Repair Regulations, Depreciation, and Cost Segregation in a Post-Tax Reform Environment

By J. Curt Gautreau, CPA, CCSP

Congress recently passed the 2017 Tax Cuts and Jobs Act (TCJA). Depreciation, capitalization under the repairs regulations and cost segregation are impacted by several provisions of the Act. The list includes bonus depreciation, Section 179 expensing, qualified improvement property (QIP), and like-kind exchanges. This article will review the impact of the changes in these areas from a non-building (Section 1245 property) and building (Section 1250 Property) perspective.

Non Buildings (Section 1245 Property)

No one provision has greater impact on capitalization decisions than changes to bonus depreciation. For purchases of personal property after 9/27/2017, taxpayers may claim a 100% bonus deduction. This bonus deduction remains at 100% until 12/31/2022 and decreases annually at the rate of 20% per year. There are several exceptions to the 100% bonus deduction. These include certain rate regulated utility companies, electing real estate companies, and businesses using floor plan financing indebtedness. Bonus may now also be claimed on used property. Additionally, the Section 179 expensing (see next page) limit has increased to $1,000,000 and the phaseout threshold has been raised to $2,500,000.

Impact:
The quick and conservative decision is to capitalize all assets and expense the assets immediately under the new bonus or the Section 179 provisions. CPAs need to remember the recapture provisions upon sale of these 1245 assets. To keep these assets off the balance sheet and avoid recapture they need to continue to:

- Annually elect the $2,500 De Minimus exception under 263(a)
- Follow written capitalization policies in place for clients and businesses
- Treat repairs as such, that do not rise to the level of improvements under 263(a)

It is important to remember bonus and Section 179 may be claimed for all tax years the statute of limitations remains open. If the Internal Revenue Service upon examination determines certain repairs expenditures should have been capitalized, these items may be expensed under the new bonus rules or Section 179 at that time.

Buildings (Section 1250 Property)

Depreciation for Real Property and Qualified Improvement Property (QIP)

The bonus deduction for qualified improvement property has been eliminated as of 12/31/2017. No area of the law necessitates a technical correction more than this provision. A quick read of the Joint Conference Committee shows the congressional intent was to assign QIP a 15-year life (making it eligible for bonus depreciation at 100%) and assign a 20-year life for ADS. The Reform Act omitted the section assigning QIP a 15-year life. This means until a technical correction is made QIP property has a 39-year life with no bonus deduction. Additionally, the Act eliminated qualified leasehold improvement, qualified retail and qualified restaurant property with the intent of rolling all improvements to buildings into a single QIP category with a 15-year life. Until such correction is made all improvements to real estate are 39-year property with no bonus. It is important to note QIP placed in service between 9/28/2017 and 12/31/2017 may qualify for 100% bonus if a written binding contract was not entered into prior to 9/28/2017

Impact:
QIP is any nonstructural expenditures made to the interior portion of commercial property. It does not include any enlargements of square footage, elevators or escalators. Generally speaking, QIP renovations on average make up 40 -70% of the expenditures of a renovation project. If the technical correction stated above is made, separating

the components into personal property and into property qualifying for QIP become paramount. A cost segregation study will maximize this 100% bonus deduction on all 5 and 15-year property including QIP. Until such correction is made, a cost segregation study will identify the shorter life assets eligible for 100% bonus in a construction improvement / renovation project.

Used Property and the 100 Bonus Deduction

Effective for used property acquired on or after 9/28/2017, taxpayer may claim the 100% bonus deduction. As with newly acquired property, transition rules apply property for certain written binding contracts. Generally speaking, related party transactions, controlled group transactions, inherited and gifted property, and property involved in carryover of basis transactions do not qualify for used bonus.

Impact:
Another significant impact to real property is the use of cost segregation combined with the 100% bonus deduction for used property. Acquiring existing rental property may generate large up-front deductions. The used values placed on the wear and tear of these components become extremely important. Cost segregation studies performed by Certified Professionals become essential. If the study is performed by a Certified Cost Segregation Professional who is following the approved guidelines, it is less likely to have issues during the audit. Older properties acquired and renovated will generate substantial up-front deductions with a QIP technical corrections bill for bonus on QIP.

Section 179 Expensing

As referenced earlier, the Section 179 expensing limit has increased to $1,000,000 and the phase out threshold has been raised to $2,500,000. Additionally, the definition of qualified real property has been changed. Prior to passage of the Act, qualified leasehold improvement, qualified restaurant improvement and qualified retail improvement property were defined as qualified real property and allowed for the Section 179 expensing up to $500,000. With the Act eliminating these categories of qualified real property, the definition has been revised and expanded. Qualified Real property now includes Qualified Improvement Property (QIP) and any of the following improvements to nonresidential property that are placed in service after the property was first placed in service:

- Roofs
- Heating, Ventilation and Air-Conditioning property
- Fire Protection and Alarm Systems and
- Security Systems

Finally, personal property used in connection with lodging (excluding transient rental) may now qualify for Section 179 expensing.

Impact:
As under prior law, a taxpayer must elect to treat qualified real property as section 179 property. If the election is made and the total cost of section 179 property, including qualified real property, exceeds the investment limitation ($2.5 million in 2018), the dollar limitation ($1 million in 2018) is subject to reduction. CPAs want to maximize the combination of the 100% Bonus and any Section 179 Expensing while avoiding the Investment Limitations and phase out.

As mentioned above property owners need to properly identify the components that meet the test of QIP and thus qualify for the Section 179 Expense. Not all of the components of renovations and improvements to real property qualify.

Finally, the taxable income limitations of Section 179 expensing in conjunction with the new excess business loss limitations need to be considered. For real estate owners wanting to improve existing property, choice of entity for ownership should be considered. CPAs need to advise clients on what entity should acquire the building and what entity should make any improvements.

Like-Kind Exchanges

The new Act changes IRC section 1031 by replacing the word "property" with the words "real property". While there is some confusion as to the exact meaning of Real Property in 1031 Exchanges based on case law, most professionals are interrupting this change to apply to only the real property elements of a building. Thus, items such as carpet, and certain types of cabinetry no longer qualify for like-kind deferrals. This is especially true post repair regulations which clearly identify separate units of property components for real and personal property. The CPA has two options to consider:

Impact:

1) **Newly Constructed Replacement Property:**
If the real estate owner exchanges property and the replacement property is newly constructed, the tax savings could be substantial. When the relinquishment property is sold, a value needs to be place on real property and personal property. Generally speaking most 1245 property has higher wear and tear. This used fair market value should generate a gain less than the value of the newly constructed 1245 property segregated from the real property. With the 100% bonus deduction, the real estate owner should be in a more favorable tax position after the exchange.

2) **Used Replacement Property:**
If the real estate owner exchanges property and the replacement property is used property some limitations apply. As mentioned above, used property acquired in a carryover basis transaction may not apply for the 100% bonus deduction. In a like-kind exchange, the used 100% bonus deduction applies only to the extent additional boot or other consideration is paid. Any replacement property up to the amount of 1245 gain does not qualify for the used 100% bonus deduction. Careful consideration should be given to 1031 Exchanges when the replacement property is used.

In summary, TCJA creates significant opportunities for CPAs, their clients and their businesses with regard to capitalization and depreciation. These opportunities are noteworthy in the area of real estate ownership with cost segregation. ❖

Curt Gautreau, CPA, CCSP is an owner of Cost Segregation Initiatives and frequently speaks and writes articles for the LCPA. Curt is a past president of the Baton Rouge Chapter and is also a Certified Cost Segregation Professional.