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BON APPÉTIT

IMPROVEMENTS SERVE UP TAX BREAKS

BY JERROLD J. STERN



Tax rules for commercial property leasehold improvements and restaurant improvements were changed by the 2004 Tax Act. As long as the criteria are met, leasehold improvements can now be depreciated over 15 years rather than 39. This advantage is offset by disallowance of a 50 percent first-year bonus depreciation deduction. In contrast, qualified restaurant improvements receive two tax benefits — a 15-year write-off plus the 50 percent bonus depreciation.

The new rules apply to improvements built in 2005 only. Congress has not yet decided on post-2005 improvements.

Nonrestaurant Leasehold Improvements

A transition rule allows both a 50 percent first-year write-off and 15-year depreciation for certain improvements made during the last two months of 2004. The same rules apply to improvements made by a lessee or a lessor. If a leasehold improvement qualifies as a restaurant improvement, defined below, both the 15-year write-off and the 50 percent first-year bonus depreciation apply.

In general, companies making nonrestaurant leasehold improvements benefit least under the new law. Taxpayers typically benefit from rapid write-offs, but in this case, losing the 50 percent one-year write-off in exchange for a shortened overall period of depreciation (15 years rather than 39 years) leaves most

taxpayers worse off. This conclusion is based on after-tax numerical analyses comparing old law and new law. Yet, a 15-year depreciation period is certainly more beneficial than a 39-year one.

To depreciate commercial leasehold improvements over 15 years, the building must be more than three years old when the improvement is placed in service. The new rules apply only to commercial property, not to residential rental property.

Here is an illustration. Assume a growing retail chain leases commercial space in various new locations in January 2005 (year 1). The chain spends \$1 million on leasehold improvements. Renovations include customized counter space, new lighting fixtures, additional air conditioning equipment and alterations to the ceiling.

The chain would be able to deduct one-half of one year's depreciation in year 1, or \$33,333 ($\$1 \text{ million} \times 1/15 \times 1/2$). The 1/2 portion of the computation represents one-half of one year's depreciation, a first-year adjustment required by law for most properties. Depreciation in years 2 through 15 is \$66,667 ($\$1 \text{ million} \times 1/15$), and year 16 depreciation is \$33,333. Thus, the entire \$1 million cost is depreciated during years 1 through 16.

Leasehold improvements that qualify for the 15-year write-off period include enlarging the building, as well as adding elevators, escalators and structural components benefiting a common area or

the internal structural framework of the building. *Structural components* for these purposes are defined as load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses and all other materials essential to the stability of the building.

Restaurant Improvements

To qualify for the new rules, restaurant improvements must be made to properties that have been in service more than three years. Also, more than 50 percent of the building's total square footage must be devoted to preparation and consumption of meals.

For example, assume a restaurant expands its capacity at a cost of \$1 million. In the first year, \$500,000 can be deducted. The \$500,000 remaining tax basis can be depreciated using the same depreciation schedule as illustrated in the previous example. The first year's regular depreciation would be \$16,667 ($\$500,000 \times 1/15 \times 1/2$). Total depreciation for the year would be \$516,667. The \$483,333 remaining tax basis ($\$1 \text{ million} \text{ less } \$516,667$) would be depreciated over years 2 through 16.

In addition to the rules discussed here, several other technical requirements must be met. Consultation with a tax accountant or tax attorney is recommended. ♦

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