation expenditures for 2004 (the unadjusted depreciable basis of $200,000 (before reduction in basis for the rehabilitation credit) multiplied by .50). For 2004, UU also is allowed to claim a rehabilitation credit of $10,000 for the remaining rehabilitated basis of $100,000 (the unadjusted depreciable basis (before reduction in basis for the rehabilitation credit) of $200,000 less the additional first year depreciation deduction of $100,000). Further, UU's depreciation deduction for 2004 for the remaining adjusted depreciable basis of $90,000 (the unadjusted depreciable basis (before reduction in basis for the rehabilitation credit) of $200,000 less the additional first year depreciation deduction of $100,000 less the rehabilitation credit of $10,000) is $1,059.30 (the remaining adjusted depreciable basis of $90,000 multiplied by the depreciation rate of .01177 for recovery year 1, placed in service in month 7).

In short, if an HTC project includes QREs attributable to qualified property eligible for bonus depreciation, the taxpayer may claim the full HTC on such expenses only if an election is made not to deduct any additional bonus depreciation. If the taxpayer does claim additional first year bonus depreciation with respect to such QREs, the taxpayer must reduce its depreciable basis by the amount of such bonus depreciation and may claim an HTC on the remaining rehabilitated basis (i.e., the unadjusted depreciable basis before any reduction for the HTC less the additional first year bonus depreciation). In such a case, the taxpayer's depreciation deductions would be calculated on the remaining adjusted depreciable basis (i.e., the unadjusted depreciable basis before reduction for the HTC, minus the additional first year bonus depreciation, minus the HTC). In the case of a transaction involving a Code § 50(d) election, there would be a corresponding reduction in 50(d) income to reflect the reduced credit amount.

Treas. Reg. §1.168(k)-1(e)(1) provides that the election not to deduct additional first year depreciation for a class of property applies to all qualified property that is in that class of property and placed in service in the same taxable year. However, as discussed in Section 2.4, Code § 168(g)(7) provides an exception to such general rule in the case of nonresidential real property and residential rental property.

Treas. Reg. §1.168(k)-1(e)(3)(i) provides that the election not to deduct additional first year deprecation must be made by the due date (including extensions) of the federal tax return for the taxable year in which the property is placed in service by the taxpayer.

Treas. Reg. §1.168(k)-1(e)(3)(ii) provides that the election not to deduct additional first year depreciation must be made in the manner prescribed on Form 4562, "Depreciation and Amortization," and its instructions. The instructions to Form 4562 provide that the election not to deduct the additional first year depreciation is made by attaching a statement to the taxpayer's timely filed tax return (including extensions) indicating that the taxpayer is electing not to deduct the additional first year depreciation and the class of property for which the taxpayer is making the election.

If a tax return has been filed for a prior year involving rehabilitation improvements that may constitute qualified leasehold improvement property or qualified property and no election out of additional first year bonus depreciation was made, it is possible to obtain an extension of time to make such election. Under Treas. Reg. §301.9100-1, the IRS has discretion to grant a reasonable extension of time under the rules set forth in Treas. Reg. §§301.9100-2 and 301.9100-3 to make a regulatory election.

Treas. Reg. §§301.9100-1 through 301.9100-3 provide the standards the IRS will use to determine whether to grant an extension of time to make an election. Treas. Reg. §301.9100-2 provides automatic extensions of time for making certain elections. Treas. Reg. §301.9100-3 provides extensions of time for making elections that do not meet the requirements of Treas. Reg. §301.9100-2.

Treas. Reg. §301.9100-3(a) provides that requests for relief under Treas. Reg. §301.9100-3 will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government.

The IRS has issued numerous rulings granting relief under Treas. Reg. §30.9100, several of which involve elections to claim (or not to claim) additional bonus depreciation under Code §168(k). If relief is granted, the taxpayer that owns the property will be granted a specified period of time to make the required election not to deduct the additional first year bonus depreciation for all classes of property placed in service in the relevant taxable year(s) that qualify for the additional deduction. The taxpayer will be required to file an amended tax return (a Form 1065 if it is a partnership) for the year(s) in question with a statement indicating that the taxpayer is electing not to deduct the additional depreciation for the applicable property placed in service in such year(s).

### 2.2 Basis Adjustment Rules

Code § 50(c)(1) provides:

> (c) Basis Adjustment to Investment Credit Property —
>
> (1) In general.— For purposes of this subtitle, if a credit is determined under this subpart with respect to any property, the basis of such property shall be reduced by the amount of the credit so determined.

Code § 50(c)(5) provides:

> (5) Adjustment in basis of interest in partnership or s corporation.— The adjusted basis of—
>
> (A) a partner's interest in a partnership, and
>
> (B) stock in an S corporation,
>
> shall be appropriately adjusted to take into account adjustments made under this subsection in the basis of property held by the partnership or S corporation (as the case may be).

Code § 50(d)(5) provides that "rules similar to" the rules of Section 48(d) (relating to certain leased property) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply for purposes of applying the provisions of this subpart. This section is the foundation for the lease pass-through structure commonly used in syndicated HTC transactions. In such transactions, an election is made by the owner of rehabilitation improvements to treat a lessee (i.e., the "master tenant" in a syndicated transaction) as the owner of such improvements and to pass through the HTC arising from the rehabilitation to the lessee (and its partners or members).

Prop. Reg. §1.48-4(n), which applies to the election described in the preceding paragraph, provides, among other things, that if such an election is made, the lessor is not required to reduce the basis of the property, but "the lessee shall include ratably in gross income, <u>over the shortest recovery period which could be applicable under section 168 with respect to the property</u>, an amount equal to 50 percent [now 100 percent] of the amount of the credit allowable under section 38 with respect to such property" (emphasis added).

In the case of property placed in service before September 19, 2016 by a lessee that is a partnership, it is unclear whether the partnership must report such income as a partnership item that is allocated to the partners on Schedule K-1s or whether each partner must separately report its share of such income outside of the partnership. The IRS has recently issued proposed and temporary regulations providing that, for property placed in service on or after September 19, 2016, the Code § 50(d) income is a partner-level item that must be reported directly by each partner of the lessee partnership. As a result, the income does not increase the outside basis of the partner for its interest in the partnership nor does the partner receive capital account credit for such income.

Since Code § 50(b)(5) states that rules similar to the rules in effect immediately prior to the enactment of the Revenue Reconciliation Act of 1990 currently apply, it can be argued that the applicable "shortest recovery period" referred to in Prop. Reg. §1.48-4(n) should be the shortest recovery period in effect in 1990 and not that in effect under the current Code. Since the QLIP rules discussed in Section 2.3 below did not exist in 1990, such an interpretation would extend the period over which 50(d) income must be recognized by the lessee (or its partners or members). Of course, the "rules similar to" language in Code § 50(d)(5) may give enough latitude to the IRS to apply the existing Code § 168 depreciation rules, which would incorporate QLIP, QIP and the other concepts discussed below.

Moreover, in Rev. Proc. 2011-26, 2011-16, IRS 664, the IRS issued detailed guidance on property eligible for 100% bonus depreciation. Section 3.03(5)(b) of that revenue procedure provides:

> For purposes of applying Code § 50(d)(5), the shortest recovery period under Code § 168 that is applicable to qualified property eligible for the 100 percent additional first year depreciation deduction is the recovery period assigned to that property under Code § 168(c).

At the time of the issuance of Rev. Proc. 2011-26, both the QLIP rules and an earlier version of the qualified property bonus depreciation rules were in effect. Section 3.03(5)(6) was deemed necessary because, as a technical matter, the shortest recovery period that could apply to the property that was the subject of a Code § 50(d) election was one year because of the bonus depreciation provisions. The Treasury wanted to make it clear that the basic depreciation recovery period under Code § 168(c) rather than the one-year bonus depreciation period would apply under such circumstances. However, while not stated explicitly in Rev. Proc. 2011-26, the default to Code § 168(c) would pick up the 15-year recovery period for QLIP. Ironically, unless an election out of bonus deprecation is made with respect to rehabilitation costs, such costs could not be QREs and Code § 50(d)(5) would not apply to such costs in the first place. Nevertheless, because a Code § 50(d)(5) election can be made with respect to other investment credits (such as the energy credit) that do not prohibit accelerated depreciation, Treasury apparently believed the clarification in Section 3.03 (5)(b) was necessary.

The approach taken in Rev. Proc. 2011-26 is in large part consistent with the treatment of bonus depreciation in Treas. Reg. 1.48-12(c)(8) and 1.168(k)-1(f)(10) described in Section 2.1 above. Read together, this revenue procedure and these regulations suggest that the IRS would look to current cost recovery periods rather than those in effect in 1990 in determining the proper period over which to report Code § 50(d) income.

### 2.3 QLIP Rules

While the depreciation recovery period for nonresidential property normally is 39 years, Code §§ 168(c) and 168(e)(3)(E)(iv) provide that so-called "qualified leasehold improvement property" (i.e. QLIP) is classified as 15-year property with an appreciable recovery period of 15 years.

Code § 168(e)(6) provides:

> Qualified Leasehold Improvement Property
>
> For purposes of this subsection—
>
> (A) In General
>
> The term "qualified leasehold improvement property" means any improvement to an interior portion of a building which is nonresidential real property if—
>
> (i) such improvement is made under or pursuant to a lease (as defined in subsection (h)(7))—
>
> (I) by the lessee (or any sublessee) of such portion, or
>
> (II) by the lessor of such portion,
>
> (ii) such portion is to be occupied exclusively by the lessee (or any sublessee) of such portion, and
>
> (iii) such improvement is placed in service more than 3 years after the date the building was first placed in service.
>
> (B) Certain Improvements Not Included
>
> Such term shall not include any improvement for which the expenditure is attributable to—
>
> (i) the enlargement of the building,
>
> (ii) any elevator or escalator,
>
> (iii) any structural component benefitting a common area, or
>
> (iv) the internal structural framework of the building.
>
> (C) Definitions And Special Rules

For purposes of this paragraph—

(i) Commitment To Lease Treated As Lease

A commitment to enter into a lease shall be treated as a lease, and the parties to such commitment shall be treated as lessor and lessee, respectively.

(ii) Related Persons

A lease between related persons shall not be considered a lease. For purposes of the preceding sentence, the term "related persons" means—

(I) members of an affiliated group (as defined in section 1504), and

(II) persons having a relationship described in subsection (b) of section 267; except that, for purposes of this clause, the phrase "80 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in such subsection.

(D) Improvements Made By Lessor

In the case of an improvement made by the person who was the lessor of such improvement when such improvement was placed in service, such improvement shall be qualified leasehold improvement property (if at all) only so long as such improvement is held by such person.

(E) Exception For Changes In Form Of Business

Property shall not cease to be qualified leasehold improvement property under subparagraph (D) by reason of—

(i) death,

(ii) a transaction to which section 381(a) applies,

(iii) a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as qualified leasehold improvement property and the taxpayer retains a substantial interest in such trade or business,

(iv) the acquisition of such property in an exchange described in section 1031, 1033, or 1038 to the extent that the basis of such property includes an amount representing the adjusted basis of other property owned by the taxpayer or a related person, or

(v) the acquisition of such property by the taxpayer in a transaction described in section 332, 351, 361, 721, or 731 (or the acquisition of such property by the taxpayer from the transferee or acquiring corporation in a

> transaction described in such section), to the extent that the basis of the property in the hands of the taxpayer is determined by reference to its basis in the hands of the transferor or distributor.

For purposes of applying the above rules, a "common area" is defined in Treas. Reg. §168(k)-1(c)(3)(ii) as

> any portion of a building that is equally available to all users of the building on the same basis for uses that are incidental to the primary use of the building. For example, stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas, and rest rooms generally are treated as common areas if they are used by different lessees of a building.

The term "structural component" is defined in Treas. Reg. §1.48-1(e)(2) as

> such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components". For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1963, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

The term "internal structural framework" is defined in Treas. Reg. §1.48-12(b)(3)(i)(D)(iii) as "all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building."

In short, QLIP includes any improvement made "under or pursuant to a lease" by the lessee, sublessee or lessor to an interior portion of a building if such interior portion is to be occupied exclusively by the lessee (or any sublessee) of that portion, and the improvement is placed in service more than 3 years after the date the building was first place in service by any person (which always will be the case in an HTC master lease transaction).

QLIP does not include any improvement for which the expenditure is attributable to an "enlargement" (which would not be a QRE in any event), an "elevator or escalator" (which also would not be a QRE), a "structural component" benefitting a "common area," or the "internal structural framework" of the building.

While a lease between "related persons" is not treated as  lease under the QLIP rules, the definition of "related person" for this purpose is extremely narrow and is unlikely to be relevant in most syndicated HTC master lease transactions.

### 2.4 ADS Rules

It should be noted that Code § 168(g)(7) permits a taxpayer to elect ADS with respect to property that otherwise would be QLIP subject to 15-year depreciation. If such an election is made, a 39-year recovery period would apply to such property under Code § 168(g)(3)(B). Note that while such an election normally applies to all property in a particular class placed in service by the taxpayer in a taxable year, in the case of nonresidential real property or residential rental property, the election may be made separately with respect to each property.

The term "nonresidential rental property" means Code § 1250 property (such as a building or improvements to a building) that is not "residential rental property" or property with a class life of less than 27.5 years.

(i) Residential rental property means any building or structure if 80% or more of the gross rental income from such building or structure is rental income from dwelling units.

(ii) This means that, in a mixed use project, the residential units in a building could be treated as nonresidential rental property (and thus subject to the QLIP rules) if the 80% test is not satisfied with respect to that building.

(iii) Note than even though QLIP must be depreciated over a 15-year recovery period, it is deemed for ADS purposes to have a class life of 39 years. See Code § 168(g)(3)(B).

There would appear to be no benefit to making an ADS election in a typical HTC transaction. In a single tier structure, annual depreciation deductions would be reduced. In a master lease structure, the 50(d) income arguably still must be recognized over a 15-year period, which is the shortest recovery period that could apply to QLIP under Code § 168.

### 2.5 Additional Depreciation Rules

Code § 168(k)(1) provides:

168(k) Special Allowance For Certain Property Acquired After December 31, 2007, And Before January 1, 2020

168(k)(l) Additional Allowance

In the case of any qualified property—

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to 50 percent of the adjusted basis of the qualified property, and

(B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

Code § 168(k)(2) provides, among other things, that the term "qualified property" includes property to which Code § 168(k) applies that has a recovery period of 20 years or less that is "qualified improvement property," (i.e. QIP), the original use of which commences with the taxpayer, and which is placed in service by the taxpayer before January 1, 2020. For purposes of these rules, Code §168(k)(3) provides that QIP means any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Such term does not include any improvement for which the expenditure is attributable to—

(i) the enlargement of the building,

(ii) any elevator or escalator, or

(iii) the internal structural framework of the building.

Code § 168(k)(7) permits a taxpayer to elect out of additional depreciation:

If a taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, paragraphs (1) and (2)(F) shall not apply to any qualified property in such class placed in service during such taxable year. An election under this paragraph may be revoked only with the consent of the Secretary.

Note the following:

(i) Bonus depreciation is <u>mandatory</u> unless the taxpayer makes an affirmative election not to claim it.

(ii) Qualified property (and thus bonus depreciation) does <u>not</u> apply to any property for which ADS under Code § 168(g) applies, determined without regard to paragraph (7) of Code § 168(g) (relating to election to have system apply) and after application of the special rules in Code § 280F(b) (relating to listed property with limited business use.)

In an HTC transaction, it is critical to affirmatively elect not to have bonus depreciation apply since under Code § 47(c)(2)(B), QREs do not include any expenditures with respect to which the taxpayer does not use the straight-line method over a recovery period determined under Code §§ 168(c) or (g). See also Treas. Reg. § 1.48-12(c)(8) and 1.168(k)-1(f)(10) discussed above.

(i) In a lease pass-through structure, the landlord (and not the master tenant) would make the election out of bonus depreciation.

(ii) The election out requirement only applies to the portion of the basis of the building that is attributable to the QREs.

(iii) Treas. Reg. § 1.168(k) – 1(f)(10) (reproduced in its entirety in Section 2.1) sets forth the requirements for depreciating the "remaining rehabilitated basis" of an historic building if an election out of bonus depreciation for the QREs is not made.

(iv) Since the exception to qualified property status for ADS property above applies to ADS property determined without regard to the election described in Code § 168(g)(7), if a taxpayer affirmatively makes such an election as to any property, such property still could constitute "qualified property" eligible for bonus depreciation and it still would be necessary to make an election out of bonus depreciation under Code § 168(k)(7) in order to insure that the expenditures relating to such property constitute QREs. As noted in Section 2.4, there appears to be no reason in a typical HTC transaction to elect ADS.

As discussed above, for purposes of bonus depreciation under Code § 168(k), the definition of "qualified property" is much broader than the definition of QLIP. For example, it includes "qualified improvement property" (i.e. QIP), which includes any improvement to an interior portion of a nonresidential building, whether or not pursuant to a lease, subject to exceptions for enlargements, elevators and escalators, and internal structural framework.

## 3. Recommendations

1. The participants in any HTC transaction should identify any improvements that may constitute QLIP or any other category of so-called "qualified property" and should always make sure the owner (which would be the landlord in a lease pass-through transaction) elects out of bonus depreciation.

2. Financial projections should reflect a 15-year recovery period for any QLIP and the recognition of 50(d) income relating to such QLIP over a 15-year period.

3. There appears to be no advantage to electing ADS for QLIP. Such an election would result in lower annual depreciation deductions but would not prevent the recognition of the 50(d) income attributable to the QLIP over a 15-year period, which is the shortest applicable recovery period that could apply to such property.

## Accountants Addendum

As part of its QLIP analysis process, the HTCC engaged its accounting firm members to develop five case studies to illustrate QLIP outcomes on actual HTC transactions. Participating firms included CohnReznick, Novogradac and Company, Baker Tilly, Rubin Brown and Plante Moran. The accountants' spreadsheets shown below summarize the estimated QLIP property generated by 5 current transactions involving different property types. The spreadsheets categorize the expenses as QLIP and non-QLIP property for each project. The first summary is for the master tenant structure transactions. The second summary is for single-tier transactions.

Since QLIP property is (among other criteria) improvements made subject to a lease, the master lease structure produces much more QLIP than the single-tier transaction. The single-tier analysis shown assumes that there is 30% preleasing for the commercial transactions. Note that a theater has no pre-leasing. Neither does a hotel or an apartment project. So while a theater, hotel and apartment project may have substantial QLIP in a master tenant structure, they have relatively little in a direct investment.

Going forward, single-tier projects will take the most thinking. A project with a certain amount of pre-leasing might acquire more leases during the construction period and potentially create more QLIP property as the property moves through construction. The HTCC's accountants see using something like the spreadsheets shown as part of their projections on new deals. QLIP numbers could shift between LOI and closing and between closing and project placement in service. The final cost cert would provide the final QLIP number.

QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY (QLIP)
SUMMART SCHEDULE OF ANTICIPATED ALLOCATIONS OF DEVELOPMENT COSTS BETWEEN QLIP AND NON-QLIP PROPERTY
MASTER LEASE STRUCTURE

| Category | Retail/Office - High Rise | Office/Retail/Apartments - Low Rise | Hotel Conversion | Theater | Hotel and Apartment - High Rise Tower | Average %'s |
|---|---|---|---|---|---|---|
| Interior Improvements | 68.0% | 65.0% | 67.0% | 74.0% | 71.0% | 69.0% |
| Exterior Improvements | 19.0% | 21.0% | 8.0% | 12.0% | 16.0% | 15.2% |
| Internal Structural Framework Improvements | 3.0% | 7.0% | 6.0% | 8.0% | 7.0% | 6.2% |
| Common area improvements/Other Non-QLIP | 10.0% | 7.0% | 19.0% | 6.0% | 6.0% | 9.6% |
| Totals | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Total QLIP % | 68.0% | 65.0% | 67.0% | 74.0% | 71.0% | 69.0% |
| QLIP as a % of QREs | 73.0% | 73.0% | 78.0% | 74.0% | 72.0% | 74.0% |

QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY (QLIP)
SUMMART SCHEDULE OF ANTICIPATED ALLOCATIONS OF DEVELOPMENT COSTS BETWEEN QLIP AND NON-QLIP PROPERTY
SINGLE TIER STRUCTURE*

| Category | Retail/Office - High Rise | Office/Retail/Apartments - Low Rise | Hotel Conversion | Theater | Hotel and Apartment - High Rise Tower | Average %'s |
|---|---|---|---|---|---|---|
| Interior Improvements | 12.0% | 20.0% | 20.0% | 0.0% | 0.0% | 10.4% |
| Exterior Improvements | 19.0% | 21.0% | 8.0% | 12.0% | 16.0% | 15.2% |
| Internal Structural Framework Improvements | 3.0% | 7.0% | 6.0% | 8.0% | 7.0% | 6.2% |
| Common area improvements/Other Non-QLIP | 66.0% | 53.0% | 66.0% | 56.0% | 77.0% | 63.6% |
| Totals | 100.0% | 101.0% | 100.0% | 76.0% | 100.0% | 95.4% |
| Total QLIP % | 12.0% | 20.0% | 20.0% | 0.0% | 0.0% | 10.4% |
| QLIP as a % of QREs | 19.0% | 22.0% | 23.0% | 0.0% | 0.0% | 12.8% |

* Assumes 30% preleasing at construction closing.



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