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Tax Depreciation of Qualified Improvement Property: Current Status and Legislative History

The federal income tax allows companies to deduct the ordinary and necessary expenses they incur in generating taxable income. These expenses include the cost of assets whose value lasts beyond the year when they are first used, such as machinery, motor vehicles, and factory buildings. The proper approach to recovering the cost of such assets is to deduct amounts over time that reflect the actual decline in their value, until the original cost has been recovered. This decline in value is known as depreciation. Deductions for depreciation usually are taken over three or more years.

Depreciation based on the actual decline in the value of an asset is known as economic depreciation. An advantage of economic depreciation is that it fosters neutrality in an income tax's impact on the returns to investment in a range of depreciable assets. For several reasons (including a desire to simplify business tax accounting), many countries employ systems for tax depreciation that deviate from economic depreciation.

Depreciation of Tangible Assets under Current Federal Tax Law

There are two systems for depreciating tangible assets (e.g., nonresidential buildings, equipment, and software) under current law: (1) the modified accelerated cost recovery system, or MACRS (Section 168 of the federal tax code); and (2) the alternative depreciation system, or ADS (Section 167 of the federal tax code). With its generally shorter depreciation lives and accelerated depreciation schedules, the MACRS allows firms to write off a larger portion of an asset's cost early in its recovery period.

The MACRS contains two provisions that allow firms to expense part or all of the cost of eligible assets. Section 179, which applies to machinery and equipment, computer software, and selected nonresidential real 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 2020 tax year, the allowance is capped at $1.04 million for a taxpayer, and it begins to phase out when a company's total spending on qualified assets in 2020 exceeds $2.59 million. Both amounts are indexed for inflation.

Section 168(k), known as the bonus depreciation allowance, 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. It is scheduled to decrease to 80% of the cost of qualified assets placed in service in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and 0% in 2027 and thereafter.

Depreciation of Qualified Improvement Property

Federal tax law regards the cost of certain improvements that leaseholders or owners make to the interior space of nonresidential buildings as a capital expense. As a result, the cost of this improvement property is recovered through allowable depreciation deductions. Improvement property can take many forms, including 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.

Before the enactment of the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357), the cost of improvement property was generally recovered over 39 years using the straight-line method under the ADS. This method requires businesses to deduct an equal amount of the acquisition cost of a depreciable asset every year until the initial cost has been recovered.

The AJCA established two categories of improvement property ("qualified leasehold improvement property," or QLP, and "qualified restaurant improvement property," or QRP) and lowered their cost recovery period under the MACRS to 15 years, making both kinds of improvement property eligible for the 50% bonus depreciation allowance then available under Section 168(k). Consequently, nonresidential building owners or leaseholders could write off half the cost of new improvement property in the year it was placed in service and the remaining half over the following 14 years with the straight-line method.

Improvements to leasehold property qualified for the 15-year cost recovery period if they (1) were made according to the terms of a lease by the lessee or the lessor; (2) were placed in service more than three years after the nonresidential building was first placed in service; and (3) did not enlarge the building, install or upgrade elevators and escalators, or alter its "internal structural framework."

Improvements to restaurant property qualified for the 15-year cost recovery period if they met two criteria. First, the improvements had to be placed in service more than three years after the building was first placed in service. Second, at least 50% of a building's interior space had to be used for food preparation and dining on the premises.

In 2008, Congress created a separate category of improvement property for retailers known as "qualified retail improvement property" (QRIP) in the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Division C of P.L. 110-343). The act assigned a 15-year cost recovery period to QRIP placed in service in 2009 and thereafter. Retail improvements qualified for this treatment

if (1) they represented an upgrade to the interior of a nonresidential building; (2) the building's interior was open to the general public and used primarily for selling tangible personal property to the general public; and (3) the improvement property was placed in service more than three years after the building was first placed in service. Like QLP and QRP, the cost of QRIP had to be recovered using the straight-line method of depreciation and was eligible for the expensing allowance 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 QRIP. It also created a fourth category of improvement property known as qualified improvement property (QIP). Improvement property qualified as QIP if it satisfied several criteria. First, the property had to improve the interior of a nonresidential building without enlarging the building, upgrading or installing elevators or escalators, or modifying its internal structural framework. Second, the property had to be placed in service after the building was placed in service, not three or more years afterward as was the case with QLP, QRP, and QRIP. Third, the property could be placed in service without a lease. Cost recovery for QIP could take place over 15 years or 39 years. The 15-year depreciation life applied only if QIP also met the requirements for QLP, QRP, or QRIP. Cost recovery for QIP had to be done with the straight-line method, and it qualified for the Section 168(k) expensing allowance only if the property qualified for 15-year cost recovery.

The tax revision enacted in late 2017 (P.L. 115-97) accelerated the depreciation of many tangible assets, but not nonresidential buildings. Still, it did modify the depreciation rules for improvement property by combining the four categories of improvement property under previous law into a single category called QIP and setting forth the conditions that had to be satisfied if QIP was to be considered 15-year property. Those conditions were the same conditions that defined QIP under previous law. This change applied to tax years beginning in 2018 and thereafter.

However, contrary to congressional intent, the act inadvertently left QIP off the list of assets eligible for a 15-year cost recovery period under the MACRS. The conference agreement for H.R. 1 (H.Rept. 115-466) specified that there was to be "a general 15-year MACRS recovery period for qualified improvement property."

As a result, the cost of QIP had to be recovered over 39 years under the MACRS (or 40 years under the ADS). As 39-year property, QIP was ineligible for the Section 168(k) 100% expensing allowance that the 2017 tax revision established through 2022—although QIP did continue to qualify for the Section 179 expensing allowance. Several bills in the 115th and 116th Congresses would have rectified this unintended omission.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) corrected the omission by designating QIP as 15-year property under the MACRS and 20-year property under the ADS, if the qualified improvement is done by the taxpayer. In both cases, cost recovery has to use the straight-line method. This modification was made retroactive to January 1, 2018, the date most of the changes made by the tax revision went into effect. Business owners have several options for claiming 15-year treatment for QIP placed in service in 2018, 2019, and 2020, including filing amended returns for 2018 and 2019.

Accelerated Depreciation and Investment in Qualified Improvement Property

The tax treatment of depreciation for QIP matters to owners of commercial real estate and leaseholders because it can affect the cost of capital. In theory, speeding up the depreciation of QIP defers the payment of tax on the profits it earns. While faster depreciation does not alter the total amount that can be deducted for the cost of QIP, it does reduce the present value of taxes on the returns from investing in the asset. This reduction reflects the fact that a dollar received today is worth more than a dollar received in a future year. Accelerating the tax depreciation of QIP lowers the pretax rate of return an investment in QIP has to earn to achieve a targeted after-tax rate of return.

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