Tax Reform: Cost Recovery

Immediate Expensing Available for Personal Property and Certain Improvements; Legislative Correction Needed for Qualified Improvement Property

Last updated: June 1, 2018

Executive Summary

- Section 13201 of the Tax Cuts and Jobs Act (H.R. 1, TCJA) generally allows immediate 100% additional first-year depreciation ("bonus depreciation") of "qualified property" (defined by section 168(k)) acquired and placed in service between September 27, 2017 and December 31, 2022.

- The bonus depreciation rate is then phased down by 20% each year until 2026 (*i.e.*, the percentage decreases to 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, and 20% for property placed in service in 2026).

- *Business Election Required.* The new law retains the MACRS recovery periods of 39 years and 27.5 years for nonresidential real property and residential rental properties, respectively. *However*, real property trades and businesses that elect out of the interest deductibility restriction of H.R. 1 must use alternative depreciation system (ADS) recovery periods, which are 40 years and 30 years for nonresidential real property and residential rental property, respectively.

- The new law excludes certain public utility property from the definition of qualified property, but does not explicitly exclude property used in a real property trade or business. However, assets with recovery periods greater than 20 years generally do not qualify for bonus depreciation.

COST RECOVERY QUICK FACTS

- The Tax Cuts and Jobs Act retains the Modified Accelerated Cost Recovery System (MACRS) recovery periods of 39 years and 27.5 years for nonresidential real property and residential rental property, respectively. Use of the MACRS is subject to businesses' election under interest expense provisions.

- Businesses electing out of interest deductibility restriction must use 40-year Alternative Depreciation System (ADS) recovery period for nonresidential real property.

- Assets used in a real property trade or business are not explicitly excluded from bonus depreciation eligibility, but assets with recovery periods greater than 20 years are generally ineligible.

- The legislation also increased the section 179 small business expensing limitation to $1 million, and increased the amount at which the benefit begins to phase out to $2.5 million (both indexed for inflation).

- The definition of qualified real property eligible for section 179 expensing purposes was expanded to include certain improvements (*e.g.*, roofs, heating/AC systems, fire systems, and security systems) to nonresidential real property placed in service after the date such property was first placed in service.

Next Steps

- **Implementing the new tax law:** H.R. 1 provides that the IRS may issue guidance for purposes of determining whether property is considered acquired after September 27, 2017, and thus eligible for the 100% bonus depreciation rate. The Treasury Department is generally authorized to write a broad range of new rules to effectuate provisions added to the tax code by the Tax Cuts and Jobs Act. IRS officials have indicated the agency will announce additional regulations and guidance involving the depreciation and expensing provisions of the new law in the future – guidance will be slow to finalize and could take nearly two years to complete.

- **Technical Corrections:** There is a mistake in the statute that affects “qualified improvement property” (generally defined as an improvement to the interior of a nonresidential building that is placed in service after the date on which the building was placed in service).

    - According to the conference report accompanying the Tax Cuts and Jobs Act, Congress intended to consolidate three categories of property—qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (all previously listed as separate 15-year properties)—into a new, expanded “qualified improvement property” category and assign that category a 15-year MACRS recovery period and a 20-year ADS recovery period.

    - However, due to two related drafting errors in revised section 168 of the Code, “qualified improvement property” was not assigned a 15-year MACRS recovery period or a 20-year ADS recovery period; rather, it has a 39-year MACRS recovery period and a 40-year ADS recovery period. Because such property does not have a MACRS recovery period of 20 years or less, it does not qualify for bonus depreciation.

    - IRS officials have said that technical corrections legislation will be required to fix this error.

CREFC Policy & Strategy

To the extent CREFC members identify the need for additional technical corrections, regulatory guidance and/or additional clarity with respect to the depreciation and expensing provisions under the new tax law, CREFC will remain engaged throughout any regulatory and/or technical corrections processes to ensure these provisions are implemented in a clear, workable, beneficial manner.

CREFC will partner with other CRE trade groups to lobby Congress on the above technical correction and have already become speaking to certain Congressman about the urgency for a legislative fix.

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Additional Background & History

- Cost recovery and depreciation rules under the pre-H.R. 1 tax code were excessively complicated, and real estate investors recovered the cost of their investments over decades – not a handful of years, as is the case with personal property.

- During the tax reform debate, CREFC advocated in favor of maintaining long-lived cost recovery for real property, worried that immediate or full expensing would lead to projects underway to be rendered economically unviable, such as happened in the late 1980s.

- Prior to the TCJA, Section 179 had a cap of $500,000 and a phase-out that started at $2,000,000. Thus, a taxpayer who bought up to $500,000 in total qualifying property could make an election under section 179 to immediately expense it. A taxpayer who bought total qualifying property of more than $500,000 and up to $2,000,000 could make an election to expense $500,000 and no more. Each dollar by which the taxpayer's purchase of total qualifying property exceeded $2,000,000 reduced the cap by one dollar. Thus the section 179 benefit phased out completely for purchases of $2,500,000 or more.

- The Tax Cuts and Jobs Act increased the cap under section 179 to $1,000,000 and the amount at which the benefit begins to phase out to $2,500,000. Thus, under current law, the benefit completely phases out for purchases of qualifying property totaling $3,500,000 or more.

CREFC Resources

Steptoe & Johnson Memo on CRE-related Tax Issues, December 4, 2017

CREFC Side-by-Side Comparing Various Tax Vehicles, December 4, 2017

For further Information, see CREFC's Resource Center at: https://www.crefc.org/library