QUALIFIED IMPROVEMENT PROPERTY (QIP) TECHNICAL CORRECTION AND BONUS DEPRECIATION

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The coronavirus has turned the world upside down. It has cost so many lives and caused agony to individuals and businesses. To help stimulate the economy and U.S. citizens and business to get over this devastating pandemic, the "Coronavirus Aid, Relief, and Economic Security Act" (CARES Act) was enacted in March 2020, providing many tax provisions that favor taxpayers. Within the CARES Act is the long-waited technical correction related to Qualified Improvement Property (QIP).

BACKGROUND

Historically, building improvement had a long useful life for depreciation purposes. Commercial real estate is depreciated over 39 years on a straight-line basis. Therefore, it takes years for businesses to recover their investment. To help stimulate the real estate sector after September 11, 2001, Congress put in place various provisions that allowed certain qualified real property to be depreciated over 15 years instead of 39 years. Furthermore, certain real property also qualified for bonus deprecation, which allowed businesses to fully depreciate such property in the placed-in-service year.

The Tax Cuts and Jobs Act (TCJA) enacted in 2017, consolidated the three categories of real property into what is now called Qualified Improvement Property (QIP): qualified leasehold improvements, qualified retail improvements, and qualified restaurant property. QIP is defined as any improvement made by the taxpayer to an interior portion of a building that is nonresidential real property as long as that improvement is placed in service after the building was first placed in service by any taxpayer. Qualified improvement property specifically excludes expenditures for (1) the enlargement of the building; (2) elevators or escalators; and (3) the internal structural framework of a building.

The introduction of QIP is meant to simplify and streamline the various provisions introduced throughout the years while maintaining the same benefits that have been provided to taxpayers. However, the TCJA was written in such a hurry that a major oversight caused qualified improvement property, to be depreciated over 39 years instead of 15 years as intended by Congress. Such oversight also caused qualified improvement property to be ineligible for bonus depreciation. We have been waiting for technical corrections on this issue ever since TCJA came out.

BONUS DEPRECIATION

In 2002, Congress enacted bonus depreciation through the Job Creation and Worker Assistance Act as a tax incentive measure to stimulate the economy. Bonus depreciation is a method of accelerated depreciation that allows businesses to deduct the cost of an eligible property in the first-year of service. Depreciable business assets with a recovery period of 20 years or less and other types of property are generally eligible. For example, machinery, equipment, computers, appliances, and furniture generally qualify.

As time goes by, the rules and limits for bonus depreciation continue to change. The Tax Cuts and Jobs Act (TCJA) of 2017 made favorable changes to bonus depreciation that impacted all industries, including real estate.

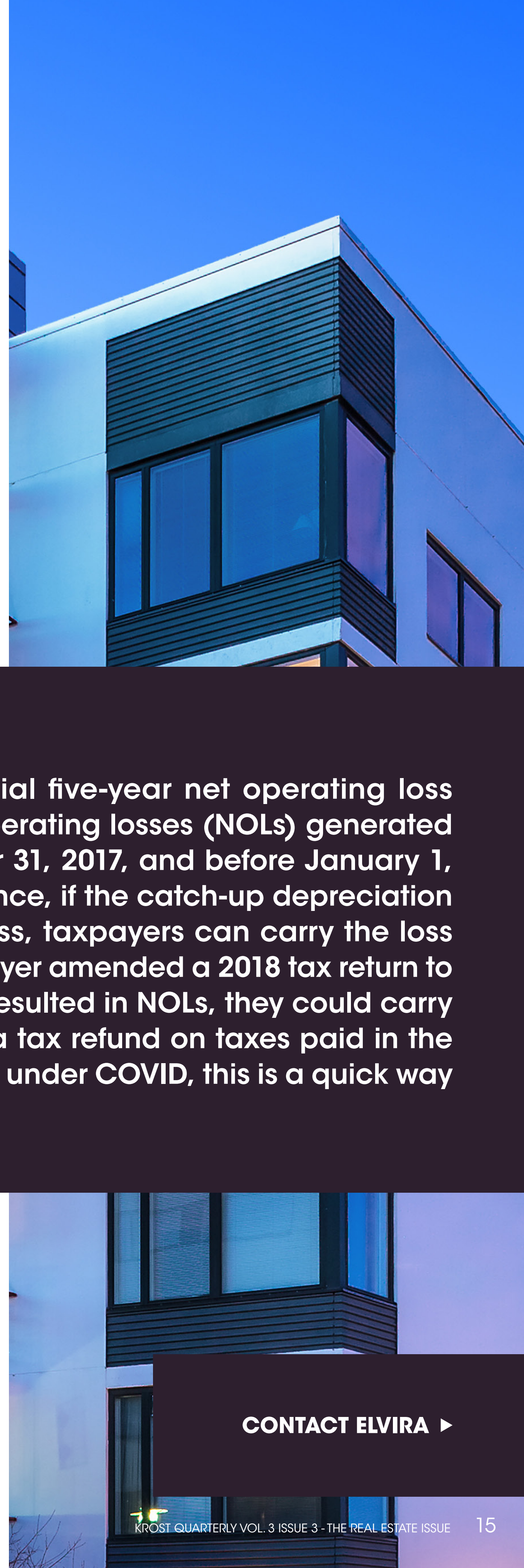
The major changes are:

- Increased first-year depreciation deduction from 50% to 100% for eligible property acquired and placed in service after September 27, 2017 and before January 1, 2023.
- Available not only to new assets but was also expanded to include used qualified property that meets the following requirements:
    - The taxpayer or its predecessor didn't use the property at any time before acquiring it.
    - The taxpayer didn't acquire the property from a related party.
    - The taxpayer didn't acquire the property from a component member of a controlled group of corporations.
    - The taxpayer's basis of the used property purchased is not figured in whole or in part by reference to the seller or transferor's adjusted basis.
    - The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.
    - The cost of the used property eligible for bonus depreciation doesn't include the basis of property determined by reference to the basis of other property held at any time by the taxpayer (for example, in a like-kind exchange or involuntary conversion).
- The law added certain film, television, and live theatrical productions as types of qualified property that may be eligible for 100% bonus depreciation.
- The 100% bonus depreciation is also allowed for specified plants planted or grafted after September 27, 2017 and extended to before January 1, 2027.
- The 100% bonus depreciation will decrease by 20% per each taxable year beginning after 2022 and expires January 1, 2027.

TECHNICAL CORRECTION ON QIP UNDER CARES ACT

The CARES Act provides a $2 trillion support relief package to help stabilize the American economy. Within the Act is the technical correction to the QIP provision, which designates qualified improvement property as 15-year property for depreciation purposes. As such, QIP is eligible for 100% bonus depreciation treatment. More importantly, this correction is retroactive for property placed in service after December 31, 2017.

To help taxpayers implement the change, the IRS released Rev. Proc. 2020-25, allowing taxpayers to file a change of accounting method using Form 3115 with the current year of income tax return filing to catch up on the missed depreciation on qualified improvement property. Alternatively, taxpayers can amend 2018 returns (and possibly 2019 returns if the 2019 returns have been filed) to claim the missed deduction.



INSIGHT:
The CARES Act also provides a special five-year net operating loss carryback. This provision allows net operating losses (NOLs) generated in tax years beginning after December 31, 2017, and before January 1, 2021 to be carried back five years. Hence, if the catch-up depreciation deduction created a net operating loss, taxpayers can carry the loss back five years. For example, if a taxpayer amended a 2018 tax return to catch up on a missed deduction that resulted in NOLs, they could carry the loss as far back to 2013 to obtain a tax refund on taxes paid in the prior five years. For businesses suffering under COVID, this is a quick way to increase cash flow.

While the pandemic is causing a lot of grief and uncertainty, the technical correction on qualified improvement property is well-received. Taxpayers should review their depreciation schedule and discuss with their tax advisor to get the most benefits in a time when it is needed most. ■

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