



The Tax Cut and Jobs Act (the TCJA) is one of the most significant pieces of tax reform in the last 30 years.

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*The Tax Cut Jobs Act (“TCJA”) is one of the most broad-sweeping pieces of tax reform to be enacted in the last 30 years. Two of the more significant components that impact affordable housing projects are the business interest deduction limitation and the 100% Bonus Depreciation.*

## Tax Law

### Business Interest Deduction Limitation

Effective for tax years beginning after December 31, 2017, the general rule is that the deduction for interest paid or accrued on a debt incurred in a trade or business is limited regardless how the taxpayer's business is organized.

IRC Section 163(j)(1) provides the amount allowed as a business deduction for any taxable year for business interest shall not exceed the sum of (A) the business interest income of such taxpayer for such year, (B) 30 percent of the adjusted taxable income of such taxpayer for such year, plus (C) the floor plan financing interest of such taxpayer for such taxable year. For tax years beginning before January 1, 2022, the adjusted taxable income is increased by the amount of the allowable deduction for depreciation, amortization, or depletion. See IRC Code Sec. 163(j)(8)(A)(v).

The limitation generally applies to all taxpayers except for small businesses with average gross receipts of \$25 million or less (adjusted for inflation). In the case of partnerships and S corporations, the deduction limitation applies at the entity level, and any disallowed interest of the entity is allocated to each partner or shareholder as excess business interest.

Although the limit is applied at the entity level, a partner or shareholder may still be subject to the limit in certain circumstances. For purposes of calculating the partner's or shareholder's annual deduction for business interest, the adjusted taxable income of each partner or shareholder is determined without regard to the partner's or shareholder's distributive share of any item of income, gain, deduction, or loss of the partnership or S corporation (see IRC Code Sec. 163(j)(4)(A)(ii)). This prevents double counting of the same dollars used in the adjusted taxable income of the entity generating additional interest deductions passed through to the partners or shareholders. As a result, most affordable housing projects must consider the business interest limitation even though the operating partnership does not meet the gross receipts test.

### ADS Election

Where an affordable housing project is highly leveraged, the loss of the business interest deduction can significantly impact the financial viability of the project. Fortunately, TCJA allows taxpayer to elect to exclude from the business interest limitation property allocable to a real property trade or business (as defined under the passive activity rules). If the taxpayer makes

the election under 163(j)(7)(B) then the business must use the alternative depreciation system (“ADS”) for certain property. This includes any nonresidential real property, residential rental property, and qualified improvement property held by the electing real property trade or business. The ADS class lives under TCJA for tax years after December 31, 2017, are 30 years for residential real property, 40 years for nonresidential real property, and 20 years for qualified improvement property. See IRC Code Sec. 168(g)(1)(F). For assets placed in service before January 1, 2018, the ADS class life for residential real property is 40 years. Qualified Improvement property is defined as any improvement to the interior portion of a building which is nonresidential real property if the improvement is placed in service after the date the building was first placed in service by any taxpayer.

The 163(j)(7)(B) election is made at a time and manner as provided by the IRS. If a taxpayer makes an election to use ADS with respect to any class of property for any taxable year, ADS applies to all property in such class placed in service during such taxable year. Once made, the election is irrevocable. The election does not result in an accounting method change. Instead, the change in use rules will apply. Thus Form 3115 is not required to be filed as a consequence of making the election.

## **Depreciation**

TCJA generates a few important depreciation questions for taxpayers.

- What is the impact of the ADS election?
- Can a project continue to claim bonus depreciation if it makes the ADS election?
- In what circumstances can taxpayers claim the 100% bonus depreciation?
- How do these issues impact tax credit delivery and capital account maintenance?

### *Impact of ADS election*

As already discussed, the TCJA changes the ADS class life from 40 years to 30 years for residential real estate placed in service after September 27, 2017. In contrast the MACRS class life is 27.5 years. As a result, for new projects there isn’t a significant difference between the two systems. The impact is more significant for projects placed in service prior to September 28, 2017, since the ADS class life continues to be 40 years for those assets. The attached decision model analyzes whether the time value of the deferred depreciation expense of greater worth than the business interest deduction.

### *Availability of Bonus Depreciation with the ADS election*

The other issue that the ADS election raises relates to bonus depreciation. In order to claim bonus depreciation, the property must be qualified property. Qualified property has a recovery period of 20 years or less, and cannot be property that must be depreciated using ADS. Fortunately, the 163(j)(7)(B) election only applies to residential real estate. Thus, if the project has assets that otherwise would be qualified property, the project will be able to claim bonus depreciation.

### *Availability of 100% Bonus*

There is now a distinction between property that has been placed in service after September 27, 2017 and property acquired before September 28, 2017. The placed in-service date determines what allowance a taxpayer can utilize under IRC Code Sec. 168(k).

For assets acquired and placed in service after September 27, 2017 and before January 1, 2023, the TCJA allows taxpayers to expense immediately the entire cost of certain depreciable assets. See IRC Code Sec. 168(k)(6)(B). For purposes of determining whether the 100 percent rate applies, property cannot be treated as acquired after the date on which a written binding contract is entered into for its acquisition.

Generally, a contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). A contract will continue to be binding even if the parties make insubstantial changes in its terms and conditions. Likewise, a contract will be treated as binding notwithstanding the fact that certain terms remain to be negotiated by the parties to the contract provided it imposes significant obligations on the taxpayer. However, an option either to acquire or to sell property is not a binding contract. See Treasury Regulations Section 1.168(k)-(1)(b)(4)(ii).

For self-constructed property, the acquisition rules are treated as met if the taxpayer begins manufacturing, constructing, or producing the property after the applicable dates. The manufacture, construction or production of self-constructed property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. However, physical work of a significant nature will not be considered to begin before the taxpayer incurs (for accrual basis taxpayers) or pays (for cash basis taxpayers) more than 10% of the total cost of the property (excluding the cost of any land and preliminary activities). See Treasury Regulations Section 1.168(k)-(1)(b)(4)(iii).

## *Tax Credit Delivery & Capital Maintenance*

Capital account maintenance will be a predominant concern under the TCJA. The general rule is that tax credits must follow depreciation in order for the allocation to be respected by the IRS. See Treas. Reg. Section 1.704-1(b)(4)(ii). As a result, 704(b) reallocations during the credit delivery period are a major concern for investors. One of the primary strategies for avoiding 704b issues is to slow down the flow of losses to the partners by electing to apply ADS rather than MACRS. The TCJA makes this strategy less effective with the change in class life to 30 years. The utilization of Deficit Restoration Obligations and Special Allocations are potential solutions to this problem.

## **Analysis**

From a decision modeling perspective, two questions must be answered. The first is whether the business interest deduction is more valuable to the Partnership than the accelerated cost recovery under MACRS (27.5 years straight line for residential real property)? Second, does the project qualify for the additional bonus depreciation?

Regarding the business interest deduction limitation, there are basically three scenarios that need to be considered:

1. For partnership assets placed in service prior to September 28, 2017, should the Partnership(s) elect out of the business interest deduction limitation for 2018. If so, what is the impact of recasting the depreciation over a 40-year recovery period?
2. For partnership assets placed in service after December 31, 2017, should the Partnership(s) elect out of the business interest deduction limitation. If so, what is the impact of recasting the depreciation over 30-year recovery period?
3. For partnership assets placed in service after December 31, 2017, what is the impact of not electing out of the business interest deduction limitation?

Regarding bonus depreciation, the analysis is primarily a determination of whether a binding contract existed prior to September 28, 2017. Additionally, both the business interest deduction limitation and the additional bonus depreciation require an analysis of their impact to the capital account maintenance.

**ABC PARTNERSHIP, LLC  
INTEREST LIMITATION AND REAL PROPERTY TRADE OR BUSINESS ELECTION  
TAX BENEFIT / (EXPENSE) UNDER EACH SCENARIO**

No Election	RPTOB Election in 2018	RPTOB Election in 2019
(373,052)	<b>317,579</b>	229,675
RPTOB Election in 2020	RPTOB Election in 2021	RPTOB Election in 2022
150,569	79,467	15,652

No Election		<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
Taxable Income without election		167,688	189,624	214,492	219,357	375,530	345,528	313,436	279,602	243,949	206,399
Tax Benefit / (Expense)	24.5%	(41,084)	(46,458)	(52,551)	(53,742)	(92,005)	(84,654)	(76,792)	(68,502)	(59,767)	(50,568)
NPV of Tax Benefit / (Expense)	10.0%	(373,052)									

RPTOB Election in 2018		<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
Taxable Income with RPTOB election in 2018		(205,865)	(184,051)	(159,350)	(154,699)	(173,241)	(203,351)	(235,762)	(269,940)	(305,957)	(343,878)
Tax Benefit / (Expense)	24.5%	50,437	45,092	39,041	37,901	42,444	49,821	57,762	66,135	74,959	84,250
NPV of Tax Benefit / (Expense)	10.0%	317,579									

RPTOB Election in 2019		<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
Taxable Income with RPTOB election in 2019		167,688	(180,383)	(155,682)	(151,031)	(169,573)	(199,683)	(232,094)	(266,272)	(302,289)	(340,210)
Tax Benefit / (Expense)	24.5%	(41,084)	44,194	38,142	37,003	41,545	48,922	56,863	65,237	74,061	83,352
NPV of Tax Benefit / (Expense)	10.0%	229,675									

RPTOB Election in 2020		<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
Taxable Income with RPTOB election in 2020		167,688	189,624	(151,806)	(147,155)	(165,697)	(195,807)	(228,218)	(262,396)	(298,413)	(336,334)
Tax Benefit / (Expense)	24.5%	(41,084)	(46,458)	37,192	36,053	40,596	47,973	55,914	64,287	73,111	82,402
NPV of Tax Benefit / (Expense)	10.0%	150,569									

RPTOB Election in 2021		<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
Taxable Income with RPTOB election in 2021		167,688	189,624	214,492	(143,053)	(161,595)	(191,705)	(224,116)	(258,294)	(294,311)	(332,232)
Tax Benefit / (Expense)	24.5%	(41,084)	(46,458)	(52,551)	35,048	39,591	46,968	54,909	63,282	72,106	81,397
NPV of Tax Benefit / (Expense)	10.0%	79,467									

RPTOB Election in 2022		<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>
Taxable Income with RPTOB election in 2022		167,688	189,624	214,492	219,357	(157,245)	(187,355)	(219,766)	(253,944)	(289,961)	(327,882)
Tax Benefit / (Expense)	24.5%	(41,084)	(46,458)	(52,551)	(53,742)	38,525	45,902	53,843	62,216	71,040	80,331
NPV of Tax Benefit / (Expense)	10.0%	15,652									