

## WHICH REAL ESTATE IMPROVEMENTS QUALIFY FOR BONUS FIRST-YEAR DEPRECIATION UNDER THE 2002 ACT?

The 2002 Act carved out a new category of depreciable assets called "qualified leasehold improvement property" and made it eligible for the bonus first-year depreciation deduction (or, as IRS refers to it, the special depreciation allowance) if the original use, timely acquisition and placed-in-service requirements are met. However, neither the 2002 Act nor the Joint Committee on Taxation's Technical Explanation supplied many details about this new category. These Comments examine the issue of which real estate improvements may qualify for bonus first-year depreciation as qualified leasehold improvement property. It also touches on the question of which improvements may qualify for bonus first-year depreciation even if they aren't qualified leasehold improvements.

### # WHAT IS "QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY?"

This term is defined as any improvement to an interior portion of a building which is nonresidential real property, if three conditions are met:

- (1) The improvement is made "under or pursuant to a lease" (namely any grant of a right to use property), either by the lessee, sublessee or lessor of the building portion.
  - ! The phrase "made under or pursuant to a lease" doesn't necessarily mean that the lease must specify the lessee (or lessor) is responsible for making specific improvements. It may be enough for the lease to contain a general statement to the effect that "the property is leased as is, and the lessee is responsible for any and all improvements to make the property suitable to its uses" or "the lessor (or lessee) shall make up to \$x of improvements to the leased property so as to make the property suitable to the lessee's uses."
- (2) The portion of the building is to be occupied exclusively by the lessee (or any sublessee) of the portion.
- (3) The improvement is placed in service more than 3 years after the date the building was first placed in service.

The bonus depreciation deduction does not apply to "qualified New York Liberty Zone leasehold improvement property," which is property that is "qualified leasehold improvement property" but is located in the Liberty Zone (essentially lower Manhattan). This excluded class of improvements may be depreciated via straight line over 5 years (regular MACRS) or over 9 years (under ADS).

For purposes of the above definition of qualified leasehold improvement property:

- ... a commitment (i.e., a *binding* commitment) to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee, respectively, and
- ... a lease between related persons is *not* considered a lease. Related persons includes members of an affiliated group.

### # TYPES OF BUILDING IMPROVEMENTS ELIGIBLE FOR BONUS DEPRECIATION

## ALLOWANCE

The 2002 Act doesn't define what types of building improvements are eligible to be treated as qualified leasehold improvement property. Rather, it lists the types of property that can't be so treated. Qualified leasehold improvement property does not include any improvement for which the expense is attributable to:

- ... enlargement of the building,
- ... any elevator or escalator,
- ... any structural component benefitting a common area, or
- ... the internal structural framework of the building.

What kinds of improvements are qualified leasehold improvements after eliminating those that are ineligible? The following types of improvements would qualify, if they benefit the tenant's space only rather than a common area:

- (1) electrical or plumbing systems (including sprinkler system);
- (2) permanently installed lighting fixtures;
- (3) heating equipment, cooling equipment, air conditioners, and other air handling equipment; and,
- (4) ceilings and doors.

! All of these assets generally are treated as structural components of a building for depreciation purposes, but none of them is part of the internal structural framework of a building, a term defined by the investment-tax-credit regulations to include all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels and all other members that are essential to the stability of the building.

! Because these assets generally are building components, they are treated as nonresidential realty, not as personal property, for depreciation purposes. That means their adjusted basis, after reduction for the special depreciation allowance, must be recovered over 39 years via straight-line depreciation.

Illustration: In January 2002, part of a commercial property is leased to a restaurant chain. The lease obligates the chain to make whatever alterations are necessary to customize the leased space to its needs. The chain spends \$200,000 on a new ceiling, permanently installed lighting fixtures and extra air conditioning equipment needed to cope with a high volume of fast-food customers. If the improvements are new, acquired by the chain generally after September 10, 2001, and before September 11, 2004, and placed in service by the chain before 2005, the chain may claim a special depreciation allowance of \$60,000 [ $\$200,000 \times .30$ ]. It also may claim \$3,445.40 of regular first-year MACRS depreciation for its improvements [ $\$200,000 - \$60,000 \times .02461$  (first-year MACRS percentage for commercial realty placed in service in January)]. The chain would have to depreciate its remaining adjusted basis in the improvements over 39 years.

! A number of assets installed in commercial buildings are personal property, depreciable over 5 or 7 years under MACRS, rather than building components depreciable over 39 years. As a result, these assets are potentially eligible for a bonus depreciation allowance *whether or not* they are qualified leasehold improvements. *Reason:* Property qualifying for the bonus depreciation allowance includes MACRS property with a recovery period of 20 years or less, if the original

use and timely acquisition and placed-in-service requirements are met. These shorter-lived assets include carpeting, movable and removable partitions and electrical and plumbing equipment necessary for the operation of specialized equipment (rather than for overall building maintenance and operation). In *Hospital Corp of America & Subsidiaries*, (1997) 109 TC 21, the Tax Court held that part of the cost of the primary and secondary electrical distribution systems (including main panels, main motor control counters, transformers, the secondary distribution panels and related wiring and conduit) relating to specialized equipment of a business (rather than overall building operation or maintenance) also is tangible personal property for depreciation purposes.

Comments is an informative publication for our clients and friends of the Firm. It is designed to provide accurate information on the subject matter covered. We recommend you consult with your legal and other advisors to determine if the information is applicable in your specific circumstances. If these advisors are not available to you, please feel free to contact Barry N. Finkelstein, CPA at 972/934-1577 or e-mail at [info@facpa.com](mailto:info@facpa.com).