The Tax Treatment of Qualified Improvement Property

By Marty McCarthy, CPA, CCIFP

The Tax Cuts and Jobs Act (TCJA) of 2017 changed some widely used deductions for purchases of qualified property. TCJA consolidated the three categories of qualified real property into one qualified improvement property (QIP). The class lives of QIP should have been defined under TCJA to determine its bonus depreciation eligibility. Although it is likely that Congress intended to make QIP eligible for a 15-year modified accelerated cost recovery system (MACRS) class life and 20-year alternative depreciation system (ADS) class life, the link was omitted in TCJA making its depreciation eligibility uncertain.

MACRS is a depreciation system which allows the capitalized cost basis of assets to be recovered over a specified life of the asset by annual deductions for value depreciation. ADS is a depreciation schedule with a longer recovery period that generally better mirrors the asset's income streams than declining balance depreciation.

The uncertainty of the class life of QIP directly affects anyone in a real property trade or business (RPTB) with average gross receipts of $25 million over the prior three years. This is due to the interplay between 100% bonus depreciation and the new rules limiting business interest. RPTB includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Business interest deductions after December 31, 2017, are limited to the sum of business interest income plus 30% of adjusted taxable income (computed before allowable deductions for interest, depreciation, amortization, depletion, net operating losses, and the pass-through entity deduction). A RPTB can elect out of the business interest limitation rules and deduct all its business interest expenses. In this case, the RPTB is generally required to depreciate any residential rental property, nonresidential rental property, and QIP using the ADS method, and with lives of 30 years, 40 years, and 20 years respectively. The ADS method prohibits the use of bonus depreciation. A RPTB could also elect to submit to the business interest limitations. In this case the RPTB could take 100% bonus depreciation on its QIP plus land improvements or other personal property building components on MACRS property with recovery periods of 20 years or less.

Because of the Congressional oversight in failing to define QIP as property qualifying for a 15-year MACRS class life and a 20-year ADS class life, QIP is currently not available for

100% bonus depreciation, and must be depreciated over 39 years. Businesses with property placed in service between September 27, 2017, and December 31, 2017, must use the prior definitions of qualified leasehold improvements, qualified restaurant property, qualified retail improvement property, and qualified improvement property. After December 31, 2017, such property is classified as QIP under TCJA and is subject to the 39-year depreciation period with no bonus depreciation available.

Section 179 and Bonus Depreciation Under TCJA

IRS code Sections 179 and 168(k) (bonus depreciation) allow for the immediate deduction of part or all the cost of qualified property. TCJA changed the limits for the deductions allowed under both code sections.

The maximum annual Section 179 deduction increased from $500,000 to $1 million for qualified property placed in service after December 31, 2017. TCJA increased the annual phase-out threshold from $2 million to $2.5 million. The Section 179 deduction begins to phase out dollar-for-dollar after $2.5 million is spent on qualified property.

TCJA expanded the definition of qualified real property eligible for code Section 179 to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Bonus depreciation allows for the faster deprecation of assets with class lives of 20 years or less. The deduction for bonus depreciation increased from 50% to 100% and TCJA extended the phase-out period. A 100% first year deduction is allowed for qualified property placed in service after September 27, 2017, and before January 1, 2024. The deduction will start phasing out in 2024, going down to 80%, with a decrease of 20% for each year after that, until it phases out completely in 2026.

Depreciation of Dismountable Wall Systems

Since the IRS classifies dismountable walls as furniture and fixtures (asset class 00.11: nonstructural component of a building), the cost can be depreciated over 7 years under MACRS instead of 39 years.

Dismountable walls generally qualify for the Section 179 deduction. The combination of the Section 179 tax deduction with bonus depreciation may allow a company to expense 100% of a dismountable wall's cost in the first year it is placed into service (if it is done after September 27, 2017, and before January 1, 2023). The bonus depreciation percentage for qualified property acquired before September 28, 2017, and placed in service before January 1, 2018, remains at 50%. Special rules apply for longer production period property.

Under Section 179 rules, qualifying assets that cost under $500,000 can be written off 100% in the first year. A bonus deprecation deduction can be used for assets costing more than $500,000. Companies can benefit from both Section 179 and the bonus depreciation deduction, regardless if they pay cash or finance an asset.

Section 179 and bonus depreciation deductions are treated differently at the state level. Some states eliminated these deductions. Instead they have a more traditional depreciation deduction. Other states use a combination of these deductions and depreciation deductions. A few states have not decided on what approach to take. Therefore, it is advisable to check the depreciation laws in each state in which you do business to ensure that you are in compliance.

QIP and Cost Segregation Studies

Since Congress did not define the class lives of QIP under TCJA, a contractor may think that their only option is to depreciate a QIP as a 39-year property. There is, however, another

possible way to accelerate the depreciation of the asset. A Cost Segregation Study combines accounting and engineering techniques to identify building costs that are properly allocable to tangible personal property rather than real property. This could potentially allow you to accelerate depreciation deductions, thus reducing taxes and boosting cash flow.

A Cost Segregation Study allocates the purchase price or costs to construct a building into various components to separate assets with depreciable lives of 5, 7, or 15 years from the building, which would be depreciated over 27.5 or 39 years.

TCJA made Cost Segregation Studies even more valuable than they were before. Under TCJA, a taxpayer can now take bonus depreciation on "used" assets. Assets with depreciable lives of less than 20 years generally may now qualify for bonus depreciation.

For assets placed in service after September 27, 2017, bonus depreciation is 100% (special rules apply for binding contracts executed prior to that date). Bonus depreciation was 50% on assets placed in service before September 27, 2017.

As a result of a Cost Segregation Study, an asset with a life less than 20 years can be fully expensed in the year the asset was placed in service or the year the Cost Segregation Study was completed provided it was done in a subsequent year.

Most providers of cost segregation services do not charge for estimates to determine the potential savings.

Contractors have a lot to consider with regards to the tax treatment of QIP. It is advisable to run different scenarios to determine which option will provide the best benefit.

About the Author

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Marty McCarthy, CPA, CCIFP, is the managing partner of McCarthy & Company, PC. Marty is well respected by sureties and bankers for the high quality of his work and profound understanding of the construction industry. Marty helps clients by providing them with the insight needed to grow their business.

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