

¶425 Recovery Periods for MACRS Real Property

NEW LAW EXPLAINED

Depreciation of real property.—The Tax Cuts and Jobs Act makes the following changes related to MACRS recovery periods for real property, effective for property placed in service after December 31, 2017:

- qualified improvement property is assigned a 15-year recovery period (however, see “Caution Note” below);
- the property classes for 15-year leasehold improvement property, retail improvement property, and restaurant improvements and buildings are eliminated’
- the MACRS alternative depreciation system (ADS) must be used by an electing real property trade or business to depreciate residential rental property, nonresidential real property, and qualified improvement property (effective for tax years beginning after December 31, 2017).

CAUTION

The explanations in this section assume that qualified improvement property placed in service after December 31, 2017 will have a 15-year recovery period as intended by Congress.

The Senate bill would have provided a 10-year recovery period for qualified improvement property (Act Sec. 13204(b)(1), adding Code Sec. 168(e)(3)(v)). The House bill contained no provision. The final bill, according to the Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466) sets a 15-year recovery period for qualified improvement property effective for property placed in service after December 31, 2017. However, the text of the final bill inadvertently omits the provision which would have given a 15-year recovery period for qualified improvement property. A technical correction will be needed to create a 15-year recovery period for qualified improvement property and all such property in the absence of such a correction will be treated as 39-year nonresidential real property, effective for property placed in service after December 31, 2017.

An unintended consequence of failing to provide a 15-year recovery period for qualified improvement property placed in service after December 31, 2017, is that such property will not qualify for bonus depreciation. As explained at ¶410, qualified improvement property was removed as a specific category of bonus depreciation property, effective for property placed in service after December 31, 2017 (Code Sec. 168(k)(3), as stricken by the 2017 Tax Cuts Act) on the assumption that all qualified improvement property would have a 15-year recovery period and, therefore, qualify for bonus depreciation under the general rule that allows MACRS property with a recovery period of 20 years or less to qualify for bonus depreciation.

Qualified improvement property assigned 15-year recovery period. Qualified improvement property is assigned a recovery period of 15 years, effective for property placed in service after December 31, 2017, assuming a technical correction is made. Qualified improvement property is depreciated using the straight-line method and half-year convention or, if applicable, the mid-quarter convention (Code Sec. 168(b)(3)(G), as added by the 2017 Tax Cuts and Jobs Act)). The alternative depreciation system (ADS) recovery period for qualified improvement property is 20 years (Code Sec. 168(g)(3)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

The amended table in Code Sec. 168(g)(3)(B), makes an erroneous reference to subparagraph (D)(iv) of Code Sec. 168(e)(3) in establishing the intended 20-year ADS period for qualified improvement property. In the original Senate Bill, subparagraph (D)(iv) of Code Sec. 168(e)(3) added qualified improvement property to the list of property with a 10-year recovery period. Subparagraph (D)(iv) was not included in the text of the final bill because the final bill intended to change the recovery period of qualified improvement property to 15-years instead. See “*Caution*” note above.

The definition of qualified improvement property for purposes of the new 15-year recovery period is the same as the definition that has applied for bonus depreciation purposes. Specifically, qualified improvement property is defined as any improvement to an interior portion of a building which is nonresidential real property if the improvement is placed in service after the date the building was first placed in service by any taxpayer (Code Sec. 168(e)(6)(A), as added by the 2017 Tax Cuts Act. However, qualified improvement property does not include expenditures attributable to:

- the enlargement of a building
- any elevator or escalator
- the internal structural framework of a building (Code Sec. 168(e)(6)(B), as added by the 2017 Tax Cuts Act):

COMMENT

Qualified improvement property has been a category of property eligible for bonus depreciation since the enactment of the Protecting Americans from Tax Hikes Act of 2015 (December 18, 2015) (P.L. 114-113) (PATH Act), effective for property placed in service after December 31, 2015. However, the depreciation period for property which met the definition of qualified improvement property for bonus depreciation purposes was 15 years if the improvement also met the definition of a qualified leasehold improvement, a qualified retail improvement, or a qualified restaurant improvement. If the 15-year recovery period did not apply, then the qualified improvement property was depreciated over 39 years as MACRS nonresidential real property. Under the new law, all qualified improvement property is assigned a 15-year recovery period. The 15-year recovery periods previously provided for a qualified leasehold, retail, and restaurant improvements are repealed.

COMMENT

The definition of qualified improvement property for bonus depreciation purposes was formerly located in Code Sec. 168(k)(3), relating to bonus depreciation. The new law moves the definition of qualified improvement property to Code Sec. 168(e)(6)(B) and assigns a 15-year recovery period (assuming a correction is made (see “*Caution*” note above). Qualified improvement property, however, still remains eligible for bonus depreciation even though it has been removed as a separate category of bonus depreciation property. Now that all qualified improvement property is assigned a 15-year recovery period it will qualify for bonus depreciation under the generally applicable rule requiring that bonus depreciation property must have a recovery period of 20 years or less. Previously, some qualified improvement property had a 39-year recovery period and could not have qualified for bonus depreciation unless qualified improvement property was treated as a separate category of bonus depreciation property without regard to its recovery period. This special treatment is no longer necessary.

15-year qualified leasehold, retail, and restaurant improvement property classes eliminated. The property classifications for 15-year qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property are removed (Code Sec. 168(e)(3)(E), as amended by the 2017 Tax Cuts Act; Code Secs. 168(e)(6), (7), and (8), stricken by the 2017 Tax Cuts Act). See “*Background*” section above for the definition of these categories of property. All improvements which previously qualified for a 15-year recovery period as qualified leasehold improvement property or qualified retail improvement property fall within the definition of qualified improvement property and have a 15-year recovery period, effective for property placed in service after December 31, 2017 (assuming a correction is made (see “*Caution*” note above). Improvements to a restaurant will only qualify for the 15-year recovery period for qualified improvement property if the improvement is to the interior of the restaurant and does not relate to an enlargement or internal structural framework of the building or an elevator or escalator. External improvements to a restaurant and restaurant buildings which currently qualify as 15-year qualified restaurant property do not meet the definitional requirements of qualified improvement property and are not eligible for the 15-year recovery period. Such property will be depreciated over 39 years, effective for property placed in service after December 31, 2017.

COMMENT

If any property meets the definition of 15-year qualified leasehold improvement property or 15-year qualified retail property it will necessarily meet the definitional requirements of qualified improvement property and be eligible for the new 15-year recovery period that applies to such property. Consequently, the elimination of these two property classifications has no negative impact. Not all 15-year restaurant property, however, will meet the definitional requirements of qualified improvement property. Most significantly, 15-year qualified restaurant property is defined to include restaurant buildings. Qualified improvement property only includes internal improvements to a building. This means that a restaurant building will not qualify for a 15-year recovery period as qualified improvement property. Instead, effective for restaurants placed in service after December 31, 2017, restaurant buildings will once again be treated as nonresidential real property and the 39-year recovery period for nonresidential real property applies. 15-year restaurant property is also defined to include external as well as internal improvements. Since external improvements to a building are excluded from the definition of qualified improvement property, external improvements to a restaurant will also be treated as 39 year nonresidential real property, effective for improvements placed in service after December 31, 2017. Again, this comment assumes that a technical correction will be enacted.

Real property trade or business electing out of interest deduction limits must use ADS for residential rental property, nonresidential real property, and qualified improvement property. An electing real property trade or business must use the MACRS alternative depreciation system (ADS) to depreciate any nonresidential real property, residential rental property, or qualified improvement property it holds (Code Sec. 168(g)(1), as amended by the 2017 Tax Cuts Act). The provision is effective for tax years beginning after December 31, 2017 (Act Sec. 13204(b)(2), of 2017 Tax Cuts Act).

An electing real property trade or business is a real property trade or business that elects out of new rules which disallow deduction for net interest expense in excess of 30 percent of a business’ adjusted taxable income (Code Sec. 163(j)(7)(B), as added by the 2017 Tax Cuts Act). “Real property trade or business” means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (Code Sec. 469(c)(7)(C)). See ¶510 for a discussion of the net interest deduction limitation and the election out for a real property trade or business.

COMMENT

The ADS period for nonresidential real property is 40 years. The ADS period for residential rental property is reduced from 40 years to 30 years, effective for property placed in service after December 31, 2017, although it is not clear whether Congress intended to make this change (Code Sec. 168(g)(2)(C), as amended by the 2017 Tax Cuts Act). See discussion below. The ADS period for qualified improvement property is intended to be 20 years, although a technical correction is necessary to create the intended 15-year regular depreciation period for such property. See, “*Caution*” above.

COMMENT

Since this provision applies to tax years beginning after December 31, 2017, and not to *property placed in service* in tax years beginning after December 31, 2017, it appears that an electing real property trade or businesses will also be required to depreciate nonresidential rental, nonresidential real property, and qualified improvement property placed in service in tax years before the election year using the ADS method beginning in year of election.

Regular and ADS recovery periods for MACRS residential rental and MACRS nonresidential real property. A provision in the original Senate bill would have reduced the recovery period for MACRS residential rental property from 27.5 years to 25 years and the recovery period for nonresidential real property is decreased from 39 years to 25 years, effective for property placed in service after December 31, 2017. This provision was dropped from the final bill. Consequently, the recovery period for residential rental property remains 27.5 years and the recovery period for nonresidential real property remains 39 years.

COMMENT

The original Senate bill also reduced the MACRS alternative depreciation system (ADS) recovery period for residential rental property from 40 years to 30 years. This provision was retained, perhaps inadvertently, in the final bill (Code Sec. 168(g)(2)(C), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments in this section apply to property placed in service after December 31, 2017 (Act Sec. 13204(b)(1) of the Tax Cuts and Jobs Act). The amendment requiring an electing real property trade or business to use ADS to depreciate its real property is effective for tax years beginning after December 31, 2017 (Act Sec. 13204(b)(2) of the 2017 Tax Cuts Act).