Congressional Oversight Lifts After-tax Cost of Leasehold Improvements



Executive Summary

Due to an oversight in the new tax bill, the depreciable life for leasehold improvements — improvements to the interior of nonresidential real property, such as office build-outs — has reverted to 39 years from 15 years. As a result, the depreciation expense one is able to take for tax purposes is significantly reduced on a per annum basis, as costs are expensed over a longer time period.

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The upshot is that the cost of improvements to internal space has become significantly more expensive from an after-tax perspective.

In Short:

Because of an oversight in the new tax bill, the depreciable life for leasehold improvements—improvements to the interior of nonresidential real property, such as office build-outs—has reverted to 39 years from 15 years. As a result, the depreciation expense one is able to take for tax purposes is significantly reduced on a per annum basis. Moreover, as written, leasehold improvements are not eligible for the 100% bonus depreciation that would have enabled firms to immediately expense the entire cost of property placed in-service after September 27, 2017 and before January 1, 2023. The upshot is that the cost of improvements to internal space has become significantly more expensive from an after-tax perspective. While the cash outlay for improvements will remain the same, the ability to immediately deduct 100% of an expense versus depreciating the same expense over a 39-year period effectively raises the cost from an overall tax perspective—mitigating part of the benefit to businesses from a reduction in the corporate tax rate to 21%. (Note that these changes refer to tax treatment, which is separate from GAAP accounting required for reporting purposes.)

Even if a fix is made to the depreciable life of leasehold improvements, many landlords will still be unable to take bonus depreciation. While most businesses will be subject to the limit on deducting net interest expense (generally, 30 percent of adjusted taxable income), "electing real property trades and businesses" are not subject to this cap. However, in exchange for this preferential treatment for real estate businesses operating with a high degree of leverage, electing entities must use the Alternative Depreciation System (ADS), which specifically precludes the use of bonus depreciation. As such, the decision as to whether the lessor or lessee owns any leasehold improvements may be more relevant than in the past should the law eventually change. (Any fix to the legislation would likely switch the depreciable life of leasehold improvements to 15 years; the use of ADS by "electing real property trades and businesses" and the inability of those entities to use bonus depreciation will likely remain in place.) When will a fix occur? It's anyone's guess since such a remedy would add to the deficit, and under the budget reconciliation process and the associated Byrd Amendment, no provision of a bill passed under reconciliation can add to the deficit beyond the budget's 10-year window.

From 2010 – 2014, all three types of qualified property were also eligible for Section 179 expensing.

First, Some Leasehold Improvement History

In October 2004, **the depreciation period for improvements of leased nonresidential real property was changed from 39 years to 15 years** under the American Jobs Creation Act (AJCA). The shorter recovery period was available to lessees, sub-lessees and lessors making improvements to the interior portion of the property as long as:

- The improvement was made under, or pursuant to a lease (not between related persons)
- The improvement was section 1250 property (i.e. a structural component), and not section 1245 property (personal property, such as furniture or equipment)
- The interior portion of the building was to be occupied exclusively by the lessee or any sub-lessee
- The improvement was placed into service more than three years after the date the building was first placed into service

Improvements qualified as long as they did **not** include:

- The enlargement of the building (as defined in Reg. section 1.48-12(c)(10))
- Elevators and escalators
- Structural components (as defined in Reg. section 1.48-1(e)(2)) benefiting a common area
- Internal structural framework (as defined in Reg. section 1.48-12(b)(3)(i)(D), see: *"Area of external walls and internal structural framework"*)

For example, qualified leasehold improvement property included the addition of built-in cabinetry, interior walls/partitions, electrical additions and flooring/carpeting as examples, but excluded the removal of load-bearing walls, replacement of a roof or windows or changes to external HVAC units.

The 2004 law also defined **'qualified restaurant property'**[1] as eligible for 15-year depreciation; subsequent law added **'qualified retail property'** to the list of eligible property as well.[2] Qualified leasehold improvement property was also eligible for bonus depreciation, whereas qualified restaurant and qualified retail improvement property were not, unless the improvements also met the definition of qualified leasehold improvement property.

[1] Qualified restaurant property: Any section 1250 property that represented an improvement to a building (and was later redefined to include the building as well), provided that more than 50 percent of the building's square footage was devoted to preparation of, and seating for, on-premises consumption of, prepared meals.

[2] Qualified retail property: Any improvements to interior portions of a nonresidential building that were open to the general public and used in the retail trade or business of selling tangible personal property to the general public. Qualified retail improvements had to be placed in service more than three years after the building was first placed in service in order to be eligible for 15-year depreciation, and extended to owners as well as lessees of such improvements.

For improvements placed in service starting in 2016, Congress created 'Qualified Improvement Property' (QIP) .

From 2010 – 2014, all three types of qualified property were also eligible for Section 179 expensing, although the amount was capped at $250k. (Keep in mind that expensing under Section 179 is taken first, followed by bonus depreciation on the remaining adjusted basis, and then "regular" MACRS depreciation, if needed.)

Note: The 15-year depreciation for qualified property was not elective. If a taxpayer wanted to depreciate improvements over a 39-year basis instead, he or she could do so by choosing the MACRS Alternative Depreciation System (ADS). However, this treatment would then apply to all other 15-year improvements placed in service over the same year.

What Changed with the PATH Act of 2015

The Protecting Americans from Tax Hikes (PATH) Act of 2015, P.L. 114-113 made a significant change to improvements eligible for bonus depreciation. **For improvements placed in service starting in 2016, Congress created 'qualified improvement property,' (QIP) a class of nonresidential real property eligible for bonus depreciation irrespective of its recovery period.** Note that the PATH Act did not eliminate qualified leasehold improvement property, qualified restaurant improvement property or qualified retail property; it just added QIP to the mix.

While QIP did not require the building to which improvements were being made to be at least 3 years old and such improvements did not need to be made subject to a lease, the "downside" to QIP was that the depreciable life of such property was 39 (and not 15) years; moreover, QIP was not eligible for Section 179 expensing. QIP also had to be original-use property (i.e., the original use of the property must have started with the taxpayer.) **Because QIP did not require that improvements be made subject to a lease, interior components such as common area improvements in multi-tenant buildings or interior improvements in owner-occupied buildings were generally eligible for bonus depreciation treatment.**

As with qualified leasehold improvement property, qualified restaurant improvement property and qualified retail property, QIP excluded expenditures used for any elevator or escalator or used to enlarge a building or modify a building's internal structural framework. **The PATH Act made permanent the 15-year depreciable life for qualified leasehold improvement property, qualified restaurant improvement property and qualified retail property, and lifted the cap for Section 179 treatment to $500K with dollar-for-dollar**

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phase-outs at $2M, retroactive to 2015, and indexed to inflation thereafter. Qualified retail improvement property was also made eligible for bonus depreciation. (While qualified restaurant property remained ineligible for bonus treatment, in those instances where qualified restaurant property also met the definition of QIP, it too was eligible for bonus depreciation.) Note that QIP was not eligible for Section 179 expensing unless it also met the definition of a qualified leasehold improvement property, qualified retail improvement property or qualified restaurant property.

Changes under the Tax Cut and Jobs Act of 2017

Possibly making leasehold improvement depreciation even more confusing, the Tax Cut and Jobs Act passed in December 2017 eliminated qualified leasehold improvement property, qualified restaurant improvement property and qualified retail property entirely; all that currently remains is qualified improvement property (QIP). **And here's the rub: due to an error in the text of the bill, QIP is no longer eligible for bonus depreciation (although it is eligible for Section 179 expensing), despite the fact that this appeared to be Congress' intention.**

As written, only assets with "regular" depreciable lives of 20 years or less are considered 'qualified property' eligible for bonus treatment. **QIP appears to have been left off the list of 15-year property** (and 20-year property, too) **and instead, is "regular" nonresidential real property with a 39-year life** (Appendix I). Moreover, only assets that are NOT depreciated under the Alternative Depreciation System are eligible for bonus depreciation (Appendix II).

Why is this important? Real estate entities that elect to "opt out" of the restriction on deducting interest expenses in excess of 30% of taxable income are compelled to use the Alternative Depreciation System, whereby nonresidential real property is depreciated over 40 years, and residential rental property is depreciated over 30 years (Appendix III). **Even if a "fix" is made to allow bonus treatment for qualified improvement property, it is almost certain that those real estate entities that avail themselves of the ability to opt out of the interest expense deduction cap (as 'electing real property trades or businesses') will remain ineligible to take bonus depreciation.**

Are there any positives for leasehold improvements from December's tax changes? One benefit that was retained is the ability for QIP to be eligible for Section 179 expensing; limits were raised to $1M, with dollar-for-dollar reductions beginning at $2.5M (up from $500K and $2M, respectively, under the PATH Act.) In addition, improvements to nonresidential real property including a) roofs b) heating, ventilation, and air-conditioning property c) fire protection and alarm systems and d) security systems were explicitly added as eligible property under Section 179, as were certain depreciable tangible personal property items used predominantly to furnish lodging or in connection with furnishing lodging. This may be small consolation in light of the fact that first-year bonus depreciation is rising from 50% to 100%, and now applies to purchases of new or used property (previously, only new property was eligible.)



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Appendix I

QIP Defined; Missing From List of 15-Year Property

IRC Sections 168(e)(6)(A) and 168(e)(6)(B)

(6) Qualified Improvement Property

A. In general

A. The term "qualified improvement property" means any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.

B. Certain improvements not included

(i) the enlargement of the building,

(ii) any elevator or escalator, or

(iii) the internal structural framework of the building

IRC Sections 168(e)(3)(E)

E. 15-year property The term "15-year property" includes:

(i) any municipal wastewater treatment plant,

(ii) any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications,

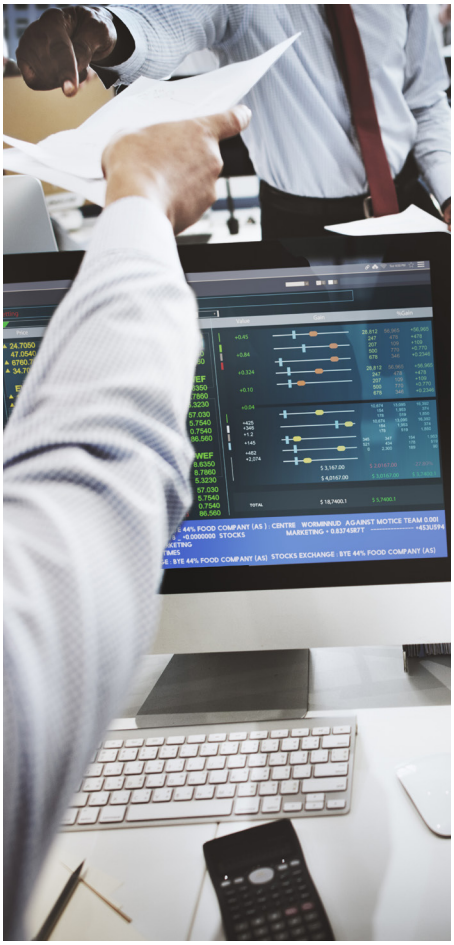
(iii) any section 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet),

(iv) initial clearing and grading land improvements with respect to gas utility property,

(v) any section 1245 property (as defined in section 1245(a)(3)) used in the transmission at 69 or more kilovolts of electricity for sale and the original use of which commences with the taxpayer after April 11, 2005, and

(vi) any natural gas distribution line the original use of which commences with the taxpayer after April 11, 2005, and which is placed in service before January 1, 2011.

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IRC Section 168(c)

C. Applicable Recovery Period

i. For purposes of this section, the applicable recovery period shall be determined in accordance with the following table:

In case of:	The applicable recovery period is:
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
Water utility property	25 years
Residential rental property	27.5 years
Nonresidential real property	39 years
Any railroad grading or tunnel bore	50 years



Appendix II

Property Eligible for Additional (Bonus Depreciation) Allowances

IRC Sections 168(k)(1)(A), 168(k)(1)(B) and 168(k)(2)(A)

(K) Special allowance for certain property

(1) Additional allowance in the case of any qualified property

A. the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property, and

B. the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

(2) Qualified property for purposes of this subsection

A. **In general**, *the term "qualified property" means property*

(i)

(I) to which this section applies which has a recovery period of 20 years or less

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection, or

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection,

IRC Section 168(k)(2)(D)

(D) Exception for alternative depreciation property the term "qualified property" shall not include any property to which the alternative depreciation system under subsection (g) applies, determined

(i) without regard to paragraph (7) of subsection (g) (relating to election to have system apply), and

(ii) after application of section 280F(b) (relating to listed property with limited business use).



Appendix III

ADS and Electing Real Property Trades and Businesses

IRC Section 168(g)(1) and 1689(g)(2)

(g) Alternative depreciation system for certain property

(1) In general in the case of

(A) any tangible property which during the taxable year is used predominantly outside the United States,

(B) any tax-exempt use property,

(C) any tax-exempt bond financed property,

(D) any imported property covered by an Executive order under paragraph (6),

(E) any property to which an election under paragraph (7) applies,

(F) any property described in paragraph (8), and

(G) any property with a recovery period of 10 years or more which is held by an electing farming business (as defined in section 163(j)(7)(C)),

the depreciation deduction provided by section 167(a) shall be determined under the alternative depreciation system.

(2) Alternative depreciation system for purposes of paragraph (1), the alternative depreciation system is depreciation determined by using

(A) the straight line method (without regard to salvage value),

(B) the applicable convention determined under subsection (d), and

(C) a recovery period determined under the following table:

In case of:	The recovery period shall be:
(i) Property not described in clause (ii) or (iii)	The class life
(ii) Personal property with no class life	12 years
(iii) Residential rental property	30 years
(iv) Nonresidential real property	40 years
(v) Any railroad grading or tunnel bore or water utility property	50 years

IRC Section 168(g)(8)

(8) Electing real property trade or business

The property described in this paragraph shall consist of any nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business (as defined in 163(j)(7)(B)).