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TAX BREAK

For LEASEHOLD IMPROVEMENTS

By Jerrold J. Stern

The 2002 Tax Act provides "bonus" depreciation deductions for leasehold improvements and certain other property. These tax benefits are part of the \$123 billion tax reduction package signed into law by President Bush. The new law is intended to stimulate the economy, which has languished since the Sept. 11, 2001, terrorist attacks.

The new rules allow 30 percent of the cost of leasehold improvements made to commercial real estate to be deducted in the first year. In addition to this bonus depreciation, taxpayers can deduct regular depreciation on the improvements. Either the lessor or the lessee may make the improvements and take advantage of the tax benefits.

Example. A rapidly expanding fast-food chain leases commercial space in various new locations in January 2002. 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 bonus depreciation of \$300,000 (30 percent of \$1 million). Regular depreciation can be deducted as well. The first-year depreciation percentage for commercial real estate placed in service in January is 2.461 percent. Regular depreciation would be \$17,227 ($[\$1 \text{ million} - \$300,000] \times 2.461 \text{ percent}$). The tax law allows the \$682,773 balance (\$1



million - \$300,000 - \$17,227) to be written off during the next 38 years.

To take advantage of these benefits, the building must be more than three years old when the improvement is placed in service. If possible, taxpayers should consider delaying improvements in relatively new buildings to avoid that three-year period.

A binding commitment to enter into a lease is treated as a lease for these purposes. If a lease is between related parties, improvements are not eligible for bonus depreciation.

Nonqualified improvements. The law specifies that certain commercial realty

improvements are not eligible for bonus depreciation and can only be depreciated over 39 years. These improvements include enlargement of a building, elevators, escalators, any structural components benefiting a common area and changes to a building's internal structural framework.

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

Personal property. Bonus depreciation also applies to personal property used in a business. Various assets used in commercial buildings fall into this category. Examples include computers, furniture, removable lighting fixtures, office equipment, movable partitions, carpeting and plumbing and electrical equipment used in connection with specialized equipment that does not benefit the entire building. All costs involved for specialized equipment are eligible, including the costs of parcels, transformers and wiring.

Personal property used in a business is typically subject to depreciation over five or seven years. To qualify for bonus depreciation, the taxpayer must be the original user of the property.

The benefit of bonus depreciation is that deductions are accelerated into the current tax year. However, there may be **reasons not to use bonus depreciation** even if it is available. First, the taxpayer may have net operating losses from prior tax years that are nearing their expiration dates. Second, the taxpayer may expect to be in a higher tax bracket in future years. In both cases, the taxpayer could be better off by using the slowest methods of depreciation to maximize the size of deductions when marginal tax rates are highest.

The tax rules and computations for bonus depreciation and depreciation in general can be complex. Consultation with an accountant or attorney is recommended. ♣

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