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Recent Tax Law Developments Relating To Commercial Real Estate

On February 15, 2002 the IRS issued guidance concluding that local "impact fees" paid by real estate developers in connection with the construction of new rental buildings are costs that should be capitalized and included in the tax basis of a building. A second point of interest is the Job Creation and Worker Assistance Act of 2002 (the "2002 Act"), which President George W. Bush signed into law on March 9, 2002. The 2002 Act contains a provision allowing for first-year "bonus depreciation" with respect to certain types of property placed in service after September 10, 2001. Both of these items are particularly relevant to those engaged in the development and ownership of commercial real estate.

Capitalization Of Impact Fees

In Revenue Ruling 2002-9, the IRS addressed whether impact fees paid by a taxpayer in connection with the construction of a new residential rental building should be capitalized costs allocable to the basis of the building. "Impact fees," in general, are one-time charges imposed by a state or local government for new development or expansion of existing development. Such fees are intended to finance specific offsite capital improvements used by the general public that are made necessary by the new or expanded development. The amount of an impact fee is usually based on the number of rental units in the taxpayer's building and the size of the building. Such fees are usually paid when the construction building permit for the property is issued.

In this ruling, the IRS clarified that impact fees should be capitalized and added to the basis of the property produced. If a depreciation deduction is allowable for the building, the taxpayer must depreciate the impact fees as residential real property or nonresidential real property, as appropriate, beginning when the newly constructed building or the expansion of the building is placed in service by the taxpayer.

Any change in a taxpayer's treatment of impact fees incurred in connection with the new construction or expansion of a building to conform with this new rule is a "change in method of accounting," and requires the filing of IRS Form 3115. If a taxpayer does change its method of accounting for this purpose, the treatment of impact fees will not be raised as an issue for the taxpayer in any taxable year before the year of change.

First-Year "Bonus" Depreciation

The 2002 Act amended current law to authorize an additional allowance for depreciation equal to 30% of the adjusted basis of certain "qualified property." The special depreciation allowance is

computed before the otherwise allowable depreciation deduction with respect to such property. The term "qualified property" includes, among other things, "qualified leasehold improvement property."

Qualified Leasehold Improvement Property

In general, to be "qualified leasehold improvement property," property must satisfy the following requirements: (1) the improvement must be made to the interior portion of a nonresidential building; (2) the improvement must be made under or pursuant to a lease by a lessee (or sublessee), or lessor, or pursuant to a commitment to enter into a lease; (3) the lessor and lessee (or sublessee) may not be related persons; (4) the portion of the building that is improved must be exclusively tenant-occupied (by a lessee or sublessee); and (5) the improvement must be placed in service more than three years after the date that the building was first placed in service. Thus, leasehold improvements to residential rental property, such as apartment buildings, are not considered qualified leasehold improvements. Exterior leasehold improvements to nonresidential real property, such as the addition of a roof, also would not qualify.

In order to qualify, the property must be acquired by the taxpayer after September 10, 2001 and before September 11, 2004, provided no binding written contract for the acquisition was in effect before September 11, 2001. Alternatively, the property may be acquired by the taxpayer pursuant to a binding written contract entered into after September 10, 2001 and before September 11, 2004. Further, the taxpayer must begin its original use of the property after September 10, 2001. The property must be placed in service by the taxpayer after September 10, 2001 and before January 1, 2005 (or, in the case of certain property that has a longer production period, before January 1, 2006).

Certain improvements are specifically excluded under the new law, such as improvements relating to the enlargement of the building or its internal structural framework, improvements to elevators and escalators and structural improvements benefiting common areas.

Qualified New York Liberty Zone Property

Under another provision of the 2002 Act, qualified New York Liberty Leasehold Improvement Property placed in service after September 10, 2001, and before January 1, 2007, is depreciable over five years instead of the usual 39 years. However, leasehold improvements that are eligible for this five-year recovery period are not also eligible for the 30% first-year bonus depreciation.

Leasehold improvements are "Qualified New York Liberty Zone Leasehold Improvements" if (i) the building to which they relate is located in the New York Liberty Zone; (ii) the improvement is placed in service after September 10, 2001, and before January 1, 2007; and (iii) no binding written contract for the improvement was in effect before September 11, 2001. The New York Liberty Zone is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in New York City.

Election Out

Bonus depreciation must be claimed unless a taxpayer elects out of it. The election out is made at the property class level. The election out applies to all property in the class or classes for which the election is made that is placed in service for the tax year of the election.

If you have any questions or comments about this client advisory, please contact **Jack Garraty** at (212) 808-7653 or jgarraty@kelleydrye.com, or **Jay Kolmar** at (973) 285-3428 or jkolmar@kelleydrye.com.