CARES ACT: THE QIP TECHNICAL CORRECTION

By Mark Vorkapich, ASA

Commercial property owners who have spent money on improvements to the interior portions of their buildings in the last two years (after the property was already in service) are in for a windfall regarding their federal tax depreciation deduction. Congress recently passed a technical correction that will now allow many taxpayers to receive huge deductions for the costs of interior improvements they have made. To make things even better, if those deductions exceed the tax liability for the applicable year, they can be applied through the previous year — up to five tax years.

Background

The Protecting Americans from Tax Hikes (PATH) Act of 2015 introduced the category of qualified improvement property (QIP) as any improvement to an interior portion of a building that is nonresidential real property, as long as that improvement is made after the building was first placed in service by any taxpayer (Section 168(k)(3)). It specifically excludes expenditures for (1) enlargement of a building, (2) elevators or escalators and (3) the internal structural framework of a building. The three-year in service requirement is not applicable, and it is not restricted to expenditures pursuant to a lease between nonrelated parties. This means that if a building owner constructs or acquires a property, it does not have to be held for three years before any interior improvements will qualify for the QIP classification. The QIP provisions are effective for property placed in service after Dec. 31, 2015.

The 2017 Tax Cuts and Jobs Act (TCJA) combined qualified leasehold improvements (QLIP), qualified retail improvements and qualified restaurant property into one category and intended to speed up the depreciation on QIP. The depreciable life of QIP was to be reduced from 39 to 15 years, with 100% bonus depreciation being available for all assets with a life of 20 years or less. Unfortunately, Congress forgot to give QIP a 15-year life, so it remained 39 years and was not eligible for 100% bonus depreciation.

As a result, a taxpayer who spent $2 million on qualified interior improvements to their property in 2018 did not receive a $2 million deduction in that current year but had to depreciate the entire amount straight-line over 39 years.

Solution

The Coronavirus Aid, Relief, and Economic Security (CARES) Act provides a technical correction for QIP property.

It allows bonus depreciation or special straight-line modified accelerated cost recovery system (MACRS) depreciation over 15 years instead of 39 years and makes the change retroactive to Jan. 1, 2018. Thus, taxpayers should be entitled to file amended returns to reap the benefits of accelerated depreciation in 2018 and 2019.

The CARES Act also temporarily repeals the 80% of taxable income limitation enacted by the TCJA. This allows full use of net operating losses (NOLs) for taxpayers for 2018 through 2020. Further, for NOLs arising in a tax year beginning after Dec. 31, 2017, and before Jan. 1, 2021, taxpayers may carry back NOLs to the preceding five tax years. This is significant since corporations were generally subject to a top tax rate of 35% before 2018.

Example: The taxpayer mentioned earlier, who spent $2 million on qualified interior improvements to their property in 2018, claimed only $51,000 of depreciation related to the $2 million spent on improvements. They may now file an amended return to take an additional deduction of $1.949 million in 2019, *and any net operating loss generated by the additional depreciation may be carried back for up to five years to recover taxes previously paid.*

Value of cost segregation

A detailed cost segregation study identifies the correct units of property and components that make up a building and its site and assigns those assets their correct federal tax life for depreciation purposes. If a taxpayer has a qualified study performed for any QIP-related projects, they will now be able to correctly identify both the qualifying and nonqualifying improvements to that property. This should be a critical step, as the new QIP life and bonus depreciation will create significant depreciation deductions that can be validated through a detailed cost segregation study.

Mark Vorkapich, ASA, is the director of cost segregation services at Gladstone Strategies & Solutions, Milwaukee. Contact him at 414-418-8953 or mvorkapich@gladstonestrategies.com.