Mann Report

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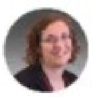
CAPTURING ADDITIONAL DEPRECIATION FOR ELIGIBLE QUALIFIED IMPROVEMENT PROPERTY



By Rachel Lawent, senior manager, Marcum LLP

Owners of nonresidential real property may be eligible for additional tax depreciation deductions (if not previously deducted). The asset must be deemed a qualified improvement property (QIP), and tax depreciation on this property must have commenced in the 2018 or 2019 tax year.

QIP is defined as any improvement made to the interior portion of a nonresidential building that occurred after the building was first placed in service, having several exceptions. Improvements such as enlarging the building, adding an elevator or escalator or adjusting the building's internal structural framework do not qualify as QIP.

When a building is designated a QIP, it has a shorter tax depreciation life compared to other nonresidential real property (15 years compared to 39 years). In addition, assuming the taxpayer does not elect out of bonus depreciation, the tax benefit can be accelerated even further by taking 100% bonus depreciation (through tax year 2022). That allows 100% of the cost of the property to be deducted as depreciation in the year the property is placed in service.

However, prior to the passage of the Coronavirus Aid, Relief, and Economic Security (CARES) Act in March 2020, a QIP placed in service after December 31, 2017 was not eligible for the 15-year depreciable life or for bonus depreciation. Due to a technical error in the Tax Cuts and Jobs Act (TCJA), property in this category was required to be placed in service with a 39-year tax life. This was an inadvertent "glitch" in the law that was later corrected by the CARES Act. Before the latter was enacted, however, 2018 (and many 2019) tax returns were filed using the 39-year life instead of the 15-year life for QIPs.

Because the CARES Act's QIP update was retroactive to January 1, 2018, taxpayers have the opportunity to update the depreciation on eligible assets that were originally placed in service with a 39-year life on the 2018 or 2019 tax returns. It's not too late to make this update; taxpayers can claim the catch-up depreciation by filing a change in accounting method with the 2021 tax return.

The purpose of filing a change in accounting method (done via IRS Form 3115) is to get taxpayers in the same position they would have been in had the asset been placed in service with the 15-year life to begin with.

In the year of filing the 3115, the difference between the depreciation that could have been taken since placing the asset in service and what was actually taken on the 2018-2020 returns is calculated. That difference is then taken as an additional deduction on the filer's tax return.

Example: A taxpayer who owns a commercial shopping center filed her 2019 return in February 2020. The return included $100,000 of leasehold improvements related to a new tenant (qualifying as QIP) that were placed in service in January 2019 with a 39-year life.

The 2019 depreciation on this asset was $100,000 x 2.461% = $2,461.

The 2020 return continued the 39-year depreciation schedule and reported depreciation expense related to this asset of $100,000 x 2.564% = $2,564.

In preparing her 2021 return, the taxpayer becomes aware that the leasehold improvements qualified as QIP. Because the taxpayer did not opt out of bonus depreciation in 2019, this asset is also eligible for 100% bonus depreciation. The taxpayer decides to file a Form 3115 with her 2021 return to change the depreciation method for the QIP asset.

With the correct method, the 2019 depreciation on the asset would have been 100% of the cost of the asset or $100,000. The additional deduction allowed on the 2021 return to catch up on the remaining depreciation is:

$100,000 – $2,461 – $2,564 = $94,975

Owners of nonresidential real estate should double-check depreciable assets placed in service in 2018 and 2019 to confirm that all eligible depreciation expense was taken. As illustrated by the above example, it is possible to take in 2021 an expense that may have otherwise been spread over the next 37 years.

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