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Qualified Improvement Property and the 2017 Tax Revision (P.L. 115-97)

The major tax revision (P.L. 115-97) enacted at the end of 2017 made significant changes in the options available to companies for recovering the cost of many of the depreciable capital assets they use in their businesses. One such asset was certain improvements to nonresidential real estate, known as qualified improvement property (QIP). While the law allowed the cost of assets other than buildings to be fully expensed (i.e., treating the cost as a current expense, not a capital expense), the cost recovery period for QIP was unintentionally extended through what some have called the "retail glitch," making the property ineligible for this treatment.

Under an income tax, companies are allowed to deduct the ordinary and necessary expenses they incur in producing income. Many of these expenses are for inputs whose value does not extend beyond the year when they are used (e.g., worker compensation and materials). But some inputs retain their value longer than the year they are first used. Examples include machines, motor vehicles, and factory buildings. The proper approach to recovering their cost is to gradually recover it through deductions for the decline in their value over time. This decline in value is known as depreciation and typically stems from wear and tear or obsolescence in the use of a depreciable asset. Deductions for depreciation usually are taken over three or more years under the federal income tax, until the original cost of an asset has been recovered.

Depreciation that reflects the actual decline in the market value of an asset from year to year is known as economic depreciation. When used as the basis for recovering the cost of depreciable assets for tax purposes, economic depreciation promotes neutrality in the impact of an income tax on investment in those assets. In practice, the difficulties and cost of measuring the actual decline in the market value of an asset mean that most systems for depreciating the cost of assets for tax purposes deviate from economic depreciation for most assets.

Current Depreciation for Tangible Assets

There are two systems for depreciating tangible assets under current law: (1) the modified accelerated cost recovery system, or MACRS (§168 of the federal tax code); and (2) the slower alternative depreciation system, or ADS (§167). The former is accelerated relative to the latter, which is thought to be a better approximation of the rate of economic depreciation for the tangible depreciable assets covered by each system. The MACRS allows shorter depreciation lives and depreciation schedules that make it possible for firms to write off more of an asset's cost early in its recovery period.

Current tax law contains two provisions that allow firms to expense (or deduct as a current cost) part or all of the cost of eligible assets in the year they are first placed in service. Section 179, which applies to machinery and equipment, computer software, and selected nonresidential real property (including improvements to such property), allows companies to expense a limited amount of the cost of qualified assets in the year when they are placed in service. For the 2018 tax year, the allowance was capped at $1 million, an amount that began to phase out dollar-for-dollar when a company's total spending on qualified assets exceeded $2.5 million.

The other provision is a 100% expensing allowance under Section 168(k) known as the bonus depreciation allowance. For the most part, it applies to tangible assets with a depreciation life of 20 years or less under the MACRS. The current allowance covers 100% of the cost of qualified assets placed in service between September 28, 2017, and December 31, 2022. This allowance is scheduled to decrease to 80% of the cost of qualified assets in 2023, 60% in 2024, 40% in 2025, and 20% in 2026; it is not available for tax years beginning in 2027 and thereafter.

Depreciation for Qualified Improvement Property

Among the assets subject to depreciation for tax purposes are certain improvements that businesses make to the interior space they occupy of nonresidential buildings. The improvements can be made by leaseholders, or by owners of the structures. They can take many forms, such as installing new lighting and carpet in a leased office, adding new woodwork and windows to the dining room of a restaurant, and painting the walls and upgrading the sound system of a retail store.

Legislative Background

Before the passage of the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357), the cost of improvements to nonresidential real property was generally recovered over 39 years, which was the recovery period for the property itself under the MACRS. This treatment reflected a long-standing tax rule that additions or improvements to nonresidential real property should be depreciated over the same period as the real property.

AJCA lowered the recovery period for both "qualified leasehold improvement property (QLP)" and "qualified restaurant improvement property (QRP)" to 15 years, making them eligible for the 50% bonus depreciation allowance that was available when this change in recovery period went into effect on October 23, 2004. Improvements to leasehold property qualified for the 15-year recovery period if they were made according to the terms of a lease

by the lessee or the lessor, were placed in service more than three years after the building was first placed in service, and did not enlarge the building, install or upgrade elevators or escalators, or alter the building's "internal structural framework." Improvements to restaurant property were depreciable over 15 years if they were placed in service more than three years after the building was first placed in service, and at least 50% of the building's interior space was used for food preparation and dining on the premises. The cost of QLP and QRP had to be recovered using the straight-line method of depreciation, which meant that the same amount of the cost was deducted in each year of the recovery period.

Congress created a separate category for "retail improvement property (QREP)" and assigned a 15-year tax life to qualified property placed in service starting in 2009. The legislative vehicle for the change was the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Division C of P.L. 110-343). Property qualified for this treatment if it involved one or more improvements to the interior of a nonresidential building; the building's interior was open to the general public and used primarily for selling tangible personal property to the general public; and the improvement was placed in service more than three years after the building was first placed in service. Such property had to be depreciated using the straight-line method. QREP was eligible for partial expensing under Section 168(k).

The Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113) permanently extended the 15-year recovery period for QLP, QRP, and QREP. It also established a fourth category of improvement property known as qualified improvement property (QIP). QIP was defined as an improvement to the interior of a nonresidential building that did not involve enlarging the structure, upgrading or installing elevators or escalators, or modifying its internal structural framework. In addition, the property only had to be placed in service after the building was placed in service, and it did not have to involve a lease. The tax life for QIP was set at either 15 years or 39 years. The 15-year recovery period applied only if the improvement property met the requirements for QLP, QRP, or QREP. As with the other categories of improvement property, the straight-line method had to be used in recovering the cost of QIP; it qualified for the Section 168(k) expensing provision only if it could be depreciated over 15 years.

Impact of P.L. 115-97

The major tax revision enacted in late 2017 (P.L. 115-97) accelerated the depreciation of most assets except for nonresidential real estate. In addition, it modified the depreciation rules for improvement property. Specifically, it consolidated the four previous categories of improvement property into a single category called QIP. This treatment applied to tax years beginning in 2018 and thereafter. The definition of QIP stayed the same from previous tax law.

The language of the bill as signed into law, however, omitted any reference to assigning a 15-year recovery period to QIP. It is unclear why this happened, but it appears that Congress intended to establish a 15-year tax life for the property under MACRS. According to the Conference Agreement for H.R. 1 (H.Rept. 115-466, p. 367), there was to be "a general 15-year MACRS recovery period for qualified improvement property." Unless Congress passes a technical correction to the law, QIP will generally be subject to a 39-year cost recovery period. Moreover, without such a correction, QIP is ineligible for the bonus depreciation allowance under Section 168(k). But QIP does qualify for the Section 179 expensing allowance.

Companion bills have been introduced in the House (H.R. 1869) and Senate (S. 803) to make QIP eligible for the expensing allowance by assigning it a 15-year MACRS recovery period and a 20-year ADS recovery period. The proposals come against a backdrop of complaints from owners and lessors/lessees of retail stores, office space, and restaurants about the financial disadvantages of using a 39-year cost recovery period for property improvements.

Accelerated Depreciation and Investment in Qualified Improvement Property

Why does the tax treatment of depreciation for QIP matter to business owners? The answer lies in the potential benefits of accelerated depreciation for companies investing in affected assets.

In theory, accelerated depreciation is a form of tax deferral. While it does not alter the total amount of depreciation allowances a company can take for an asset, it does defer the payment of income tax on the returns from investing in the asset. This is because the allowances are taken earlier than they would be under economic depreciation. The company is better off, since a dollar received today is worth more than a dollar received in a future year. Companies benefit from accelerated depreciation through (1) the interest they could earn on deferred taxes, (2) a reduction in tax liability from the net present value of deferred taxes, (3) an increase in the after-tax rate of return on an investment, and (4) a decline in the effective tax rate on the returns from that investment. This suggests that accelerated depreciation has the potential to boost investment in an asset by lowering the user cost of capital for the investment, and by increasing the cash flow of companies making such an investment.

It can be argued that current tax law inadvertently discourages investment in QIP through its treatment of depreciation for the property. This is because the property is not eligible for the benefits of accelerated depreciation. A 39-year recovery period with no bonus depreciation means a higher user cost of capital for investment in QIP and lower cash flow, relative to 100% or 50% bonus depreciation with a 15-year recovery period.

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