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Carefully Structured Ownership and Operation of a Mixed-Use Project May Offer Enhanced Depreciation Deductions

BY MIKE ROSENBERG, CPA, MBA

As Seen In
MANN REPORT

To sharpen the economic viability of a development project, a developer will often incorporate several components into a building to help offset the high land and construction costs. In particular, residential rental properties are often constructed as mixed-use projects which incorporate other uses, such as hotel, office and retail operations.

Developers of residential condominiums may also opt for more than just a one-shot event of making money on a sell-out of units. Some prefer retaining rental components of the development as a source of continuous revenue, and retention of an asset they can pass on to the next generation.

Mixed-use projects frequently incorporate an affordable housing component so they can rely on tax credits and tax-exempt bond financing to lower the cost of constructing multi-family units. For example, New York State and New York City co-sponsor the 80/20 Housing Program, which uses tax-exempt bonds to help finance affordable housing development.

Many mixed-use projects are located on a single tract of land and consist of a single building constructed in separate sections which produce different revenue streams. The sections are almost always owned by separate legal entities, such as limited liability companies (LLCs).

As a general rule, each section of the mixed-use project operated as a rental or business (such as a hotel) operation is assigned a cost recovery period for purposes of claiming depreciation deductions based on the character of the mixed-use property component. For example, recovery periods of 27.5 years and 39 years will be assigned to residential rental property and non-residential real property, respectively. Identifying the appropriate cost recovery period can have a material impact on available tax deductions which shelter a project's taxable income.

In certain cases a mixed-use building may be treated as a single property for purposes of determining the appropriate depreciation deductions, even if the mixed use components are held in separate entities. This may provide an opportunity to establish a shorter recovery period for the entire building and thus a larger annual tax deduction. The IRS has ruled favorably in this area based on the particular facts and circumstances. Although such a ruling is specific to a taxpayer and the specific facts of the case, it offers valuable insight into how to structure the ownership and operation of a mixed-use building.

For example, a single building was renovated into a mixed-use development consisting of two distinct sections – one containing residential rental apartments and the other hotel rooms. The two sections were built to function as one building. They shared numerous common elements including mechanical plant, plumbing distribution, fire protection system, electric room, freight elevators, emergency and maintenance stairways, parking and a restaurant. The lobbies were connected through a key card access door, and occupants of the rental apartments were able to purchase maid and room services from the hotel. Moreover, all building management and operations were jointly managed by a single project manager.

The project received funding from the U.S. Department of Housing and Urban Development (HUD). Because of a HUD regulatory requirement that the owner of the residential rental portion of the project not engage in any other business activity, such as a hotel operation, the ownership of the hotel and the apartment rental operations were separated into two legal entities that were structured to come under identical common ownership and control. While HUD also required maintenance of separate sets of books and records, as well as separate income statements and balance sheets, project funding was interrelated and the building's management issued a single consolidated financial statement.

Based on the above facts the IRS concluded that the apartment and hotel sections may be treated as a single building for purposes of determining whether the building can be classified as a residential property. Under current tax rules, if 80% or more of the annual gross rental income from the mixed-use building is generated from the residential rental apartments, the entire building and its structural components will qualify as a residential rental property. The significance of this classification is that the developer can depreciate the entire property using a faster cost recovery period of 27.5 years. This, coupled with a careful engineering and cost segregation study of the development costs of the property, can further enhance the depreciation deduction and provide added tax savings.

About Mike Rosenberg, CPA, MBA

Mike Rosenberg is a tax partner at Margolin, Winer & Evens LLP, where he chairs the firm's Family Business Practice Group, which focuses on integrating business, income tax, and estate and succession planning objectives of family groups and individuals. He also services clients in a wide range of industries, including real estate, manufacturing and distribution, and frequently consults on structuring domestic and international joint ventures, corporate and property acquisitions and divestitures. Mike can be reached at ***mrosenberg@mwellp.com.***

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