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The Recovery Act - Impact on Real Estate Industry

by BPM Real Estate Committee

By now, most people are aware that Barack Obama signed a significant piece of new legislation on February 17, 2009. Included within The American Recovery and Reinvestment Act of 2009 (the Recovery Act) are a number of tax law changes which will positively affect the real estate industry, although the changes are not as substantial as many had hoped.

Accelerated Depreciation:
Fortunately for real estate owners and investors, depreciation deductions are one area where Congress was generous. Under the new law, property placed in service after December 31, 2008 is eligible for an accelerated depreciation deduction equal to 50% of the cost of "qualified property."[1] In other words, 50% of the cost of the property can be written off in the first year, with the remaining 50% being depreciated using conventional methods. The property generally must be acquired and placed in service prior to January 1, 2010. Qualified property is property with a recovery period of 20 years or less, as well as qualified leasehold improvement property. Eligible property includes most types of new property other than buildings, including 15 year property such as landscaping, fences, gates, and parking lots.[2] Qualified leaseholds include improvements made under a lease by either the lessor or the lesee, but does not include items such as structural modifications or additions to a building. There are also special provisions for improvements and leases between related parties.

The original use of the property must commence with the taxpayer claiming the depreciation deduction, which means the property must be new property. The taxpayer generally must purchase the property after December 31, 2007, and before January 1, 2010 and there cannot be a written binding contract for the acquisition that was in effect before January 1, 2008.

For a taxpayer manufacturing, constructing or producing property for its own use, the requirements are treated as met if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007 and before January 1, 2010[4.]

Section 179 Boost – First Year Write Off:
IRC §179 allows, a taxpayer, other than an estate, trust, and certain noncorporate lessors, to elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in the taxpayer's trade or business (section 179 property). The Recovery Act extends the 2008 expensing limit of $250,000 to 2009, with the same dollar for dollar phase out for purchases exceeding $800,000 (with a full phase out and no expensing allowed when purchases exceed $1,050,000).[5] Unfortunately for residential property owners, this expense election is not available for personal property used predominantly to furnish lodging (i.e. apartments, duplexes and single family homes).[6] However, this increased expensing limit will be a major benefit to commercial property owners as well as hotel and motel owners. Types of property that is eligible for a first year write off for commercial property and hotel owners include the following:

- carpeting[7]
- certain types of electrical wiring
- decorative lighting fixtures
- certain types of flooring and floor coverings
- signs
- furniture
- computer equipment
- and much more

Both the accelerated depreciation and section 179 depreciation will require detailed records of assets purchased and in certain instances, cost segregation studies, to maximize deductions for tax purposes.

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Extended Net Operating Loss (NOL) Carryback Period for Small Business:
The net operating loss (NOL) provision was enacted to allow taxpayers to “smooth” out taxable income in cyclical industries. An NOL is the excess of business deductions over gross income in a particular tax year (i.e. a taxable loss for any given year). The loss can be deducted, through a NOL carryback or carryover, in another tax year where there is taxable income. In general, NOLs may be carried back two years and forward 20 years.

For NOLs arising in tax years ending after December 31, 2007, the Recovery Act permits small businesses to elect to increase the NOL carryback from 2 years up to 5 years.[8] This particular provision has the potential to be a huge benefit to residential home builders who had great years and paid substantial tax back in 2003 to 2005 when the housing market was a much different place. However, in order to qualify for this relief, the taxpayer must be a small business. In general, a small business is defined as a business whose average gross receipts for a three year period are less than or equal to $15,000,000.[9] Beware of the special aggregation rule that apply to taxpayers with several commonly owned entities. This aggregation rules combines the gross receipts of all related entities for purposes of the $15,000,000 test, and can potentially reduce the number of qualified small businesses. The benefit of this carryback provision can best be illustrated by an example:

Year	Units		Gross	Profit	Price	Federal	Tax
	Sold			Receipts	Per Unit	Per Unit	Tax Rate
2003	50	$400000	$20000000	$80000	$4000000	35%	$1400000
2004	50	$450000	$22500000	$99000	$4950000	35%	$1732500
2005	50	$500000	$25000000	$125000	$6250000	35%	$2187500
2006	25	$450000	$11250000	$45000	$1125000	35%	$393750
2007	15	$400000	$6000000	$40000	$600000	35%	$210000
2008	0	$300000	$ -	$ -	$-	35%	$ -

During the year ended December 31, 2008, condo developer forfeited option deposits on a piece of property totaling $5,000,000 due to poor economic conditions, resulting in a tax loss in the same amount.[10] Condo developer was very successful in 2003 to 2005, and subsequent to the market peak in 2005, sales started to slow down and margins became tighter. Assuming a 35% federal tax rate, the results for condo developer for the prior five years, including 2008, are as follows:

Condo developer qualifies as a small business as average annual gross receipts for 2006 through 2008 are less than or equal to $15,000,000. In 2008, condo developer has a taxable loss of $5,000,000.

Under the old rules, condo developer could carry back his $5,000,000 tax loss to 2007 and 2006. Taxable income for those two periods totaled $1,725,000, which means he could recover $603,750 in taxes previously paid (assuming 35% federal tax bracket).

Under the new rules, condo developer can carry back his tax loss all he way to 2003 and 2004, and recover $1,750,000 in taxes previously paid. Not only is the immediate refund of taxes previously paid higher, but condo developer still has 2007 that he can carry back to in the event of a 2009 loss.

Modified First-time Homebuyer Credit:
First time homebuyers can claim a refundable tax credit equal to the lesser of 10% of the purchase price of a principal residence or $8,000. A person is considered a first-time homebuyer if he didn’t own a residence in the United States during the 3 years prior to the purchase of the home. Because only ownership in a primary residence is considered, it is possible for a taxpayer who already owns a vacation home to claim the new credit. The credit phases out for individual taxpayers with adjusted gross

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income between $75,000 and $95,000, and $150,000 to $170,000 for joint filers.

The first time home homebuyer credit was in existence prior to the passing of the Recovery Act. However, the credit previously was recaptured ratably over a 15 year period. What was previously an interest free 15 year loan from the government is now a credit for 2009 purchases made before December 1, 2009.

Energy Credits:

There were a number of favorable changes to various types of energy credits. The renewable electricity production credit was extended for three years through 2013. A renewable electricity production credit is allowed for electricity produced by taxpayers from wind, geothermal energy, and other alternative energy sources. [11]

A 30% business energy credit is also allowed[12] for certain energy property placed in service, including fuel cell property, solar property, small wind energy property, and geothermal heat pump property. For facilities placed in service after December 31, 2008, the Recovery Act allows taxpayers to make an election to have qualified property of certain qualified facilities treated as energy property eligible for a 30% investment credit, rather than treating it as a renewable electricity production credit which requires more extensive calculations. Previously, there was a cap on the 30% business energy credit for qualified small wind energy property. The Recovery Act also removed this cap.

Prior to the Recovery Act, a taxpayer could claim a lifetime nonrefundable credit of up to $500 for making qualifying energy saving improvements to his home, but only $200 of this credit amount could be for qualifying window expenditures. The Recovery Act extends the nonbusiness energy tax credit for one year through December 31, 2010, in addition to raising the credit rate on the cost of installing energy efficient building components (what was previously 10% is now 30%). The ceiling on credits for residential energy efficient property purchased and placed in service before 2017 has been removed.[13]

Although not as significant as originally expected, there are a number of beneficial tax provisions for the real estate industry contained in the Recovery Act. The most disappointing change to the Senate version of the bill was the small business requirement of the expanded NOL carryback. The majority of "for sale" residential developers would have benefitted from this provision prior to the small business requirement that will limit its use to a select few. However, Congress was pressured to get this bill to the President as quickly as possible, and hopefully there will be more changes to come in the near future.

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[1] IRC §168(k)(1) , as amended by Act Sec. 1201(a))
[2] IRC §168(k)(2)(A)
[3] IRC §168(k)(3)
[4] IRC §168(k)(2)(E)(i)
[5] IRC §179(b)(7)
[6] IRC §179((d) and 50(b)(2)
[7] Hospital Corp. of America, 109 T.C. 21
[8] IRC §172(b)(1)(H) , as amended by Act Sec. 1211(a))
[9] IRC §172(b)(1)(H), 448(c), 52(a), 52(b), and Regs. §1.52-1
[10] Ordinary loss, IRC §1234(a)(1) and (a)(2)
[11] IRC §45(d)12 IRC §4813 IRC §25D credit

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