



PATH Act: Qualified Real Property Deductions

Spidell Publishing, Inc.®

Your California solution since 1975

www.caltax.com | E-mail: subscriptions@spidell.com | Phone: (714) 776-7850 | Fax: (714) 776-9906

Experienced ... Trusted ... Connected!

This publication is distributed with the understanding that the authors and publisher are not engaged in rendering legal, accounting or other professional advice and assume no liability in connection with its use. Tax laws are constantly changing and are subject to differing interpretation. In addition, the facts and circumstances in your particular situation may not be the same as those presented here. Therefore, we urge you to do additional research and ensure that you are fully informed before using the information contained in this publication. Federal law prohibits unauthorized reproduction of the material in Spidell's **PATH Act: Qualified Real Property Deductions** manual. All reproduction must be approved in writing by **Spidell Publishing, Inc.**

This is not a free publication. Purchase of this electronic publication entitles the buyer to keep one copy on his/her computer and to print out one copy only. Printing out more than one copy — and any electronic distribution of this publication — is prohibited by international and United States copyright laws and treaties. Illegal distribution of this publication will subject the purchaser to penalties of up to \$100,000 per copy distributed.

Table of Contents

PATH Act: Qualified Real Property Deductions	1
Qualified leasehold improvement property.....	1
What can qualify?.....	2
What are the benefits?.....	2
Qualified retail improvement property	2
What can qualify?.....	2
What are the benefits?.....	3
Qualified restaurant property	3
What can qualify?.....	3
What are the benefits?.....	3
Qualified improvement property	3
What can qualify?.....	4
What are the benefits?.....	4
§179 expensing.....	4
Bonus depreciation.....	5
15-year depreciation.....	5
Improvements that involve multiple categories of property	5
Other expensing provisions under the repair regulations	6

PATH ACT: QUALIFIED REAL PROPERTY DEDUCTIONS

Prior to 2004, all nonresidential real estate, including improvements, had to be depreciated over a painfully long 39 years. However, the American Jobs Creation Act of 2004 allowed “qualified leasehold improvements” to be depreciated over 15 years.

Subsequent tax acts allowed 15-year depreciation for qualified retail improvements and qualified restaurant property, and opened the door to IRC §179 expensing and bonus depreciation on some or all of those three categories of property. Generally, these were all extender provisions.

The PATH Act, however, made those provisions permanent and enhanced them with further changes:

- The \$250,000 IRC §179 limit on those three types of property was eliminated;
- It created a new type of property with its own set of rules: “qualified improvement property;”
- It made qualified retail improvement property eligible for bonus depreciation; and
- It made air conditioning and heating units eligible as qualified property.

Thus, there are now four categories of qualified real property, each with its own set of requirements and limitations. There are also four possible treatments, each of which may be allowed or required: 39-year depreciation, 15-year depreciation, bonus depreciation, and IRC §179 expensing. To complicate matters further, any improvement may fall into more than one category. Moreover, a project may have multiple improvements and each of those improvements may fall into multiple categories.

QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY

A qualified leasehold improvement is any improvement to an interior portion of a building which is nonresidential real estate if:

- The improvement is IRC §1250 property;
- The improvement is made under or pursuant to a lease by the lessee, lessor or sub-lessee. Leases between related persons aren’t treated as leases;
- The portion of the building is to occupied exclusively by the lessee and/or sub-lessee; and
- The improvement is placed in service more than three years after the building is first placed in service.

(IRC §168(e)(6)(A); Treas. Regs. §1.168(k)-1(c)(1))

Certain improvements do not qualify:

- Enlargement of the building;
 - Any escalator or elevator;
 - The internal structural framework of the building; and
 - Any improvement to the common area of the building.
- (IRC §168(e)(6)(B))

If a lessor makes improvements that are qualified leasehold improvements, those improvements cannot be qualified leasehold improvements to any subsequent owner (subject to exceptions for nonrecognition and death transfers). (IRC §168(e)(6)(D))

What can qualify?

Examples of eligible improvements include new non-load-bearing walls, doors, ceilings, floors, and other components used to create new space inside the building. New bathrooms, remodeled lobbies (not common areas), and new offices fall under this category as well.

Improvements for energy efficiency may also qualify and may allow the taxpayer to enjoy other tax benefits. These improvements may include improvements to heating and air conditioning systems, lighting systems and windows.

What are the benefits?

Qualified leasehold improvements are eligible for the hat trick: §179 expensing, bonus depreciation, and 15-year depreciation.

Example of qualified leasehold improvements

A calendar-year landlord spends \$1 million in 2016 on qualified leasehold improvements for a new tenant. The taxpayer placed in service \$100,000 of other property eligible for §179 consisting of office equipment.

The taxpayer elects to take §179 on the leasehold improvements and not the office equipment because the office equipment has shorter recovery periods.

Thus, under §179, the taxpayer can expense \$500,000 of the improvements. The taxpayer can then take bonus depreciation of \$250,000 (50% of the basis after the §179 deduction). The remaining \$250,000 is depreciated over 15 years.

QUALIFIED RETAIL IMPROVEMENT PROPERTY

Qualified retail improvement property is any improvement to an interior portion of nonresidential building if (subject to general exclusions above):

- That portion of the building is open to the general public and is used in the retail trade or business of selling tangible personal property; and
- The improvement is placed in service more than three years after the date the building was first placed in service.
(IRC §168(e)(8))

Certain improvements do not qualify (same as for qualified leasehold improvements):

- Enlargement of the building;
- Any escalator or elevator;
- The internal structural framework of the building; and
- Any improvement to the common area of the building.
(IRC §168(e)(8)(C))

What can qualify?

Improvements made by tenants, or owners even when the building is owner-occupied, qualify.

Retail establishments that qualify include those primarily engaged in the sale of goods, such as grocery stores, clothing stores, and convenience stores. Establishments primarily engaged in providing services (such as professional services, entertainment, etc.) aren't eligible.

What are the benefits?

Qualified retail improvements are also eligible for the hat trick: §179 expensing, bonus depreciation, and 15-year depreciation (see the example above).

QUALIFIED RESTAURANT PROPERTY

Qualified restaurant property is any building or improvement to a building if more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of, prepared meals. (IRC §168(e)(7))

What can qualify?

Qualified restaurant property is unique in that it allows the building itself, and not just improvements, to qualify. In addition, a qualifying improvement need not be placed in service more than three years after the building was first placed in service, as is the case with qualified leasehold improvements and qualified retail improvement property.

What are the benefits?

Qualified restaurant property is eligible for 15-year depreciation and for §179 expensing. It is not eligible for bonus depreciation. However, property that also qualifies as qualified leasehold improvements or qualified improvement property may be eligible for bonus depreciation.

Example of qualified restaurant property

Taco Tuesday completes construction on a new restaurant and places it in service in 2016. It is qualified restaurant property. Construction costs are \$1 million. The company has no other §179 eligible property. They may expense \$500,000 of the construction costs. They will depreciate the balance over 15 years.

QUALIFIED IMPROVEMENT PROPERTY

The PATH Act created a new category of qualified real property eligible for bonus depreciation. Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service. (IRC §168(k)(3)(A))

However, qualified improvement property does not include:

- Enlargement of the building;
 - Any escalator or elevator; and
 - The internal structural framework of the building.
- (IRC §168(k)(3)(B))

Note that these exclusions are the same as for qualified leasehold improvement and qualified retail improvement property *except that* they don't include the exclusion for common areas.

What can qualify?

Thus, qualified improvement property liberalizes the rules for property eligible for bonus depreciation in three ways:

- Improvements to common areas are eligible;
- Improvements are eligible for bonus depreciation regardless of whether the property is subject to a lease. Thus, a business that improves property it owns is eligible; and
- Improvements need not be placed in service more than three years after the building is first placed in service.

What are the benefits?

Qualified improvement property is eligible for bonus depreciation but not for 15-year depreciation or §179 expensing. However, if the qualified improvement property also qualifies as one of the other three categories, it may qualify for 15-year depreciation and/or §179 expensing.

Qualified improvement property all encompassing

Qualified improvement property is broader than qualified leasehold improvements and qualified retail improvement property. By definition, all qualified leasehold improvement property is qualified improvement property. All qualified retail improvement property is also qualified improvement property. But not all qualified improvement property is qualified leasehold improvement property or qualified retail improvement property.

For example, work done prior to three years after the building is placed in service may be qualified improvement property but cannot be qualified leasehold improvement property or qualified retail improvement property.

Example title text

A company makes improvements to the interior portion of a building that is qualified improvement property that it owns and uses for its own business. It is not qualified restaurant property and not qualified retail improvement property. The total cost of the improvements is \$1 million.

If the improvements are made prior to 2016, the company would have no choice but to depreciate the improvements over 39 years. However, if the improvements are made after 2015, the company may take bonus depreciation. The balance is not eligible for 15-year depreciation because the improvements do not meet the requirements for qualified leasehold improvements, qualified retail improvement property, or qualified restaurant property. The \$500,000 balance must be depreciated over 39 years.

§179 expensing

Prior to the PATH Act, a taxpayer could elect to treat qualified real property as §179 property. However, the aggregate amount of the cost of qualified real property that a taxpayer could elect to treat as an expense was subject to an annual limit of \$250,000 of qualified real property plus an overall limit of \$500,000.

The PATH Act removed the annual \$250,000 limitation on the amount of qualified real property that can be expensed for tax years beginning after December 31, 2015. Thus, all §179 property is subject to a single, overall limit of \$500,000 (adjusted for inflation after 2016).

Real property improvements eligible for §179 is automatically also eligible for 15-year depreciation. Property that meets the definition of qualified improvement property is also eligible for bonus depreciation.

Generally, taxpayers will elect to expense those items with the longest recovery periods. Thus, taxpayers that acquire both personal property and qualified real property eligible for §179 will choose to expense the qualified real property. The personal property will generally have recovery periods of five or seven years, whereas the qualified real property will have a recovery period of 15 years.

Bonus depreciation

For property placed in service prior to 2016, bonus depreciation was available for qualified leasehold improvements. It was not available for qualified retail improvement property or qualified restaurant property.

Beginning in 2016, bonus depreciation is available for qualified improvement property. Accordingly, as noted above, leasehold improvement property and qualified retail improvement property automatically qualify. Qualified restaurant property does not automatically qualify for bonus depreciation but may qualify if it meets the definition of qualified improvement property.

Note: The bonus depreciation percentage is 50% for property placed in service during 2015, 2016, and 2017, but then phases down to 40% in 2018 and 30% in 2019. After that, it expires unless further extended by Congress.

15-year depreciation

Qualified real property is eligible for 15-year depreciation.

Property eligible for 15-year depreciation is automatically also eligible for §179 expensing. Property that meets the definition of qualified improvement property is also eligible for bonus depreciation.

⚠ Caution

15-year depreciation for qualified real property is different from 15-year depreciation for land improvements. Qualified real property uses the straight line method, whereas land improvements are depreciated using the 150% declining balance method.

Improvements that involve multiple categories of property

Improvements made under certain circumstances may involve multiple categories of property.

Improvements made by a landlord

Landlord owns and operates an office building that is leased to professional tenants. In 2016, Landlord improves and upgrades all of the bathrooms in the building including fixtures, flooring tiling and other improvements at a cost of \$700,000. Of the total \$700,000 cost, \$500,000 is attributable to bathrooms in space leased by tenants and \$100,000 is attributable to bathrooms in common areas. The improvements are made more than three years after the building is placed in service. Landlord has no other §179-eligible expenditures in 2016.

Landlord may elect to expense \$500,000 of the \$600,000 expenditures attributable to bathrooms in leased spaces because it is qualified leasehold improvement property. Landlord may take bonus depreciation of the remaining \$100,000. The final \$50,000 is depreciated over 15 years.

Landlord may take bonus depreciation of \$50,000 on the improvements made to the common areas because it is qualified improvement property. The remaining \$50,000 is depreciated over 15 years.

In 2016, Landlord gets to write off \$603,333 of the total expenditure of \$700,000 (\$500,000 of §179 expense, \$100,000 of bonus depreciation and \$3,333 of depreciation (\$100,000 at 15-year straight-line, half-year convention)).

Assume that the improvements are made before the date three years after the building was first placed in service. In that case, the improvements cannot be treated as qualified leasehold improvements and are not eligible for §179 or 15-year depreciation. However, the improvements do qualify as qualified improvement property eligible for bonus depreciation. In that case, Landlord would write off \$350,000 as bonus depreciation and depreciate the balance over 39 years.

Other expensing provisions under the repair regulations

Remodel-refresh costs

Rev. Proc. 2015-56 outlines a safe harbor method for restaurant and retail store remodeling projects that will allow qualified taxpayers to write off 75% of such costs. Costs of a remodel-refresh project will be allocated 75% to current expense and 25% to improvements. The capitalized portion must be depreciated under one or more general asset account (GAA) elections. Additionally, the taxpayer must include existing buildings and capitalized improvements in new GAA elections and can make late GAA elections.

A qualified taxpayer is one that:

- Sells merchandise at retail; or
- Is in the business of preparing meals, snacks, or beverages.

However, qualified retailers do not include auto dealers, manufactured home dealers, and nonstore retailers.

Unfortunately, this provision is generally limited to only larger taxpayers. There are numerous limitations and complexities including:

- The space on which remodel-refresh work is done cannot exceed more than 20% of the square footage of the qualified building;
- The capitalized portion of the costs cannot qualify for a partial disposition election;
- Taxpayers must have an applicable financial statement;
- The 25% that must be capitalized must be put in a new GAA; and
- Taxpayers must apply for an accounting method change and file Form 3115.

Safe harbor for small taxpayers with buildings

The regulations include a \$10,000 annual safe harbor election for buildings owned or leased with an unadjusted basis no greater than \$1 million. (Treas. Regs. §1.263(a)-3(h)) If the taxpayer qualifies and makes the election, the taxpayer is not required to capitalize, and may deduct, qualifying expenditures.

Under this provision, both residential and nonresidential properties qualify.

To qualify, the taxpayer must have average annual gross receipts of \$10 million or less during the three preceding taxable years. Gross receipts include income from sales (not reduced by cost of goods sold), services, and investment income.

An eligible building property is one with an unadjusted basis no greater than \$1 million. (**Note:** Unadjusted basis does not include land value.)

The expenditures must meet a cliff test. Under the safe harbor, a small taxpayer is not required to capitalize improvements if the total amount paid with respect to an eligible building for repairs, maintenance, improvements, and similar activities does not exceed the lesser of \$10,000 or 2% of the building's unadjusted basis.

The election is made *annually* by attaching a statement to the taxpayer's timely filed (including extensions) original return for the tax year for which the property is placed in service.

In the case of a partnership or S corporation, the election is made by the partnership or S corporation, and not by the partners or shareholders.

Once made, the annual election is irrevocable.

Qualified Real Property Quick Reference Chart: Assets Placed in Service on or After January 1, 2016

Property type	Recovery period	Eligible for bonus	Three-year rule	Unrelated party rule	Eligible for §179	Subject to general exclusions¹	Notes
Qualified leasehold improvements (QLI)	15 SL	Yes	Yes	Yes	Yes	Yes	Landlord, lessee, or sub-lessee can make improvements. Must be lease between unrelated parties. Does not apply to common areas.
Qualified retail improvement property (QRIP)	15 SL	Yes	Yes	No	Yes	Yes	Building can be owner-occupied.
Qualified restaurant property (QRP)	15 SL	No (see Notes)	No	No	Yes	No	Can be acquired building. Encompasses entire building structure as well as common area. Improvements that also meet the definition of QLI or QIP are eligible for bonus.
Qualified improvement property (QIP)	39 SL (see Notes)	Yes	No	No	No (see notes)	Yes	Improvements that also meet the definition of QLI, QRIP or QRP are eligible for 15 SL and §179. Applies to common areas.

¹All property types except qualified restaurant property are subject to the general exclusions. Improvements that do not qualify under the general exclusions include:

- Enlargement of the building;
- Any escalator or elevator; and
- The internal structural framework of the building.

Qualified Real Property Quick Definition Guide

Property type	Definition
Qualified leasehold improvements	<p>Any improvement to an interior portion of a nonresidential building if (subject to general exclusions above):</p> <ul style="list-style-type: none"> • The improvement is IRC §1250 property; • The improvement is made under or pursuant to a lease by the lessee, lessor, or sub-lessee. Leases between related persons aren't treated as leases; • The portion of the building is to occupied exclusively by the lessee and/or sub-lessee; • The improvement is placed in service more than three years after the building is first place in service.
Qualified retail improvement property	<p>Any improvement to an interior portion of nonresidential building if (subject to general exclusions above):</p> <ul style="list-style-type: none"> • That portion of the building is open to the general public and is used in the retail trade or business of selling tangible personal property; and • The improvement is place in service more than three years after the date the building was first placed in service.
Qualified restaurant property	<p>Any building or improvement to a building if more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals.</p>
Qualified improvement property	<p>Any improvement to an interior portion of nonresidential building if (subject to general exclusions above):</p> <ul style="list-style-type: none"> • The improvement is placed in service after the date the building was first placed in service.