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REAL ESTATE LAW ALERT | NIXON PEABODY LLP

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IRS eases rules for seniors housing to claim deductions for interest expense

By Forrest Milder

As you may remember, a couple of years ago, the Internal Revenue Code was modified to limit the ability of many taxpayers to deduct their interest expense to 30% of the taxpayer's income (a special COVID-19 rule makes the limit 50% for 2020). The rules are written to make them apply to a lot of mid-sized and larger businesses, as well as many businesses that have tax-equity investors. For example, the new limits apply to any business that averages more than $25 million in receipts over a three-year period. And, they also apply to any business where more than 35% of the losses are allocated to limited partners or members.

Of course, many real estate businesses meet either or both of the $25 million or 35% allocation of loss rules. Holding real estate in partnership or LLC form with passive investors, who are allocated losses, is a common real estate deal structure.

At the same time, because of depreciation, many real estate businesses operate at a loss for tax purposes, meaning that these businesses would not be able to deduct ***any*** interest, because 30% of a negative number would be less than zero. Accordingly, the law provides two exceptions from the 30% cap (50% for 2020).

First, depreciation is added back to the computation for 2020 and 2021. Thus, it is less likely that the computation will start with a negative number. Second, the Code provides a special rule for "electing real property trade or businesses" (RPTOBs). They can ***elect*** to deduct ***all*** their interest expense, provided that the business also agrees to use longer depreciation periods for its real estate. The rules require 30-year depreciation instead of 27–1/2-year for residential real estate, 40-year depreciation instead of 39-year for commercial real estate, and 20-year depreciation, instead of 15-year, or 1-year, "bonus" for site improvements.

This raises the question of whether or not providing seniors housing and care is a "real property trade or business" that can make the RPTOB election. With that in mind, the IRS recently published Notice 2020-59, which provides a PROPOSED revenue procedure that would set a SAFE HARBOR for real estate that also provides "supplemental assistive, nursing or routine medical services."

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The proposed revenue procedure would treat a facility that has the following three features as a "real estate trade or business," eligible to make the election described above, if:

1. The facility has multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences.
2. The facility provides supplemental assistive, nursing, or routine medical services.
3. The facility has an average period of customer or patient use of the individual rental dwelling units that is 90 days or more.

The proposed revenue procedure provides an illustration of how the average period of customer use is computed. Note that this test only applies for purposes of the real estate trade or business election. It doesn't otherwise address what kind of activity is required for real estate generally to be considered a "trade or business."

An especially interesting aspect of this notice is that it seeks taxpayer input as to whether the proposed revenue procedure makes sense. Taxpayers and their advisors have until September 28, 2020, to submit comments to the IRS on the proposed revenue procedure.

A further question is whether the management of a seniors housing and care facility, without actual ***ownership***, is sufficient to constitute a real estate trade or business. For example, if a company's sole function is to operate the facility and provide services to its residents that otherwise meets the three requirements outlined above, does that constitute a RPTOB eligible to make an election? While Notice 2020-59 and the proposed ruling do not address this question, we note that there is case law treating real estate brokerage and appraisal services as RPTOBs, without regard to the ownership of the real estate, indicating that the management of seniors housing and care communities meeting the three requirements should also pass. Nonetheless, we wonder if the IRS might ultimately decide to add a fourth requirement to the proposed ruling, requiring that the business manage the actual physical real estate or something similar in order to be a RPTOB. Such a requirement is not currently in the proposed ruling.

A second question has to do with the implications of making a RPTOB election on bonus depreciation. The notice states, "Taxpayers that make an election under section 163(j)(7)(B) must use the alternative depreciation system under section 168, ***and cannot claim bonus depreciation.*** See section 163(j)(11)(A)." [emphasis added]. However, pursuant to Section 168(g)(8), the inability to use bonus depreciation only applies to "nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business." In other words, despite the implication of the Notice, the Code ***does*** allow an electing RPTOB to claim one-year bonus depreciation on its non-real estate property, like kitchen appliances and office furniture.

If you have thoughts and questions, or if you would like help with submitting comments to the IRS, please do not hesitate to contact the author, one of the attorneys on our Seniors Housing and Care team, or your regular NP attorney.

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