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End-of-Year Tax Planning for LIHTC Properties.

With five months remaining in the year, it is time to start thinking about tax-planning strategies, especially for owners of low-income housing tax credit (LIHTC) properties. Outlined below are some items to consider as 2020 approaches.

Bonus Depreciation

Internal Revenue Code (IRC) Section 168(k) governs bonus depreciation for qualified property, which is property with a recovery period of 20 years or less. For LIHTC property owners, site improvements and personal property are the most common examples. Per the Tax Cuts and Jobs Act (TCJA) passed at the end of 2017, 100 percent of the depreciable basis of qualifying property placed in service after Sept. 27, 2017, and before Jan. 1, 2023, can now be expensed.

It should be noted that there is still property subject to the old bonus depreciation rules. Per IRC Section 168(k)(8), qualified property acquired before Sept. 28, 2017, and placed in service after Sept. 27, 2017, can be expensed up to the following applicable percentages:

- In service in 2018: 40 percent
- In service in 2019: 30 percent
- In service after 2019: 0 percent

Owners should ensure that qualifying property is in service before the end of 2019. By doing so, 100 percent of the property can be expensed, or 30 percent if the property is subject to the old rules. Additionally, if the qualifying property is expected to be placed in service near the end of the year, measures can be taken so that the property is in fact placed in service before year-end in order to take advantage of the accelerated deduction in 2019 rather than having to wait until 2020. For property under the old rules, this will allow a 30 percent deduction instead of no bonus depreciation whatsoever.

Cost-Segregation Study

Related to bonus depreciation is the matter of cost-segregation studies. A cost-segregation study is performed by a specialist who reviews architectural drawings, plans and other such documentation to identify assets that might typically be grouped with buildings and reclassifies them as different asset classes. The advantage of doing so is the identification of assets with shorter depreciable lives and thus a benefit from accelerated depreciation.

For example, if a LIHTC property owner obtains a cost-segregation study in the same year in which the property is placed in service, then the owner may be able to use shorter depreciable lives, including the possibility of using bonus depreciation on the qualified property identified in the study. However, cost segregation is not necessarily required when an owner acquires or constructs new property; it also applies to previously acquired or constructed property. A caveat to this is that if too much time has elapsed from when the property was placed in service, there may not be enough remaining adjusted basis of the assets to warrant a study-i.e., the cost of the study would exceed the

benefit of any additional depreciation deductions.

Tenant Lease-Up

Per IRC Section 42(f)(2), the first-year tax credit is calculated by determining the average applicable fraction using the applicable fractions at the close of each month of the first year of the credit period. To maximize the first-year tax credits, two important items should be considered: meeting the minimum set-aside, otherwise no credits can be claimed; and meeting the target applicable fraction to ensure that the credits promised to the investor are delivered.

Consider a hypothetical building comprised of 100 percent LIHTC units in the first year of its credit period. All units are of equal floor space, thus the applicable fraction is equivalent for both the unit and floor space fractions. Furthermore, the 40-at-60 minimum set-aside has been elected and the property reached its target applicable fraction (100 percent) in December with an average applicable fraction of 67.5 percent for the year. The minimum set-aside has been met, therefore, credits can be claimed for the first year. Additionally, 67.5 percent of the annual credit allocation can be claimed for the first year, but the investor requires 70 percent of the annual allocation in the first year of the credit period. In this scenario, the investor may apply a “downward timing adjuster” and reduce the next equity contribution to account for the late delivery of credits.

To avoid this situation, an owner should ensure that units are leased up as early as possible. Furthermore, units not leased up by Dec. 31 cannot count toward the calculation of the first-year credits. These units could trigger “two-thirds credits” (i.e., “15-year credits”). Now the owner may need to consider electing to defer the start of the credit period to the following year on Form 8609.

The timing of placing the building in service should also be considered. Per Revenue Ruling 2004-82, a LIHTC unit must be in service for a full month, even though the unit only needs to have been initially qualified as low-income by the last day of the month. If a unit is not in service on the first day of the month, then it cannot generate credits for that month. To illustrate, if construction on a building is completed Dec. 3 and despite the fact that every unit is occupied by a qualified household before Dec. 31, none of the units would be qualified for the month of December. The minimum set-aside would not be met; LIHTCs cannot be claimed and the start of the credit period would need to be deferred. This would have been avoided if the building was placed in service Dec. 1.

The 2018 Consolidated Appropriations Act created a new minimum set-aside on Form 8609, which is known as the average-income test or income averaging. This set-aside requires that 40 percent or more of the residential units in a property must be both rent restricted and occupied by households whose income does not exceed the limitation designated by the owner. Additionally, the average of the income limitation designations must not be more than 60 percent of the area median income (AMI) using 20 percent, 30 percent, 40 percent, 50 percent, 60 percent, 70 percent or 80 percent designations. For example, if an owner designates a unit at 80 percent, then the unit must be occupied by a household whose income at initial occupancy is no greater than 80 percent of AMI and is charged rent at or below the applicable rent limit for the 80 percent AMI level. However, an owner must ensure that the average-income test is passed before the end of the first year of the credit period. If a property places in service late in the year, the owner may need to consider deferring the start of the credit period to allow enough time to pass the average-income test. Otherwise, there is the risk of not being able to claim credits at all.

Casualty Loss

When a unit is damaged by a casualty loss (e.g., fire or flood) rendering it uninhabitable, IRC Section 42(j)(4)(E) provides a reprieve from tax credit recapture as long as the damage is repaired within a

reasonable period. However, per IRC Section 42(c)(1), the qualified basis of a building for any year is equal to product of the applicable fraction at the end of the year and the eligible basis. If a fire occurs in a unit Dec. 25 and if the unit is not repaired/restored before Jan. 1, then the unit will not generate any credits for the entire year because it is excluded from the building's qualified basis at Dec. 31. The owner of a LIHTC property damaged by a casualty loss must repair any damaged units and place them back in service before the end of the year to avoid a loss of credits for the year.

Electing Real Property Trade or Business

With the passing of the TCJA, entities taxed as partnerships are now subject to the business interest expense limitation imposed by IRC Section 163(j). That is, business interest expense can be deducted up to only 30 percent of adjusted taxable income. However, by electing to be treated as a real property trade or business (RPTOB), a LIHTC partnership can avoid this limitation in exchange for depreciating its buildings using the alternative depreciation system (ADS). For buildings placed in service before Jan. 1, 2018, the depreciable life is 40 years versus 27.5 years under the general depreciation system. For buildings placed in service after Dec. 31, 2017, the ADS life is 30 years in lieu of 40.

Once the RPTOB election is made, it is irrevocable, but the election can be deferred until a future year. In this situation, tax planning becomes extremely important. A LIHTC property owner should confer with its investor and tax professional on whether making the election for the upcoming year will yield the best tax benefits or if forgoing the election is still the most optimal position.

What has been discussed above is by no means an exhaustive list. LIHTC property owners should seek out the advice of their tax professionals to ensure that they get the most out of their investments in LIHTC properties.

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