Capital Improvement Incentives
By: Matt Madden, CPA

The 2010 Tax Relief Act provides significantly increased incentives for business investment in capital improvements and equipment. This legislation encourages taxpayers to make such investments in certain periods from 2010 through 2012. The legislation includes an extended and enhanced bonus depreciation allowance of 100 percent of the cost of qualified property purchased as well as a temporary increase in the deductible amount and investment limitation for a small business deduction (Code Section 179).

100 Percent Bonus Depreciation
Since 2008, taxpayers have been allowed to deduct 50 percent first-year bonus depreciation on qualifying property purchased. This basically has allowed businesses to immediately write-off half the cost of the property instead of depreciating the cost over a longer recovery period. The property must be new (original use, not used), placed in service during the eligible period, and be one of the following types of qualifying property: 1) property with a recovery period of 20 years or less, 2) purchased computer software, 3) water-utility property, or 4) qualified leasehold improvement property. Therefore, a business could purchase new qualifying equipment or leasehold improvements and immediately write-off half the purchase price to reduce their taxable income or increase their losses.

The 2010 Tax Relief Act not only extended this bonus depreciation incentive through 2012, but also expanded the 50 percent allowance to 100 percent for property placed in service between September 9, 2010 and December 31, 2011. For the 2012 tax year, the allowance will revert back to 50 percent bonus depreciation.

This bonus depreciation incentive is unique because it allows businesses to completely write-off the cost of qualifying new purchases and it applies retroactively to property placed in service since the bill was introduced on September 9, 2010. This incentive is different from the small business deduction, described below, because Section 179 is only allowed up to a certain dollar limitation and only applies to businesses that have taxable income (i.e. not allowed for businesses reporting losses). Furthermore, bonus depreciation is allowed for rental property while Section 179 is not.

Code Section 179 Expensing
This section generally allows businesses with taxable income that meet certain requirements to expense the cost of qualifying property rather than depreciating the cost over time. For tax years beginning in 2010 and 2011, taxpayers are permitted to expense up to $500,000 of the cost of qualifying property. This amount is reduced if the qualifying investment for the year is greater than $2,000,000, on a dollar-for-dollar basis up to $2,500,000. Qualifying property includes depreciable tangible personal property purchased for use in the active conduct of a trade or business, however, this deduction does not apply to most rental properties. After 2011, the maximum amount a taxpayer may expense under Code Section 179 is only $125,000 and on investments less than $500,000.

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**Qualified Leasehold Improvement, Retail Improvement, and Restaurant Property**

The Tax Relief Act of 2010 also extended through 2011 prior regulations that allow for a reduced 15-year recovery period on these specific types of property. While all three types of property qualify to be depreciated over 15 years using the straight-line depreciation method, only qualified leasehold improvements qualify for bonus depreciation, and thus, the temporary 100 percent bonus depreciation allowance.

Qualified leasehold improvements are defined as interior improvements made to nonresidential property by a lessor or lessee pursuant to a lease, but not including enlargement of the building, elevators, structural components benefiting a common area, or the internal structural framework. The improvements must be made more than three years after the building was first placed into service.

**Summary**

The qualified leasehold improvement classification coupled with 100 percent bonus depreciation is an extremely beneficial incentive for tenants and property owners of commercial real estate. In the past, improvements on these properties needed to be capitalized and depreciated over either 15 or 39 years. This new legislation allows for the immediate write-off of the improvement costs. For example, under prior legislation, a $500,000 improvement on qualifying leasehold improvement property would have to be depreciated at $33,333 per year for 15 years. This new legislation would allow the improvement, if qualifying and placed in service between September 9, 2010 and December 31, 2011, to be expensed in the first year.

The income tax savings and cash-flow impact of these new incentives can be significant, but it will be important for taxpayers to verify they meet the comprehensive requirements for each benefit. It will also be important to analyze which incentive is most beneficial to a business, as there are times when Section 179 may be more beneficial than bonus depreciation, and vice-versa. Please consult with one of Elliott Davis’ Real Estate team members or your tax advisor on your specific situation.

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**Matt Madden, CPA** is a manager in the real estate practice of Elliott Davis. Located in the firm’s Greenville, S.C. office, he has five years of public accounting experience. Matt may be reached at 864.552.4811 or mmadden@elliottdavis.com.