

IRS provides guidance on claiming bonus depreciation for qualified improvement property

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In brief

The CARES Act provides a technical correction to a drafting error in the 2017 tax reform act (the Act), which had omitted qualified improvement property (QIP) from the definition of qualified property eligible for additional first-year (bonus) depreciation. The IRS has released Rev. Proc. 2020-25, allowing taxpayers to change depreciation for QIP placed in service after December 31, 2017. The revenue procedure also allows taxpayers to make certain elections late or to revoke or withdraw previous elections.

In detail

Claiming bonus depreciation for QIP

Background

Qualified property eligible for bonus depreciation includes property with a recovery period of 20 years or less. The drafting error in the Act omitted QIP, which includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, from the list of property with a 15-year recovery period. Thus, under the ACT, QIP was treated as 39-year property and not eligible for bonus depreciation.

The CARES Act technical correction adds QIP ‘made by the taxpayer’ (referred to in this Insight simply as QIP) to the list of property with a 15-year recovery period and a 20-year class life under the alternative depreciation system (ADS). Rev. Proc. 2020-25 clarifies that a taxpayer that treats QIP placed in service after December 31, 2017 as 39-year property is on an improper method of accounting.

Observation: The impact of the rule that QIP must be ‘made by the taxpayer’ means that a taxpayer may not claim bonus depreciation for QIP acquired from another taxpayer. QIP is a capitalized improvement to a building and not a separate and distinct depreciable asset that can be sold to another taxpayer.

Procedures

Rev. Proc. 2020-25 generally allows taxpayers that placed QIP in service after 2017 in a tax year ending

in 2018, 2019, or 2020 to change to a proper method of accounting for depreciation for QIP by filing an amended federal income tax return (return) for the placed-in-service year. The taxpayer must file the amended return on or before October 15, 2021, but no later than the expiration of the period of limitations for the amended return tax year.

Alternatively, a taxpayer may change its method of accounting by filing a Form 3115 with its timely filed return under the automatic change procedures. The new procedures for changing from an impermissible to a permissible accounting method for depreciation for QIP generally apply to property placed in service after 2017 (1) for which a taxpayer used an impermissible method for at least two consecutive tax years before the year of change, and (2) that the taxpayer owns at the beginning of the year of change. The procedures may be applied to a change for QIP placed in service in the year immediately before the year of change if the Section 481(a) adjustment includes the amounts attributable to that QIP and to all other property subject to the Form 3115.

The restrictions on making a method change in a business's final year and on changing the same item during the previous five tax years are waived for these method changes for the later of (1) the first or second tax year after the placed-in-service year, or (2) a tax year for which the taxpayer timely files an original return between April 17, 2020, and October 15, 2021. Taxpayers are required to complete only certain sections of the Form 3115.

These procedures do not apply to (1) taxpayers that made a late election or withdrew an election under Section 163(j)(7)(B) (real property trade or business) or 163(j)(7)(C) (farming business) for the tax year the QIP was placed in service, or (2) QIP for which the cost or basis is expensed.

Observation: Taxpayers may experience a net operating loss (NOL) for their 2019 or 2020 tax year that may be carried back five years under the CARES Act. Taxpayers may wish to recoup missed bonus depreciation for QIP placed in service in 2018 in an NOL year, thereby maximizing the NOL for that year and potentially obtaining a permanent tax rate benefit in higher, pre-tax reform tax rate years. Conversely, taxpayers that do not anticipate incurring an NOL but are seeking to maximize cash flow may want to claim bonus depreciation on the QIP in either 2018 or through a method change in 2019.

Elections

Background

A taxpayer may elect to opt out of bonus depreciation for all qualified property in a class placed in service during the tax year. This election applies annually and on a class-by-class basis.

A taxpayer also could elect to claim 50% bonus depreciation in lieu of 100% bonus depreciation for qualified property acquired after September 27, 2017 and placed in service in the first tax year ending after September 27, 2017 (the tax year that includes September 28, 2017). This election applies to all qualified property placed in service during that tax year rather than on a class-by-class basis.

A third bonus depreciation election allows a taxpayer to claim bonus depreciation for specified plants in the tax year the taxpayer plants or grafts a plant instead of the date the plant is placed in service.

Under proposed regulations, a taxpayer must make these bonus depreciation elections by the due date, including extensions, of the taxpayer's return for the year the qualified property is placed in service. A taxpayer may revoke an election within the six-month period following the original due date of the taxpayer's timely filed return or through a private letter ruling request. Following a change in the regulations, Rev. Proc. 2019-33 provided procedures for taxpayers to change a previously made election or make a late election for certain tax years. See [Rev. Proc. 2019-33 provides procedures for changing bonus depreciation elections](#).

A taxpayer may elect to depreciate any class of property the taxpayer places in service during the tax year under the ADS. This election generally applies to all property in the same class placed in service in the same tax year. However, for nonresidential real property and residential rental property, the ADS election may be made on a property-by-property basis. A taxpayer must make the election by the due date, including extensions, of the taxpayer's return for the placed-in-service year. The election is irrevocable.

Late depreciation elections and revocations

Rev. Proc. 2020-25 provides procedures for a taxpayer to make or revoke these bonus depreciation or ADS elections if the taxpayer placed depreciable property in service during its tax year ending in 2018, 2019, or 2020, has not withdrawn or revoked the election, and timely filed its return for the placed-in-service year on or before April 17, 2020. For the election to claim 50% bonus depreciation for the first tax year after September 27, 2017, the taxpayer must have placed the property in service in, and timely filed its return for, that tax year.

Observation: The provisions for making a late election or revoking an election are not limited to elections relating to QIP.

Under Rev. Proc. 2020-25, a taxpayer may make a bonus depreciation or ADS election on an amended return for the placed-in-service year. The taxpayer must file the amended return on or before October 15, 2021, but no later than the expiration of the period of limitations for the amended return tax year.

Alternatively, a taxpayer may make a bonus depreciation or ADS election by filing Form 3115 under the automatic accounting method change procedures. A taxpayer may use the automatic method change procedures to make a late election by filing a Form 3115 with a timely filed return (1) for the taxpayer's first or second tax year following the placed-in-service year, or (2) filed on or after April 17, 2020 and no later than October 15, 2021. The method change is made with a Section 481(a) adjustment and the terms and conditions are similar to those for a change from an impermissible to a permissible method.

Rev. Proc. 2020-25 generally allows a taxpayer that previously made one of the bonus depreciation elections to revoke the election by filing an amended return or Form 3115 under requirements and conditions similar to those for making a late election. However, a taxpayer may withdraw an ADS election only by filing an amended return.

Note: Generally, making or revoking elections are not changes in methods of accounting. Rev. Proc. 2020-25 treats these actions for certain elections as method changes only for limited periods.

The takeaway

A taxpayer that placed QIP created by the taxpayer in service after 2017 may claim missed depreciation for the property. A taxpayer that treated the property as 39-year property is on an impermissible method of accounting and must change to a permissible method by filing either an amended return or a Form 3115 under the automatic procedures. Taxpayers also may use these procedures to make late depreciation elections or revoke bonus depreciation elections.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact one of the PwC professionals listed below or your local [Accounting Method Services](#) contact:

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