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The Ability to Expense Capital Costs (Section 179 Expensing) Now Includes Certain Real Property

Today's 3 R's of Real Estate:

Resources
Renewables
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On September 27, President Obama signed the 2010 Small Business Jobs Act (the "Act") which includes a number of tax incentives for businesses. For the first time, owners of real property have the ability to expense (i.e., currently deduct) certain costs which are typically capitalized and depreciated.

Prior to the Act, taxpayers could expense annually up to \$250,000 of qualifying property (e.g., machinery, equipment and certain software) placed in service in tax years beginning in 2010. The annual limit was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service in tax years beginning in 2010 exceeded \$800,000. Under the Act, for tax years beginning in 2010 and 2011, the \$250,000 limit is increased to \$500,000 and the \$800,000 limit is increased to \$2,000,000.

The Act allows taxpayers to elect to expense up to \$250,000 of the \$500,000 overall annual Section 179 limit for the cost of "qualified real property." Qualified real property consists of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. Qualified real property must be depreciable, acquired for use in the active conduct of a trade or business, and cannot be ineligible property (i.e., certain lodging property, property used outside the U.S.,

property used by governmental units, foreign individuals or entities, and certain tax-exempt organizations, and air conditioning or heating units).

Qualified Leasehold Improvement Property
Generally, qualified leasehold improvement property is any improvement to an interior part of a

building that is nonresidential real property, provided all the following requirements are met: (1) the improvement is made under or according to a lease by the lessee (or any sublessee) or the lessor of that part of the building; (2) that part of the building is to be occupied exclusively by the lessee (or any sublessee) of that part; (3) the improvement is placed in service more than three years after the date the building was first placed in service by any person; and (4) the improvement is Section 1250 property (i.e., depreciable real property). However, qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building

Generally, a binding commitment to enter into a lease is treated as a lease and the parties to the commitment are treated as the lessor and lessee. However, a lease between related parties is not treated as a lease.

Qualified Restaurant Property
Qualified restaurant property is either



(1) a building, if such building is placed in service in 2010 or 2011; or (2) an improvement to a building, and, in either case, more than 50% of the building's square footage is devoted to the preparation of and seating for the on-premises consumption of prepared meals.

Qualified Retail Improvement Property

Qualified retail improvement property is any improvement to an interior portion of a building that is nonresidential real property, if that portion of the building is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and if such improvements are placed in service more than three years after the building was first placed in service. Qualified retail improvement property does not include any improvement that consists of an enlargement of the building, any elevator or escalator, any structural component benefiting a common area of the building, or the internal structural framework of the building.

Limitations

As stated above, the amount of real property that may be expensed under Section 179 is limited to a \$250,000 annual limit and the dollar limit is phased out when the cost of Section 179 qualifying property exceeds \$2,000,000. In addition, if the taxpayer has no taxable income, the taxpayer cannot deduct anything under Section 179. No amount

of a Section 179 deduction attributable to qualified real property can be carried over to a tax year beginning after 2011. Thus, a carryover from 2010 can only be used in 2011. If the taxpayer has unused Section 179 depreciation relating to qualified real property in 2010, the taxpayer will assume that no Section 179 election had been made for that amount and will treat the unused Section 179 depreciation relating to qualified real property as if attributable to property placed in service on the first day of the taxpayer's next tax year beginning in 2011.

Examples

1. During 2010, a company's only asset purchases are Section 179-eligible equipment costing \$100,000 and quali-

fyng leasehold improvements costing \$350,000. Assuming the company has no other asset purchases during 2010, and is not subject to the taxable income limitation, the maximum Section 179 deduction the company can claim for 2010 is \$350,000 (\$100,000 with respect to the equipment and \$250,000 with respect to the qualifying leasehold improvements).

2. A taxpayer places \$500,000 of qualified retail improvement property in service in 2011 and deducts \$250,000 under Section 179. Because of the taxable income limit, the taxpayer is able to expense only \$100,000 of the \$250,000 relating to qualified retail property. The taxpayer will treat the \$150,000 as if it had not been expensed under Section 179 and it can depreciate the \$150,000

under the regular depreciation rules starting in 2011.

Since the mid-1980's, it has been rare occurrence for Congress to offer tax incentives to owners of real estate. In those instances where a real estate owner/lessor cannot expense improvements to qualifying real property due to the limitations of Section 179, the owner/lessor should consider this tax benefit in negotiating with tenants who may qualify for the deduction for tenant improvements made to the property.

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