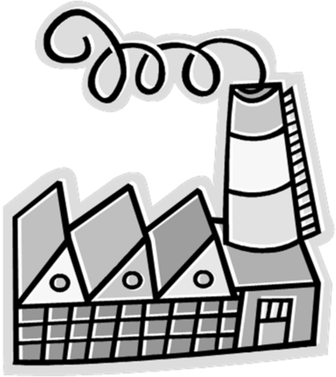
WELCOME TO

Tax Depreciation, Amortization and Property Transactions



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Chapter #1
Depreciation Overview

2012 – Important Developments

- Sec. 179
  - $500,000 drops to $125,000 (adjusted for inflation to $139,000)
  - Phaseout drops from $2 million to $500,000 (adjusted for inflation to $560,000)
  - Phaseout range now $560,000 to $599,000

2012 – Important Developments

- Sec. 179 expensing of up to $250,000 of “qualified real property” dropped
- Included “qualified leasehold improvements,” “qualified retail improvements,” and “qualified restaurant property”
  - MACRS 15-year treatment for this otherwise 39-year commercial real estate also gone for 2012
  - Any unused QRP write-off as of 1/1/12 lost and basis has to be depreciated instead
  - Sec. 179 s/b revoked and bonus depreciation instead s/b claimed

2012 – Important Developments

- 50% bonus depreciation for 2012, but what about 2013?
- Critical new proposed regs on repairs v. capitalization
  - Return of “component depreciation”
  - 3-prong test for writing off repairs eliminated?
  - Increased importance of cost seg studies to allocate building costs to “component systems?”

2012 – Important Developments

- Drop of T/B use to ≤ 50% causing recapture of Sec. 179 deductions (compare this to Sec. 1245 depreciation recapture)
- Ramifications of tax-deferred exchanges on depreciation deductions (up to 16 types of such exchanges)
- Using Form 3115 to expense repairs v. capitalization (or, vice versa)
- Using Form 3115 to catch-up on missed depreciation deductions or bonus

2012 – Important Developments

- How should open-air parking structures be depreciated?
- Treatment of other assets such as pallets or shipping containers
- Depreciation of assets held for rent v. sale; assets used in sales displays (p. 1-3)
- Site lighting or security lighting – 15-year "land improvements" or 5-year property
- Sec. 179 carryovers when SMLLCs convert to multi-member LLC or S corps

2012 – Important Developments

- Recent IRS audits on cost seg studies or expensing renovation repairs
- Restrictions on noncorporate lessors and Sec. 179; impact on mere oral leases
- Writing off covenants-not-to-compete

Introduction

- What do we Depreciate?
- Capital expenditures used in: (§168)
  - Taxpayer's trade or business, or
  - Production of income
- Not capital (i.e., investment) assets
- Not inventory items

Depreciable Assets

- Tangible Personal or Real Property
- Intangible Property
  - Copyrights
  - Patents and Computer software
- Intangible Assets
  - Goodwill
  - Covenants-not-to-compete

Allowed or Allowable

- Correct adjusted basis must be used when calculating gain or loss on dispositions, even if all depreciation has not been claimed
  - Example of new client w/ two Schedule E rental properties where one was sold last year and the other continues to be held, but no depreciation claimed on either

Basic Requirements

To be depreciable, the property must meet **all** of the following requirements:

C. Must hold title to the asset or incidents of ownership

D. Used in business or income-producing activity

H. Have a determinable useful life

I. Expected to last more than one year

Repairs v. Capitalization (p.1-4)

3- Prong Test - Does the expenditure:

1. "Significantly prolong" useful life?
2. Adapt asset to new or different use?
3. "Materially increase" value of entire asset?

Repairs v. Capitalization (p.1-4)

- This 3-prong test long-existed in IRS regs; cited in various revenue rulings and numerous court cases
- "Useful life" <u>not</u> same as MACRS recovery period
- Advisable perhaps not to do "repair" at the same time as other major renovations
- Examples: Repair roof, repave parking lot, replace HVAC, return property to pre-casualty condition, remove mold, etc.

Repairs v. Capitalization (p.1-4)

- Examples: Replace tires on a fleet of trucks (CCA 200252091)
- What is a "material increase" in FMV of asset being "repaired?"
  - > 5%? >10%? (Cf. fn. #4 & 5)

Some Important Terms (p. 1-14)

- "Active conduct of T/B"
  - Sec. 179 requires this type of K-1 income for the "T/B taxable income" limitation
  - Therefore, mere K-1 investors can't use this T/B income for meeting the Sec. 179 test
- Idled or closed facilities
  - "Idled" – keep depreciating; "Closed" – considered "taken out of service" for depreciation purposes
  - Example: Converting apt. bldg. to condos

Some Important Terms (p. 1-15)

- "Mixed-use property"
  - Property w/ retail stores/restaurants on ground level and apartments on higher floors
  - Sec. 280A and the 80/20 test re: gross rents
  - Could be one type of depreciable property initially and then use of property changes (i.e., based on % of gross rents changing)
  - Election out of "change-of-use" regs especially when it would be disadvantageous

Some Important Terms (p. 1-15)

- "Structural components"
- Individual parts that when put together form an entire structure, such as a building
  - Walls, partitions, floors, and ceilings, as well as any permanent coverings such as paneling or tiling, windows and doors, and all components of a central A/C or heating system including compressors, pipes and ducts; also includes plumbing fixtures such as sinks, bathtubs, electrical wiring and lighting fixtures, and other parts that form the structure

Chapter #2

Proper Classification of Depreciable Assets

MACRS Recovery Periods (p.2-1)

- 3-, 5-, 7-, 10-, 15- 20-year recovery periods
  - Mostly used for tangible personal property
  - Six types of real estate though:
    - Single-purpose ag & horticultural structures (10-year)
    - Car wash bldgs (whether or not attached to gas station convenience store – 15-year)
    - Gas stations bldgs (> 50% gross receipts; 15-year)
    - Land improvements (15-year)
    - Billboards (15-year)
    - Multi-purpose ag or horticultural structures (20-year)
  - Means bonus depreciation possible

Rev. Proc. 87-56 (p.2-1)

- Main source of IRS guidance for classifying depreciable assets
  - Not listed in procedure; results in auto classification as 7-year property w/ 12-year M/P
  - IRS Pub. #946 excellent source of information
    - Has Rev. Proc. 87-56 reproduced in Appendix B
    - Appendix A contains depreciation %'s for each year of MACRS recovery period
  - Very important to check for asset misclassifications on Form 4562 for new clients

Rev. Proc. 87-56 (p.2-2)

- Assets used for specific purposes
  - Can have varied MACRS recovery periods & "whole" #'s in ADR classification system
  - On the other hand, "generic" assets (e.g., F&F) have a ADR classification of < "whole" number
  - Example: ADR Class .11 for F&F; Class .12 computers; Class .22 vehicles; Class .3 land improvements

Change-of-Use Regs (p.2-3)

- T.D. 9132
- Regs take a pro-taxpayer approach insomuch as they **give the option to treat the change in the use of the asset as if it had never occurred** if the taxpayer wishes to ignore it
- If regs apply, treat remaining adjusted basis as "new" asset placed into service at time use changes

Key Court Decisions (p.2-3)

- ***Norwest***
  - F&F treated as MACRS 7-year property if used in an "office" space (includes professional services such as accounting & law conference in advising clients)
  - F&F in rendering professional services in a "hands-on" setting (e.g. dentist, doctors, etc.) treated as MACRS 5-year property
  - F&F in residential settings also 5-year
  - F&F in retail/wholesale also 5-year

“Qualified Nonpersonal Use Vehicles” (p.2-4)

- Important exception to both the “luxury car caps” and $25,000 limit on Sec. 179 for “heavy vehicles”
- Includes:
  - Commuter/hotel vans w/ seating for > 9 behind driver’s seat
  - Pick-up trucks w/ ≥ 6’ beds not “readily accessible from cab”
  - Other vehicles “not susceptible of significant use”

Chapter #3
“Depreciation Choices for Regular Tax & AMT”

Tangible Personal Property

- Regular tax:
  - 200% DB (MACRS)
  - 150% DB (AMT depreciation)
  - S/L over MACRS recovery period
  - 150% DB over mid-point
  - S/L over mid-point
- AMT:
  - 150% DB over MACRS recovery period
  - 150% DB over mid-point
  - S/L over mid-point

Real Estate Depreciation

- Regular tax”
  - S/L over 27.5-year for residential property
  - S/L over 39 years for commercial property
  - S/L over 40-year mid-point for both types
- AMT:
  - S/L over 27.5-year for residential property
  - S/L over 39 years for commercial property
  - S/L over 40-year mid-point for both types
- Note: Before ‘99, only S/L for both types over 40-year mid-point

AMT Conformity Method

- Choosing to forgo 200% DB method for regular tax and instead use 150% DB
  - Normal MACRS recovery period used for both
  - Avoids AMT adjustment
  - If less than 150% DB used for regular tax (e.g., S/L over recovery period or mid-point), no “negative adjustment” for AMT purposes
  - Advisable for “big ticket” items (e.g., tractor/trailers, heavy construction equipment, planes, etc.)

AMT Conformity Method

- Note: If either Sec. 179 or bonus depreciation is used, no AMT adjustment is made for that portion of the asset’s write-off
- Planning point: If marginal rates are expected to increase, should assets be written off over longer period, or less generous depreciation methods?

Depreciation Convention Methods

- Half-year convention
  - – Doesn't matter if asset placed into service first or last day of the tax year
- Mid-quarter convention
  - – Occurs when > 40% of assets w/ $\leq$ 20-year MACRS recovery periods placed into service during last quarter of tax year
    - Sec. 179 helps to avoid M/Q but not bonus depreciation
    - Real estate (e.g., land improvements) in 10-, 15-, or 20-year classes can cause M/Q to apply

Bonus Depreciation (p.3-5)

- 50% bonus depreciation for 2012
  - – "Original use" assets including those first leased by taxpayer (e.g., cars, equipment)
  - – No phaseout, no caps, no "T/B taxable income" requirement
  - – Automatically applies unless election out made (done on class-by-class basis)
  - – Results in $8,000 first-year luxury car cap
  - – Bonus allowed for QLIs, but not qualified retail or restaurants or improvements

Cost Segregation (p.3-9)

- Might be more important with new “repair v. capitalization” regs & return of “component depreciation”
  - – Besides faster write-offs for 5-, 7-, and 15-year MACRS properties, could mean additional Sec. 179 or bonus depreciation deductions
    - Canopies/awnings, millwork, special wiring, decorative facades, certain floor and wall coverings, land improvements, signs, etc.
  - – IRS Cost Segregation Guide

Chapter #4
Sec. 179 Immediate Expensing

Sec. 179 Immediate Expensing

- Sec. 179
  - – $500,000 drops to $125,000 (adjusted for inflation to $139,000)
  - – Phaseout drops from $2 million to $500,000 (adjusted for inflation to $560,000)
  - – Phaseout range now $560,000 to $599,000
- New or used property
- “Active” T/B taxable income
  - – W-2 or S/E income but <u>not</u> “investor” K-1s

Sec. 179 Immediate Expensing

- Limited by “luxury car caps”
- $25,000 special limit for “heavy” vehicles
- “Business use” must be > 50% or recapture occurs (even w/o any sale or exchange”
  - – Example: “Heavy” SUV converted to personal use when taxpayer buys new hybrid vehicle
- Can be made or revoked on amended return
- T/B taxable income test at entity and owner levels
  - – Adjustments for Form 1065/1120S (p.4-8)

Sec. 179 Immediate Expensing

- Carryovers
  - – Results from lack of T/B taxable income
  - – If at entity level, owner's basis nevertheless reduced during carryover period
- Qualifying property
  - – Tangible personal property, but not HVAC or intangible assets except "off-the-shelf software"
  - – No real property except "single-purpose ag or horticultural structures"

Sec. 179 Immediate Expensing

- Noncorporate lessors – special test (p.4-13)
  - – Be careful w/ clients who don't have written leases
  - – Oral leases might mean Sec. 179 N/A (***Ross Thomann, TC Memo 2010-241(11/1/2010)***)
- Sec. 179 Chart
  - – Page 4-14 to 4-20

Chapter #6
"Sec. 197 – Amortization of Intangible Assets"

Amortization

- Sec. 197 15-year write-off for qualifying assets
  - – Goodwill/going concern value
  - – Patient/customer lists
  - – Workforce-in-place
  - – Covenants-not-to-compete
- Commences in month intangible asset placed into service
  - – S/L over 180 months

Amortization (p.6-3)

- Software – custom made v. off-the-shelf
  - Rev. Proc. 200-50 allows 36-month write-off for custom designed software
  - Sec. 179 use for latter software
- Website development costs
  - Initial costs over 36 months
  - Current deduction for maintaining and updating the website

Amortization (p.6-4)

- **CCM 20111101**
  - Unamortized basis of intangible assets when disposed of added to remaining Sec. 197 assets
  - Example: Purchase of car dealership w/ several brands; one or more brands then discontinued; unamortized basis of disposed brands added to those still remaining

Chapter #7
“Faster Write-Offs Using Cost Segregation Studies”

Hospital Corp of America

- Excellent review of what tangible assets can be separated out from otherwise residential or commercial real estate
  - Depending on materiality, engineered cost seg study recommended
  - IRS response in CCM 199921045
  - Reg. *1.*48-1(c) definition
  - ***Whitco Industries*** standards (p.7-3)
  - “Structural components” (p.7-4)
  - Example: open-air parking structure

Cost Segregation (p.7-5)

- Examples:
  - – Building entrances
  - – Special dedicated wiring
  - – Exit signs & emergency lighting
  - – Wall sconces & decorative lighting
  - – Movable partitions
  - – Cabinets and counters
- Distinguish separate assets such as rugs, appliances, washer/dryer, etc.
  - – Assisted living facilities

Missed Depreciation Deductions

- Catch-up depreciation (p.7-7)
  - – Form 3115
  - – Automatic consent (Rev. Proc. 2011-14)
  - – "Negative adjustments" taken all in <u>one</u> year (Rev. Proc. 2002-19)
  - – Typically from misclassified assets
  - – Even for assets already disposed of (use amended return – Rev. Proc. 2007-16)

Chapter #9
"ADR 57.0 – Distributive Trades and Services"

ADR Class 57.0

- Includes assets used in wholesale/retail activities, or in rendering personal or professional services
- Example: Assets used by doctors, dentists v. lawyers, accountants
- Restaurant assets (Cf. IRS "Cost Segregation Guide")
  - Surprising as to what "permanent type" assets are still 5-year property
  - "Smallwares" – priced under $500

Thank you!

- If you are interested in obtaining the full text of the **“2012 Depreciation Tax Guide”** contact Prof. Connors at **TaxesProf@msn.com**
- Special discount price for conference attendees $149. (normally $195)
- One copy sent electronically good for entire office – comes with hyperlinks to all source documents cited today!

“2012 COMPLETE GUIDE TO DEPRECIATION, AMORTIZATION & TRANSFERS OF PROPERTY - ISSUES, STRATEGIES & ANSWERS”

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CHAPTER #1: DEPRECIATION OVERVIEW[1]

Introduction

The most profound changes to this 2012 edition of the depreciation tax guide include:

- Sec. 179 continued at a $500,000 level (with a $2 million threshold) for 2010 and 2011. But, if Congress does not act, the inflation-adjusted cap will drop to $139,000 with a $560,000 phaseout starting point starting in 2012.

-The opportunity to immediately charge off up to $250,000 "qualified real property" (i.e., out of the overall $500,000 Sec. 179 cap) ends at 12/31/2011. This included "qualified leasehold improvements," "qualified restaurant property" and "qualified retail improvements." But, given the taxpayer did *not* have sufficient "trade or business taxable income," any carryover of the expensing of such property is lost as of 1/1/2012. Instead, such property would now have to be capitalized as of that date and normal depreciation deductions claimed from that point forward.

Comment: A taxpayer has the right to revoke or elect Sec. 179 on an amended return. And, if the above capitalization of "qualified real property" would now be required as of 1/1/2012 (due to the lack of sufficient profits to cover a Sec. 179 carryover on such property) with the affected assets being treated as having all been placed into service as of 1/1/2012, then amended returns should be filed for 2010 and/or 2011 to revoke the original Sec. 179 elections. Then, at least for "qualified leasehold improvement," bonus depreciation could instead be claimed (i.e., given an election out of bonus depreciation for 15-year property had *not* been made), let alone MACRS depreciation.

- As of 12/31/11, it is not yet clear whether Congress will act to extend 100% bonus depreciation. But, if not, then 50% bonus depreciation will be available for 2012.

- The IRS has just issued new regulations which offer guidance on the repair v. capitalization issue. Chapter #1 has expansive coverage of the 3-prong test that has long been in the law allowing for immediate write-off as a repair where the expenditure did not "materially increase" the FMV of the underlying asset involved, nor did it "significantly prolong" the useful life of the asset.

Some of the other depreciation-related issues that have been confronted by practitioners include:

- Distinguishing between Sec. 179 recapture (which does *not* necessitate the sale or exchange of the assets; only a drop of its "trade or business use" to 50% or below) v. Sec. 1245 recapture (which would involve a disposition of the underlying asset).

- Under Sec. 168(i)(7), there are five specific tax-deferred exchanges cited which dictate that "shoes" depreciation be used by the recipient transferee. However, there is a total of 16 different types of tax-deferred exchanges which can be encountered and the effect on the transferee's depreciation method can be "shoes" depreciation in some instances, while "fresh start" depreciation must be used in others.

- The IRS is insisting that despite "automatic consent" approval for changes in depreciation methods allowed

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[1] For additional information, one can refer to several IRS publications: **#334 - "Tax Guide for Small Businesses**;**"** **#534 - "Depreciating Property Placed in Service Before 1987**;" **#535 - "Business Expenses**;" **#538 - "Accounting Periods and Methods**;" **#551 - "Basis of Assets**;" and **#946 - "How to Depreciate Property**." Also, the following forms and schedules, along with their accompanying instructions, provide a good source of information: **Schedule C - "Profit or Loss From Business**;" **Form 2106 - "Employee Business Expenses**;" **Form 3115 - "Application for Change in Accounting Method**;" **Form 4562 - "Depreciation and Amortization**."

on Form 3115, a taxpayer's switch to charging off "repairs" v. their capitalization can still be reviewed by the Service in subsequent audits. In fact, the IRS has issued specific "industry directives" with regard to this sensitive issue. Finally, there may be a limited window of opportunity to automatically switch over from capitalization of assets to charging them off as "repairs." (**Tier I Industry Director's Directive on the Planning and Examination of Repairs vs. Capitalization Change in Accounting Method (CAM) #2**)

Comment: As mentioned above, the IRS during the last week of 2011 published (**IR-2011-126**) temporary regulations that provide guidance to taxpayers on the treatment of amounts paid to acquire, produce or improve tangible property and regarding the accounting for, and dispositions of, property subject to depreciation. These regulations provide objective standards and bright-line rules intended to simplify compliance with the capitalization provisions contained in **Code §263(a)**.

- Service insists that open-air parking structures are 39-Year MACRS property and *not* 15-year "land Improvements" (**LMSB4-0709-029**)

- Should pallets (and, other shipping containers) be inventoried and included as part of goods sold? Or, are they used over and over again and, therefore, should be capitalized as a separate asset class of their own.

- The Service is insistent that depreciation deductions or LKE treatment should be denied for equipment held for sale v. rent. What factors distinguish one situation from the other? (**CCA 201025049**)

- In what instances can "site lighting" be treated as 5- or 7-year macrs property instead of 15-year land improvements? (***PPL Corporation & Subsidiaries v. Commr.*, 135 T.C. No. 8 (07/28/2010)**)

- What happens to Sec. 179 carryovers when proprietorships (e.g., SMLLCs) covert over to LLCs, or corporate entities?

- Examine a recent case study on an IRS audit where the Service insisted that kitchen cabinetry and counter tops had to be capitalized as part of the residential real estate where an upgrade/renovation was done to an apartment complex.

- As more tangible personal property such as trucks and other equipment are held in a separate LLC and leased back to a related trade or business (often on a triple net lease basis), a Sec. 179 deduction can be denied to *noncorporate* lessor where only an *oral* lease arrangement existed (i.e., because the taxpayer could *not* prove that the lease term was less than one-half of the otherwise allowed MACRS recovery period for these assets). (***Ross Thomann*, TC Memo 2010-241(11/1/2010)**)

- The courts have continues to confirm that covenants-not-to-compete associated with stock sales are always to be treated as Sec. 197 intangibles and therefore amortized over 180 months. (***Recovery Group, Inc.*, TC Memo 2010-76 (4/15/2010)**)

- A taxpayer was denied a deduction for the balance of unamortized goodwill where other intangible assets of acquired business still existed. Instead, the business had to take the basis of the unamortized goodwill and write it over the remainder of the 15-year period. (**CCM 20111101f**)

- There is now a revised **Form 3115** which should be used to request accounting method changes. (**Ann. 2010-32**)

- The Service has released **Rev. Proc. 2011-14** which has made additional changes to the automatic consent procedures to be used when applying for a change in a taxpayer's accounting method.

6. INVENTORY

a. Inventory is *not* a depreciable assets since it is *not* **held for use** in a trade or business (i.e., it is only available for possible sale to customers)

b. When an asset might switch over to being “inventory” is sometimes a question of fact as seen in the cases below.

☞**Depreciation Deductions or LKE Treatment Denied for Equipment Held for Rent or Sale** (**CCA 201025049**)
The IRS has concluded that a taxpayer failed to demonstrate that the equipment was devoted to use in its trade or business. Instead, the Service decided that it was inventory that was held for rent, and possibly later on, for sale in its trade or business. As a result, the taxpayer was *not* permitted to claim depreciation deductions for the equipment. Furthermore, it could *not* treat exchanges of the equipment as like-kind exchanges under **Code §1031**.

☞**How Should Pallets Be Depreciated**

1. If the pallets tend to break down and really don't have a useful life beyond a year, then they would be a current deduction.

2. If the pallets go with the shipments to the customer, then they would be charged off as part of the cost of goods sold.

3. If the pallets tend to be usable for several years, and constitute a material cost (when you consider how much is spent on them in total), then **ADR 57.0 "Distributive Trades and Services"** (which covers assets used in wholesale or retail activities) would treat them as 5-year MACRS property. Of course, you would then have the option to take a Sec. 179 immediate expense deduction (given your client does *not* exceed the current phaseout limit) and/or 50% bonus depreciation (for 2008, 2009 or 2010). Remember, if they denied the expense, and the tax year is still open under the statute of limitations, you can go back and amend the return to take a Sec. 179 deduction (if it is still otherwise available; that is, you have not used up the overall limitation for that particular tax year).

☞**Depreciation Not Allowed on Display Furniture** (**FSA 199949031**)
A manufacturer of furniture displayed various items in showrooms that it operated. Even though the models were on the showroom floors for an *average of three years* before they were eventually sold, the Service said that such assets constituted “inventory to be sold in the normal course of the trade or business.” That is, the company expected to eventually sell these items to the public at a profit, which it normally did. As a result, the cost of the furniture was *not* eligible for depreciation. Only in the tax year that a particular item was sold could its cost be charged off against income (i.e., as part of the “cost of goods sold”). **(Code §168; Display Furniture)**

> **Comment:** There would be an exception if the display period extended beyond the useful life of the floor samples (i.e. based on **ADR Classlife 57.0** to be 5 years). And, similar rules apply to model homes that are sold by developers (Cf. **Rev. Rul. 89-25**).

C. ALLOWED OR ALLOWABLE: Pursuant to **Code §1016(a)(2)**, “*all* appropriate adjustments to basis must be made.” Therefore, an asset’s basis for tax purposes must reflect all depreciation deductions “allowed or allowable.” And, taxpayers should be careful in initially classifying an asset. Should they assign a recovery period longer than that otherwise allowed (e.g., as 39.0 commercial real estate instead of 5-year **ADR 57.0 “Distributive Trade or Services”** personal property), basis would still have to be reduced using the correct life and method even though a tax benefit for these corresponding depreciation deductions may never have been realized by the taxpayer.

1. **CATCH-UP DEPRECIATION:** Unexpectedly, the Service released a revenue procedure[2] in May of 1996 which introduced a new concept known as “catch-up depreciation.” Although it involves the filing of a Form 3115 for a change in accounting methods, a taxpayer is *automatically* permitted to claim *all* of its missed depreciation deductions (i.e., even for *closed* tax years) as if the correct recovery period and depreciation method was assigned to the asset as of the date that it was first placed into service.

> **Comment:** There is a more detailed description of "catch-up depreciation" in **Chapter #7** which also covers the concept of using cost segregation studies to uncover these missed deductions.

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[2] **Rev. Proc. 96-31** and an ensuing series of later procedures which spell out the automatic consent procedure for obtaining this tax benefit.

☞**“Maintenance or Repair” vs. “Capital Expenditure?”**

> **Comment:** Even the IRS haD recognized the impact of the cases below and had previously issued proposed regs (**IR 2008-35** discussed below) which had allow a “safe-harbor” for the write-off of recurring repairs. The initial approach in the first set of proposed regs was the “Repair Allowance Method” (RAM)) which would permit a taxpayer to deduct 50% of the costs associated with maintaining an asset over its MACRS recovery period without risk of audit. That first set of proposed regs were withdrawn and replaced with the March, 2008 regs, but it did give an indication of what the Service was previously open to as far as expensing any recurring types of repair expenses. Now, in Dec., 2011, proposed regs were released which attempt to limit repairs which are made to “component systems” (e.g., HVAC, roofs, etc.) and which are part of real estate assets (i.e., buildings).
>
> **Comment:** More detail on the proposed regs can be found in the Supplement to the 2012 Depreciation Tax Guide.

Are we capitalizing items for our clients that perhaps could be written off as repairs? In the ***Cinergy*** case discussed below, the Tax Court once again stated that if an expenditure, even if quite substantial, does *not* prolong the asset’s useful life or otherwise adapt it for a new or different use, then it can be written off in the *current* tax year. The IRS, in **Rev. Rul. 2001-4**, reached a similar conclusion. Namely, there are two basic determining factors for expensing vs. capitalization: 1) whether the item extends the original estimated useful life of the *entire* asset; or 2) whether it increases the value of the entire asset to a *significant degree*. Even the regs state that “the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense . . . Repairs in the nature of replacements, to the extent they arrest deterioration and ‘*appreciably* prolong the life of the property,’ shall be capitalized and depreciated in accordance with **Code §167** (and, **Code §168**).”[3]

> **Comment:** There might be a greater chance that an expenditure will be upheld as a “repair deduction” if the expenditure is *not* made at the *same* time that substantial improvements are also being made or when a “general plan of renovation” is being carried out. It would also be helpful if separate invoices for repairs were obtained rather than having a contractor include *both* general repairs and even major improvement costs on just *one* invoice. Furthermore, it would be wise for any property owners to document the reason for the repair, including a description of the problem that the repair is intended to correct.

When trying to determine whether a particular expenditure “extends the useful life” of an asset, it is essential to first ascertain what was the original estimated useful life of that asset. And, remember that the “estimated useful life” is *not* the same as the “recovery period” or MACRS classification for tax purposes. Rather, the “useful life” is the “anticipated period over which the asset is expected to remain in service.” In addition, the expenditure should extend the useful life of the *entire* asset as opposed to just part of the asset. An excellent example would be the replacement of a roof. Most buildings have a roof that is *not* designed to last for the full “useful life” of the structure. Consequently, the replacement of the roof covering (or, placement of another layer of shingles) should probably be allowed as a current expense. This was evident in the ***Campbell*** **(T.C. Summary 2002-117)** case (discussed below), where the tenant threatened to move out if the leaking roof and water-damaged walls in his master bedroom were not repaired. Mrs. Campbell, the landlady, replaced the *entire* roof, along with new, freshly-painted dry-wall in his bedroom. The IRS forced her to take the case to Tax Court in order to deduct the expenditure as a current deduction on her Schedule E for that particular tax year. But, she emerged successful in her quest (while, no less, representing herself *pro se*).

Another good example of an expenditure that should be currently deducted is the replacement of tires on a fleet of trucks or vans. While the original tires are treated as part of the cost of the truck or van when it is first purchased, any replacement tires may be expensed. In fact, the IRS conceded this very issue when it released **CCA 200252091**.

The *second* test used to determine whether an item should be expensed vs. capitalized is whether the expenditure increases the overall value of the *entire* asset to a “significant degree.” Some commentators suggest the following rule of thumb: If the cost of the repair does *not* extend the useful life of the asset and does *not* exceed 5% of the current

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[3] **Reg. §1.162-4**.

FMV of the asset, then expensing would be in order in nearly all instances. If the cost of the repair is between 5% and 10% of the current FMV of the asset, then expensing or capitalization of the expenditure could go either way. Finally, if the expenditure were to exceed 10% of the asset's current FMV, then capitalization would probably be in order. When making this analysis, some extra attention should be given to assets with longer useful lives (e.g., over 15 to 20 years). Their replacement cost today might be far greater than what it originally cost to acquire the asset. For instance, a single engine airplane might have cost $25,000 in 1955 but could cost up to $250,000 in today's dollars. Therefore, when making the above comparison of the repair expenditure to the original cost of the asset, it might make more sense to use the $250,000 replacement cost of the plane in today's dollars if an older (yet, still valuable) asset was involved.

> **Comment:** At times, IRS agents and the Tax Court will do a "percentage comparison" of the amount of the expenditures to the cost of the property. And, if the percentage is very high, relatively speaking, they will attempt to deny the deduction as being a "repair." For instance, expenditures that were almost twice the cost of a noninhabitable building were found to be capital improvements.[4] Even so, maintenance costs in this same case were allowed as current deductions even though incurred during a general plan of renovation. In fact, the Tax Court has even allowed as deductible repairs expenditures which equaled 35% of the building's total cost.[5]
>
> **Comment:** Just because the cost involved with the "repair" is substantial does *not* automatically result in the item(s) having to be capitalized. Considered the following court decisions where current repair or maintenance deductions were allowed for:
>
> - Over $46,000 spent to arrest and prevent further damage to the building's foundation piles caused by an unexpected lowering of the water level;[6]
> - Costs of $108,000 spent for second-hand engines to replace broken-down engines on a cargo vessel;[7]
> - Expenditures of over $1 million made to repair and prevent cave-ins at a plant that had been erected on a geological fault;[8]
> - Costs of $12,000 to add layers of insulating material over the roof of a newly-constructed factory building. The court found that the new roof only put the building "back to its former efficient operating condition;[9]
> - Costs of $21,000 to repair a leaking roof where the only reason for the repair was to prevent leaks (i.e., the property was originally leak-free and the repair "merely restored it to that condition).[10]
> - Costs of $50,000 to enlarge a reservoir by one-fourth acre to one-half acre in order to prevent the dam from leaking, and thus, "keep it in ordinary operating condition." The reservoir was drained and soil excavated from the dam and then replaced with 10,000 cubic yards of clay to seal the dam. Despite being "extensive," the court found that the expenditures "merely restored the capability of retaining water;"[11] and
> - Costs of $270,000 incurred to repaint and repaper a hotel as part of normal, ongoing maintenance. The hotel had done this in order to retain its 5-star rating. Furthermore, the court agree with the

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[4] *Stoeltizing v. Commr.*, 266 F.2d 374 (3rd Cir. 1959).

[5] *Buckland v. Commr.*, 66 F. Supp. 681, 35 AFTR 161 (D. Conn. 1946).

[6] *Illinois Merchants Trust Co.*, 4 BTA 103 (1926).

[7] *Shore v. Commr.*, T.C. Memo. 1959-166, *rev'd.* on another issue 286 F2D 742, 7 aftr 2D 653 (5TH Cir. 1961).

[8] *American Benberg Corp. v. Commr.*, 10 T.C. 361 (1948), *aff'd.* 177 F2d 200, 38 AFTR 758 (6th Cir. 1949).

[9] *Munroe Land Co. v. Commr.*, T.C. Memo. 1966-2.

[10] *Oberman Mfg. v. Commr.*, 47 T.C. 471 (1967).

[11] *Evans v. Commr.*, 557 f.2d 1095 (5th Cir. 1977), 40 AFTR 2d 177-5602.

taxpayer's treatment of these costs even though they were "substantial in amount and done in conjunction with major remodeling."[12]

Finally, according to the **Reg. §1.168-2(l)(1)**, the retirement of a "structural component" of real property (i.e., just a "part" of the overall asset) is *not* considered a "disposition." It does *not* matter whether the component was ACRS or MACRS property (although the reg still states a "15-year recovery period" which is indicative of ACRS real estate). The IRS even released a Field Service Advice (**FSA 200001005**) which, among other issues, reiterates the proposed reg cited above.[13] The only exception would be for leasehold improvements which are abandoned at the end of the lease term (i.e., either by the lessee or the lessor). There, a **Code §1231** loss can be taken for the unrecovered basis remaining at the time of abandonment. An excellent example, once again, is where a taxpayer is forced to replace a roof on a building. The roof, being an integral part of the real estate, is depreciated over either the residential (i.e., 27.5 years) or commercial (i.e., 31.5 or 39.0 years) using the straight-line method (i.e., assuming it is MACRS property placed into service after 1986). Yet, after only 10 or 15 years, the roof may be in need of major repair or, maybe, complete replacement. The "bad news," based on **Reg. §1.168-2(l)(1)**, is that the remaining basis of the original roof must continued to be recovered over its MACRS life. However, the "good news" based on the result reached in cases like ***Campbell***, is that the new roof may be treated as a deductible "repair" (i.e., which might yield a larger deduction than taking the remaining basis on the old roof as a Sec. 1231 write-off).

> **Practitioner Tip:** If a client had instead taken a write-off for the remaining basis in an old roof that was replaced and this was a lot less than what would have been deducted had the cost of the new roof been used, then an amended return might be filed for the difference. This, in fact, is what may have been done in the past as many of us took a **Code §1231** loss for the adjusted basis remaining on the *old* roof (if, indeed, this cost could be segregated from the remaining basis of the building) and then proceeded to set up the "new asset" on the **Form 4562** for roof that was just installed. Note that you wouldn't be filing a Form 3115 to "catch-up" on any missed depreciation because the argument that you would be making is that this "new" roof was a "repair" and that you should have continued depreciating the "old" roof (i.e., as part of the building that is still standing).

IRS Pub. #527 lists the following as examples of "repairs:" repainting inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows. Also, minor expenditures in replacing small parts are generally considered "repairs."[14]

> - **Building additions & major renovations:** Capital improvements would normally include new additions to a building and other major renovations or construction.[15] And, a number of cases have held that even incidental repairs, when done contemporaneously with a major plan of renovation, must be capitalized. Examples would include carting refuse, mending a door, patching plaster, clearing ice and trash removal. Nevertheless, a number of cases go the other way and hold that it did *not* matter that incidental repairs were being done at the *same* time as a major overall of the property involved.[16] Maintenance costs were also deductible even when incurred during a general plan of major

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[12] *Moss v. Commr.*, 831 F.2d 833, 60 AFTR 2d 87-5910 (9th Cir. 1987), *rev'g.* T.C. Memo. 1986-12.

[13] Remember, "component depreciation" was outlawed in 1981 when ERTA '81 introduced ACRS; however, this is distinguishable from "cost segregation studies" which serve to identify separate assets that are *not* merely "components" of the same asset (e.g. landscaping is separate 15-year property as a "land improvement" vs. the real property that it otherwise surrounds).

[14] *Libby v. Blouin Ltd.*, 4 BTA, 910 (1926).

[15] Code §263; *Human Engineering Institute v. Commr.*, T.C. Memo. 1978-45; *LaPoint v. Commr.*, 94 T.C. 733 (1990).

[16] *Markovits v. Commr.*, 11 T.C. Memo 823 (1952); *Universal Mills v. Commr.*, 7 T.C. Memo. 886 (1948); *Kaonis v. Commr.*, T.C. Memo. 1978-184.

renovation.[17] Nevertheless, it helps to keep separate records and secure separate invoices for minor repair or maintenance work vs. a major renovation program. Where a law firm was renovating its offices, the Tax Court stated that it may have been able to charge some of the work off as deductible repairs had they been incurred and accounted for separately.[18]

- **Equipment, furniture & fixtures:** Capitalization is required for equipment, furniture and fixtures (5- or 7-year property), if it has a useful life of more than one year.[19] Examples would include appliances, air conditioners, carpets, and other personal property items such as furniture and fixtures. A current deduction, however, was allowed for the cost of carpet used to repair sections that were worn out or needed replacement.[20]

Comment: Please distinguish between the purchase of an entirely new asset, such as an appliance (e.g., washer, dryer, stove, microwave, refrigerator, etc.) and the replacement of "part" of a current asset (e.g., where a new furnace or hot water heater is being installed). In the latter instance, the IRS has consistently held that heating and air conditioning will generally be considered part of the real estate to which it is attached. Therefore, how is it different when a entire layer of shingles is replaced (i.e., which is part of the overall real estate structure) vs. a hot water heater or a furnace? Did such a replacement: (1) adapt the property to a "new or different use:" (2) significantly prolong its useful life (i.e. as opposed to keeping the property in efficient operating condition so that it will indeed even have its normal "useful life;" and (3) "materially add" to the overall current FMV of the property? If the collective answer is "no" to these questions that the courts are posing, are there sustainable grounds for expensing these costs (i.e., vs. capitalization)? How about when a parking lot is resurfaced? Is that analogous to the "roof" cases discussed below? Certainly, the original 4- or 5-inch gravel base and 2 to 3 inches of asphalt surfacing, along with the grading of the earth to make it suitable for a parking lot, would have to be separately capitalized as a 15-year "land improvement." However, especially in those areas where extreme winter temperatures and constant plowing and use of road salt extract dramatic wear and tear on a road surface such as a parking lot, would a 1 to 2-inch resurfacing of the lot have to be capitalized as a new and separate asset in light of the questions posed above?[21] Or, would it be proper to simply treat the resurfacing of the lot as a "repair."

EXAMPLE: Craig owns four hotel/motels. This past year he spent $40,000 to $60,000 at each location to replace the carpeting and mattresses. Can he write these costs off as "repairs?" The answer is "no." Since they are their own assets (i.e., ADR 5-year MACRS property), they need to be capitalized. In other words, they are *not* "repairs" to an existing asset (e.g., a new boiler or furnace with regard to the commercial real estate such as a hotel/motel in this instance). However, given the phaseout limit ($800,000 for 2008 and 2009; $2 million for 2010 and 2011) is *not* exceeded, Sec. 179 could be used to write off such costs. Furthermore, since the MACRS classlife is 20 years or less, bonus depreciation could be used to write off any costs exceeding the Sec. 179 cap on immediate expensing. Remember, unlike an apartment building or other residential unit, Sec. 179 is allowed in this instance since the occupants are "transient dwellers" who occupy their rooms on an average of 30 days or less each year. A bed and breakfast type of business would also qualify under this exception.

Comment: Certainly, practitioners needed to be aware of the new preparer penalty (i.e., "more likely than not" standard) which was to take effect with the filing of 2007 tax returns. However, that change was *retroactively* repealed and now practitioners continue to face the same "substantial authority" standard as their clients. Nevertheless, given the overwhelming support for taking a repair deduction in these cited cases and rulings,

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[17] *Stoeltizing v. Commr.*, 266 F.2d 374 (3rd Cir. 1959); *Moss v. Commr.*, 831 F.2d 833, 60 AFTR 2d 87-5910 (9th Cir. 1987), *revg.* T.C. Memo. 1971-31.

[18] *Bane v. Commr.*, T.C. Memo. 1971-31.

[19] Reg. §1.263(a)-2(b); *Otis v. Commr.*, 73 T.C. 671 (1981).

[20] *Beck v. Commr.*, T.C. Memo. 1994-122.

[21] New York state actually imposes a sales tax when the resurfacing project is 2 inches or less which is indicative of their interpretation of this expenditure as being merely a repair.

it seems that even the “more-likely-than-not” standard would have been met under these circumstances.

- **Expenditures to “put” vs. “keep” property in ordinarily efficient operating condition:** A number of cases discussed the theory that expenditures made to “put” property into an ordinarily operating condition are capital improvements. On the other hand, those made to “keep” the property in such condition should be treated as deductible repairs or maintenance costs. The former are generally made upon the initial acquisition of the property (i.e., when it might need substantial rehabilitation before it is available for rent in a safe, habitable condition). The issue becomes, what should be the “cutoff date” between those costs incurred “get the property into shape” (i.e., in order to rent or otherwise use it in a trade or business) and those repairs made to “keep it in shape.” Some argue that when a certificate of occupancy is issued(and, the property is otherwise “available for rent or use in a trade or business”), this would be an appropriate point in time to establish the distinction between these two types of costs.

Comment: The following cases all represented instances where “repair” treatment was allowed:

- Painting, papering and decorating;[22]
- Mending and resurfacing floors;[23]
- Maintenance expenses to keep a property safe;[24]
- The cost of cleaning, sanding and painting, even though the useful life of the asset was extended for several years beyond this maintenance program;[25] and
- Patching leaks in an existing roof (although the court found that the cost of a new roof would have to be capitalized).[26]

Comment: The following cases all represented instances where expenditures had to instead be treated as capitalizable improvements:

- The cost of covering an old pine floor with a *new* oak one;[27]
- Replacing an old brick floor with a *new* special concrete floor which was “smoother” because the old floor was causing accidents involving mechanical equipment.[28] The Tax Court determined that the change did more than “just restore the property to its previous condition.” It became “more valuable” to the company because the new flooring was “safer and easier to clean and repair.”
- *New* exits signs and fire escapes.[29]

Comment: Even though “new,” the cost of installing new flooring was currently deductible in ***Knoxville Iron Co. v. Commr.*, T.C. Memo. 1959-54** and in ***Hudlow v. Commr.*, T.C. Memo. 1971-218**. And, where concrete steps replaced older wooden ones to “allow continued use of the property,” a repair deduction was also

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[22] *Rose v. Haverty Furniture Co.*, 15 F.2d 345, 6 AFTR 6335 (5th Cir. 1926); *Luce Furniture Company*, 9 BTA 1413 (1928); IRS Pubs. #523 & 527.

[23] *G&R Corp. v. Commr.*, 8 T.C. Memo. 970 (1949).

[24] *Schmid*, 10 BTA 1152.

[25] PLR 199949003.

[26] *Pierce Estates, Inc. v. Commr.*, 16 T.C. 1020 (1951).

[27] *G&R Corp. v. Commr.*, 8 T.C. Memo. 970 (1949).

[28] *Vanalco v. Commr.*, T.C. Memo. 1999-265.

[29] *RKO Theatres, Inc. v. U.S.*, 163 F. Supp. 598 (Fed. Claims 1958); even today, IRS agents draw a tough line with cost segregation studies which attempt to put these exit signs and emergency lighting fixtures in other than real estate recovery classes (i.e., either 27.5-year or 39-year, depending on the type of property involved).

allowed.[30]

Practice Tip: Much work resulting in the "permanent improvement" of property actually consists of a series of *separate* repairs. Therefore, these repairs might be immediately deductible if they had instead been done separately. But, they might lose their status as "repairs" if they are part of a general plan of renovation, as stated above. As a result, "planned improvements" should be reviewed to ascertain whether they can be broken down into smaller components (i.e., if the work can be done piecemeal at different times, each separate job might qualify as a fully deductible repair).

☞**Despite Approval of Accounting Method Change, Service Still Free to Determine Appropriateness of Expensing vs. Capitalizing Repairs (Tier I Industry Director's Directive on the Planning and Examination of Repairs vs. Capitalization Change in Accounting Method (CAM) #2)**

An industry director for the Large and Mid-Size Business Division has issued a directive to LMSB examiners, instructing them that they are *not* precluded from auditing the treatment of expenses as deductible repairs or costs that should instead be capitalized, even though the taxpayer has previously received IRS's [automatic] approval of a change of accounting method (i.e., via **Form 3115**). This directive is intended to "reinforce" that consent (even if "automatic" pursuant to **Rev. Prov. 2009-39**) to a change in accounting method request does *not* preclude examination of the issue.

☞**New Regs Provide Guidance on Deduction and Capitalization of Tangible Property Expenditures (T.D. 9564)**

The IRS has issued temporary regs that provide guidance on the application of **Code §162(a)** and **Code §263(a)** to amounts paid to acquire, produce, or improve tangible property. Among other things, the temporary regs: (1) clarify and expand the standards in the current regs; (2) provide certain new bright-line tests for applying these standards; (3) provide guidance under **Code §168** regarding the accounting for, and dispositions of, property subject to that section; and (4) amend the general asset account regs.

Comment: Upon an initial reading of these regs, the more important changes appear to be that certain "repairs" such as a new roof might now have to be capitalized, while a Sec. 1231 ordinary loss would be taken on the remaining basis allocable to the cost of the old roof (even though this would appear to fly in the face of the repeal of the "component depreciation rules" which were outlawed by the '81 Tax Act). This would also apply to other "repairs" such as replacing central air conditioner units, furnaces, hot water heaters, etc.

Comment: These regs are temporary and are awaiting finalization after they have gone through a "comment period." Nevertheless, they appear to contradict established case law which consistently apply a test whereby, if a "repair" did *not*: (1) adapt an asset to a new or different use; (2) materially add to the FMV of the asset; or (3) significantly prolong the asset's useful life, it did *not* have to be capitalized.

Background: Costs are currently deductible as a repair expense under **Code §162** "if they are incidental in nature, and neither materially add to the value of the property nor appreciably prolong its useful life." Costs also are currently deductible if they are for materials and supplies which will be consumed by the taxpayer during the *current* tax year (i.e., *not* otherwise held as "inventory" for sale in the normal course of the taxpayer's trade or business as inventory). On the other hand, expenses must be capitalized under **Code §263** "if they are for permanent improvements or betterments that increase the value of the property, restore its value or use, substantially prolong its useful life, or adapt it to a new or different use."

New Temporary Regs: The new temporary regs will affect virtually all taxpayers that acquire, produce, or improve tangible property. They adopt and refine many of the rules contained in the 2008 proposed regs, but also modify certain provisions and provide additional rules. Some of the specific retained or changed rules include the following:

- **Materials and supplies:** The temporary regs modify and expand the definition of "materials and supplies" set out in the 2008 proposed regs, provide an alternative optional method of accounting for rotable and temporary spare parts, and provide an election to treat certain materials and supplies under the de minimis rule of **Reg. §1.263(a)-2T**.

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[30] *Campbell v. Commr.*, T.C. Memo. 1973-101.

- Repairs: The temporary regs retain the rule from the 2008 proposed regs and clarify that a taxpayer is permitted to deduct amounts paid to repair and maintain tangible property, provided that such amounts are *not* required to be capitalized under **Code §263(a)** (or, any other provision of the Code or regs).

- Rentals and leased property: The temporary regs retain the rule in **Reg. §1.162-11(a)** allowing a taxpayer to amortize the costs of acquiring a leasehold over the term of the lease, and make only minor revisions to the rule in **Reg. §1.162-11(b)** that provides that the cost of erecting a building or making a permanent improvement to property leased by the taxpayer is a capital expenditure and is therefore *not* deductible as a current business expense. However, the temporary regs provide that a lessee or lessor must depreciate or amortize its leasehold improvements under the cost recovery provisions of the Code applicable to the improvements (e.g., 15-year "qualified leasehold improvements"), without regard to the term of the lease, and also remove the rules permitting amortization over the shorter of the estimated useful life or the term of the lease.

- Amounts paid to acquire or produce tangible property: The temporary regs largely retain the rules from the 2008 proposed regs regarding the capitalization of amounts paid to acquire or produce units of tangible property, including the general requirement to capitalize acquisition and production costs and the requirement to capitalize amounts paid to defend and perfect title to property. However, in response to comments received, the temporary regs: (1) clarify the application of the rules to moving and reinstallation costs; (2) add and clarify certain rules with respect to transaction costs; and (3) modify and refine the de minimis rule.

- Amounts paid to improve property: The temporary regs retain many of the "simplifying conventions" set out in the 2008 proposed regs, including the "routine maintenance safe harbor" and the "optional regulatory accounting method," but also modify the 2008 proposed regs in several areas. The temporary regs retain the rule that the "unit of property" for a building consists of the building and its structural components, but revise the manner in which the improvement standards must be applied to the building and its structural components. Also, the temporary regs do *not* include the 50% thresholds and recovery period limitation for determining whether a replacement rises to the level of a "major component" or "substantial structural part" of a unit of property.

- Dispositions: Finally, the temporary regs include new provisions under **Code §168** that expand the definition of "dispositions" to include the retirement of a structural component of a building, and incorporate more detailed rules for determining the "units of property" for condominium, cooperatives, and leased property, for the treatment of leasehold improvements, and for additional costs incurred during an improvement, such as related repair and maintenance costs.

<u>**Effective Date**</u>**:** The temporary regs are generally effective on Jan. 1, 2012. **(**[**Code §168**]**; Repairs)**

☞**<u>Guidance Offered on Automatic Accounting Method Change for Repair Costs Under New Regs</u> (Rev. Proc. 2012-19)**

This new revenue procedure explains the procedures by which a taxpayer may obtain the IRS's "automatic consent" to change to the accounting methods provided in recently issued **Reg. §1.162-3T**, **Reg. §1.162-4T**, **Reg. §1.263(a)-1T**, **Reg. §1.263(a)-2T**, and **Reg. §1.263(a)-3T** for tax years beginning on or after Jan. 1, 2012. Specifically, this revenue procedure addresses the changes with regard to the treatment of repair & maintenance, and materials & supplies as a result of the tangible property temporary regs.

<u>**Comment**</u>**:** The IRS has issued two much-anticipated revenue procedures (**Rev. Proc. 2012-19** and **Rev. Proc. 2012-20**) that spell out how taxpayers can automatically change their accounting methods to a method permitted under recent temporary tangible property capitalization-repair regs. Taxpayers who follow the guidance in the revenue procedures do *not* have to obtain advance consent from the IRS to change their methods of accounting to conform to the sweeping new rules under the temporary regs.

<u>**Comment**</u>**: Rev. Proc. 2012-19** basically addresses the issue of repairs versus capitalizable improvements, including de minimis costs, materials and supplies, and costs of acquiring property. On the other hand, **Rev. Proc. 2012-20** addresses changes which deal with the depreciation rules of **Code §§167** and **168**, including general asset account treatment.

<u>**Comment**</u>**:** Whether or not it is seeking automatic consent or advance consent, a taxpayer must request the

change on **Form 3115, Application for Change in Accounting Method**.

Comment: Keep in mind that when a taxpayer files a method change *voluntarily*, it generally gets audit protection. This, in turn, can provide protection for any current exams that the IRS might be conducting on that particular taxpayer. Otherwise, the IRS can seek to make changes pertaining to the earliest open tax year, as well as trying to impose the entire positive Sec. 481(a) adjustment in a *single* year. The bottom line is that for a *voluntary* change with a *positive* adjustment, taxpayers get the benefit of a four-year spread so audit protection is important.

Comment: For some of the more significant issues addressed in these regs, taxpayers must make a full Sec. 481(a) adjustment, which essentially makes these particular changes *retroactive*. Other changes, however, are prospective in that they apply only to amounts paid or incurred in 2012 and later years. In other words, if the change applies to expenses paid or incurred in 2012 or later years, taxpayers are permitted to keep the opening basis intact and only make the needed changes going forward.

☞**Additional Guidance on Automatic Accounting Method Changes for Depreciation Under New Regs (Rev. Proc. 2012-20)**

The IRS has provided the procedures by which a taxpayer may obtain the IRS's "automatic consent" to change to the accounting methods provided in recently issued **Reg. §1.167(a)-4T**, **Reg. §1.168(i)-1T**, **Reg. §1.168(i)-7T**, and **Reg. §1.168(i)-8T** for tax years beginning on or after Jan. 1, 2012.

Comment: This revenue procedure addresses the changes with regard to the treatment of depreciation, disposition, and related methods as a result of the tangible property temporary regs. Nevertheless, if a taxpayer placed the affected assets (e.g., real estate) in service *before* 2003, the taxpayer does *not* have to treat a change to comply with the regs as a "change in method of accounting."

- Disposition of a building or structural component: For a building, condominium unit, cooperative unit, structural component, or an improvement or addition thereto, automatic consent approval applies for (1) a change to the appropriate asset as determined under **Reg. §1.168(i)-8T(c)(4)(ii)(A), (B), (C), (E)**, or **(F)**, as applicable, for purposes of applying **Reg. §1.168(i)-8T(c)(4)** (i.e., dealing with the determination of asset disposed of); (2) a change from depreciating the disposed asset to recognizing gain or loss upon disposition, if the taxpayer makes the change in (1) or the taxpayer's present accounting method is in accord with **Reg. §1.168(i)-8T(c)(4)(ii)(A), (B), (C), (E)**, and **(F)**, as applicable, and the taxpayer disposed of the asset in a tax year before the year of change but continues to deduct depreciation for the disposed asset under the taxpayer's present accounting method; or (3) for property accounted for in multiple asset accounts, a change in the method of identifying which assets have been disposed of from an accounting method *not* specified in to one specified in **Reg. §1.168(i)-8T(f)(1)** or **(2)(i), (ii)**, or **(iii)**, as applicable (e.g., from the LIFO accounting method). (**Rev. Proc. 2011-14, APPENDIX section 6.29**)

Comment: What is still a bit troubling is how the IRS, through these regulations, is essentially resurrecting the "component depreciation" system despite the fact that it was specifically outlawed by Congress when it enacted ERTA '81. Furthermore, there is abundant case law which consistently upholds the fact that when a "repair" (e.g., new roof, or HVAC system) is made which does *not*: (1) adapt the underlying asset to a new and different use; (2) significantly prolong its useful life; or (3) materially add to its current FMV, it can be currently deducted. And, these new regs, if closely followed, would now require that such "repairs" be capitalized with only the allocable adjusted basis remaining of the "component system" (if this amount can even be readily determined) being taken as an ordinary Sec. 1231 loss.

☞**Cost of Repairing Roof Currently Deductible (*Campbell v. Comm.*, T.C. Summary 2002-117)**

As discussed above, the Tax Court determined that the taxpayer would be permitted to currently deduct the cost of removing and replacing the "roof-covering material" on her rental property. The key was that the "only purpose in having the work done was to keep her rental house in operating condition."

Comment: During the tax year in question, the taxpayer owned a rental property which she had leased to a tenant for about 4 years. After receiving complaints of roof leaks and water seeping into the walls of the main bedroom, a contractor was hired to make the necessary repairs. The taxpayer stated that she could *not* have continued to rent the house if this was not done. The roof was repaired by removing the existing top layers

> (i.e., shingles) and covering it with fiberglass sheets and hot asphalt. However, no structural changes (e.g., replacement of underlying roof beams) were made. Interior repairs were also made and new drywall was installed. The taxpayer took a current tax deduction for these repairs, but the IRS insisted that they should be capitalized and depreciated.

The Tax Court sided with the taxpayer, finding that the roof repairs were "incidental" based on **Reg. §1.162-4** since they did *not* "materially add to the value of the property," nor did they "appreciably prolong the life of the property." The Court did stress that "repairs in the nature of a replacement, to the extent that they arrest deterioration and prolong the life of the property, generally must be capitalized and depreciated according to **Code §167**." The decision in ***Oberman Manufacturing Co. v. Comm.*** was cited where the cost of removing and replacing roof-covering material was a deductible expense, especially where the purpose of making the repair was only to maintain the asset in proper working condition. There was no "replacement or substitution of the roof," and the taxpayer "was merely restoring her rental house to a house that was free of leaks." **(Code §162; Deductible Repairs)**

☞**Once Again, Tax Court Holds Cost of Removing and Replacing Entire Roof Covering Currently Deductible *(Thomas Northen and Shirley Cox*, TC Summ. Op. 2003-113)**

This issue has now been decided in several cases and is at the point where the Tax Court merely issues a "summary decision" to reiterate it stance on the matter. Once again, the taxpayer was seeking to deduct the entire cost of removing and replacing roof-covering material on a commercial building. After citing ***Oberman Manufacturing*, 47 TC 471 (1967)**, where it concluded that the cost of removing and replacing roof-covering material was a currently deductible expense, the court went on to state that: "Here, as in ***Oberman Manufacturing Co.***, there was no replacement or substitution of the roof. [Taxpayer's] only purpose in having the work done to the roof was to prevent the leakage and to keep her commercial property in operating condition and *not* to prolong the life of the property, increase its value, or make it adaptable to another use." **(Code §168; Deductible Repairs)**

> **Comment:** Practitioners seem to still be hesitant in taking such a stance when a client replaces a roof. What they need to remember, though, is that "component depreciation" was specifically outlawed by **ERTA '81**. Therefore, even if the client had the ability to break out that portion of the cost attributable to a roof's covering, he could *not* take a **Code §1231** ordinary loss when it was replaced. Instead, the entire cost of the removing and replacing the old roof covering is what should be currently deducted as a repair.

☞**Although Extensive, Engine Repair Expenses Deductible (FedEx Corp. v. U.S., 92 AFTR 2d 2003-XXXX (D.C. W. Tenn.))**

When auditing FedEx's 1993 and 1994 returns, the IRS proposed the capitalization of engine shop visits (ESVs), as well as the company's airframe heavy maintenance activity. The company refused and took the matter to district court where it agreed that the ESV costs were deductible in full. In siding with the taxpayer, the court noted that the ESVs did *not*: (1) *adapt* any engine or auxiliary power unit (APU) to *a new or different use*; (2) *materially increase* the value of FedEx's aircraft, engines, or APUs; or (3) *appreciably prolong* the lives of FedEx's aircraft, engines or APUs, but merely maintained them in proper working order *during their expected useful lives*. The court stated that in determining which unit of property is being "repaired" and whether the repair materially adds to the value or appreciably prolongs the life of that unit of property, four factors should be considered: (1) whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes; (2) whether the economic useful life of the component part is co-extensive with the economic useful life of the larger unit of property; (3) whether the larger unit of property and the smaller unit of property can function without each other; and (4) whether the component part can be and is maintained while affixed to the larger unit of property. Here, the court concluded that the engines and APUs were treated as part of fully-assembled aircraft for purposes of acquisition, operation, maintenance, and disposal, which favored classifying the aircraft as a unit of property. The court also found that the lives of the engines and APUs were "co-extensive with the airframes on which they were mounted" and that the engines and APUs could *not* perform their functions unless they were mounted on the aircraft in proper working order. Finally, the court noted that although the engines and APUs could be removed from the aircraft for maintenance, they were integrally linked to the aircraft that they power and the aircraft should be considered a single unit of property. **(Code §162; Deductible Repairs)**

> **Comment:** We continue to see rulings by the Tax Court, and now, various district courts which affirmed that we may have been capitalizing too many "repairs" in the past (e.g., roof replacements, extensive engine, transmission, or equipment overhauls, etc.), so long as the above standards are met. This is in spite of the fact that the costs involved might otherwise be quite substantial (in this FedEx case, the refund request amounted

to over $66 million plus interest).

☞**6th Circuit Affirms Costs Associated With Jet Engine Maintenance & Repair Currently Deductible** (***FedEx Corp. v. U.S.*, 95 AFTR 2d ¶2005-577 (6th Cir., 2/16/2005)**)
The 6th Circuit has *affirmed* **without comment** a district court's decision that FedEx should be allowed to claim a current expense deduction (i.e., vs. having to capitalize and depreciate) for the cost of engine shop visits (ESVs) (i.e., off-wing maintenance and repair of the engines used in its fleet of jet aircraft).

> **Comment:** Had the court held that the proper unit of property was just the engine itself, rather than the entire aircraft, the question of whether there was a "material increase" in value would have focused on the before-and-after value of the individual engines. However, given that "component depreciation" was outlawed by the '81 Tax Act (i.e., ERTA), an asset is *not* longer broken down into its individual components, if they are otherwise an integral part of the overall asset (e.g., wiring and roof of a building). So, it is important to note that the repair costs "ranged from 1% to 8% of an aircraft's value."
>
> **Comment:** Practitioners have sometimes reached the informal conclusion that repairs costing up to 5% of an asset's current FMV should *not* be considered "material," those costing between 5% to 10% are a "grey area," and those exceeding 10% of the asset's current FMV probably are a "material" increase to overall value.

The district court concluded that an ESV "clearly did *not* adapt the engines to a new or different use." Nor, did an ESV "appreciably prolong the useful life" of FedEx's aircraft (i.e., which were acquired with the expectation that both the airframe and engines would last over 30 years). On the question of before and after valuation, the court, based on IRS's assertion that engine values "remained relatively flat over time," concluded that the value of an engine "fresh from an ESV was *not* more than it had been worth immediately after its previous ESV." And, since the ESV did *not* increase the value of the engine (i.e., "material" or otherwise), it did *not* increase the overall value of the aircraft. As a result, the district court held that FedEx properly claimed a repair deduction for its ESV-related costs.

☞**Taxpayer Allowed Current Deduction For Mold Remediation Project (PLR 200607003)**
The costs incurred in connection with a mold remediation project for a building owned by the taxpayer were currently deductible as ordinary and necessary business expenses (i.e., and did *not* have to be capitalized and depreciated). **(Code §168; Capital Improvements)**

☞**Repairs Made to Restore Property to Pre-Flood Conditions Currently Deductible (CCA 199903030)**
This Chief Counsel Advice dealt with the proper tax treatment for the cost of restoring uninsured property damage caused by severe flooding in the Red River Valley of North Dakota and Minnesota in April 1997. Specifically, it addressed how taxpayers should treat the expenses relating to the restoration of business property to its pre-flood condition. In other words, should such costs be treated as part of the casualty loss under **Code §165**, as repairs deductible under **Code §162(a)**, or as capital expenditures under **Code §263** (i.e., which would then be depreciable under the normal rules of **Code §168**)?

8. **WHEN MUST FORM 4562 BE FILED?:** **Form 4562** must be attached to the tax return if any of the following items are being claimed:

   a. **SECTION 179 ELECTION:** A Section 179 deduction for the current year or a section 179 carryover from a prior year (See **Part I of Form 4562**),

   b. **NEW DEPRECIABLE ASSETS:** Depreciation for property placed in service during the current year (See **Part II of Form 4562**),

   c. **CARS & LISTED PROPERTY:** Depreciation on any vehicle or other listed property (e.g., computers or cell phones[31]), regardless of when it was placed in service (See **Part V of Form 4562**),

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[31] Cell phones were eliminated as "listed property" as part of the **Small Business Jobs Act** signed into law on 9/27/10 effective for tax years beginning after 2009.

d. **CERTAIN AUTOS:** A deduction for any vehicle, if the deduction is reported on a form *other than* Schedule C (Form 1040) or Schedule C-EZ (Form 1040) (See **Part V of Form 4562**),

e. **NEW AMORTIZABLE ASSETS:** Amortization of costs that began in the current year (See **Part VI** of **Form 4562**),

f. **C CORPORATION ASSETS:** Depreciation on *any* asset on a corporate income tax return (other than **Form 1120S**) *regardless* of when it was placed in service (See **Parts II and III of Form 4562**).

g. **BONUS DEPRECIATION:** For assets placed into service after 9/10/01 and before 2005 (and, again for the 2008 and 2009 tax years with the reinstatement of 50% bonus depreciation), Form 4562 must be filed *to elect out*, by MACRS recovery class, for any new property otherwise eligible for either 30% or 50% bonus depreciation. If this specific election is *not* made on Form 4562, then the property in question is automatically deemed to have bonus depreciation claimed for it.[32]

☞**Practice Pointer:** You must submit a *separate* Form 4562 for *each* business or activity on your return for which Form 4562 is required (i.e., based on the above guidelines). As a practical matter, even if the guidelines above might seem to exempt the inclusion of Form 4562 for a particular tax year, most taxpayers using tax prep software still usually attached Form 4562 (even if detailed listings of the various assets might *not* always be included with the return).

8. **EMPLOYEES CLAIMING DEPRECIATION:** Form 4562 should *not* be used if you are an employee and you deduct job-related vehicle expenses using either actual expenses (including depreciation) or the standard mileage rate. Instead, use either **Form 2106** or Form 2106-EZ. Note, Form 2106-EZ should be used if you are claiming the standard mileage rate and you are *not* reimbursed by your employer for any expenses.

E. GLOSSARY OF TERMS ASSOCIATED WITH DEPRECIATION[33]

2. **ACTIVE CONDUCT OF A TRADE OR BUSINESS**: To determine if a trade or business is "actively conducted" requires an examination of all the facts and circumstances. Generally, in order to claim a **Code §179** deduction, a taxpayer is considered to "actively conduct a trade or business" if he or she "meaningfully participates in the management or operations of the trade or business." In contrast, a mere passive investor in a trade or business does *not* actively conduct the trade or business.[34]

Comment: In 1991, when the regs under **Code §1245** were revised to define what the "active conduct of a trade or business" entailed, many practitioners seized on the opportunity to include the rental of *residential* real property (since it is technically **Code §1231** property) as meeting this definition. As a result, **Code §179** immediate expensing was being elected for tangible personal property (e.g., appliances, rugs, furniture, fixtures, etc.) used in such activities. However, Congress in the 1996 Tax Act made it clear that residential

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[32] For additional discussion of "bonus depreciation," see **Chapter#3** below. Also, when 50% bonus depreciation was available for new assets after 5/5/03, which amount (i.e., 30% or 50%) were you deemed to have taken by failing to elect out? Probably, 50% since this was the default method up until the bonus depreciation rules expired as of 12/31/04.

[33] Adapted from IRS Pub. #946.

[34] This issue is becoming increasingly important as the Section 179 amount continues to rise each year and more flowthrough entities are being used to provide limited liability protection to their owners. The position that the regulations (Cf. **Reg. §1.179-2(c)(6)**) take is that the owner (i.e., who will be receiving their respective share of any Form 1065 or Form 1120S Sec. 179 amount) must "actively manage" at least one of the entity's trade or businesses to be able to include their share of the entity's income as coming from the "active conduct of a trade or business." Otherwise, they must have sufficient independent sources of such active T/B income (e.g., wages or S/E income) on their personal returns to get a current (vs. a carryover) tax benefit from the Sec. 179 amount flowing through the K-1 (even though their ownership basis in the flowthrough entity must be immediately reduced by the entire Sec. 179 amount otherwise reported on their K-1s).

rentals did *not* meet this test (and, they stated so on a *retroactive* basis). Therefore, it is clear that if the residential property does *not* meet the "trade or business" standard, such as a hotel/motel, or a bed and breakfast, an immediate expensing election would *not* be allowed. But, please keep in mind that *commercial* rentals involving tangible personal property (e.g., office furniture and fixtures and equipment) would still be eligible under **Code §179**.

☞**Loss Deduction Delayed for Closing Facility** (**FSA 200141026**)

When a taxpayer closed its computer operations, it wrote down the value of the facility to the amount determined by a broker, which resulted in a tax loss. The facility was then vacant until it was sold to another tenant in the building. In this field service advice, the IRS concluded that taxpayer should *not* be able to claim a loss deduction when it first closed the facility because "it was *not* retired or permanently withdrawn from usage" (i.e., there had *not* been a realization event for tax purposes upon the initialization retirement of the property). Instead, taxpayer was required to depreciate the facility until the date that it was actually sold. **(Code §168; Idled Facilities)**

Comment: A company had housed some of its computer operations in this property it owned. Then, to save money, the facility was closed and the space was put up for sale. Eventually, the property was sold in a subsequent tax year. But, the company felt that it should be entitled to claim a tax loss in the year that it originally stopped using the building for business purposes. The IRS' contention was that the company continued to own the property after computers were moved out (i.e., even if it was *not* still "in service"), and the space had more than a nominal value when the business use ceased.

Example: Tony's Pizzeria was a small establishment which served take-out pizzas and other Italian specialties. However, it was successful is obtaining one of the few liquor licenses in town where another proprietor decided to retire and closed his restaurant. With the ability to now serve alcohol, Tony's decided to upscale its menu and to re-open as a full-service restaurant. During the current tax year, Tony's decided to do extensive renovations and even purchased the business located immediately adjacent to it (i.e., an retail clothing store) breaking through its walls to triple its current restaurant space. As a result, Tony's was only open for two of the months during its current tax year. Besides having to capitalize these improvements as either fixtures or real estate (i.e., and recovering their basis through depreciation once the premises where re-opened for business), Tony's would have to suspend current depreciation write-offs for the assets that were already in service and for which it had been taking a deduction until such time that the restaurant was operating once again. One could argue that they were "temporarily idle," but it is clear that the assets are *not* "available for use" in that trade or business while it is shut down (unlike the computer facility mentioned above).

34. **RESIDENTIAL RENTAL PROPERTY**: Real property, generally buildings or structures, if 80% or more of its annual gross rental income is from dwelling units which, as a result, placed the property into the 27.5 recovery period.[35]

a. **MIXED USE PROPERTY:** It is not unusual to have a retail establishment on the ground floor (i.e., street level) with the upper floors consisting of dwelling units. Nevertheless, the property *cannot* be split for classification purposes (i.e., part of it being in the 39-year commercial real estate recovery class, with the remainder being 27.5-year residential property). Instead, this 80% test mentioned above is employed as of the date that the property is first placed into service. As discussed above, this can result in a building that has vacant retail space when first purchased (i.e., and which is refurbished over the next few months) being grouped together with the residential units resulting in an overall 27.5-year life for the structure. Even when the retail space is eventually placed into service, the property's recovery period is still *not* split into residential v. commercial at that point in time. Nor, does it appear that the original 27.5-year recovery period has to now be *reclassified* into 39-year commercial property for the remainder of its life for depreciation purposes, given that an election out of the "change-in-use" regs is properly made.

40. **STRUCTURAL COMPONENTS**: Individual parts that when put together form an entire structure, such as a building. The term includes those parts of a building such as walls, partitions, floors, and ceilings, as well as any

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[35] Code §168(e)(2)(A)(i).

permanent coverings such as paneling or tiling, windows and doors, and all components of a central air conditioning or heating system including motors, compressors, pipes and ducts. It also includes plumbing fixtures such as sinks, bathtubs, electrical wiring and lighting fixtures, and other parts that form the structure.

> ☞**Practice Pointer:** It is interesting, let alone extremely conservative from a tax standpoint, to have this definition originating from the IRS publication. Tax practitioners would be well-advised to review the ***Hospital Corporation of America*** decision (discussed below), along with examining the benefits of doing a "cost segregation study" when a client is contemplating a major real estate project. There is quite a different approach possible when ascertaining what is or is not a "structural component." Yet, years after the ***HCA*** case has been decided (with even the Service admitting[36] that some of the very items listed above being eligible as either 5- or 7-year property), **IRS Pub. #946** still takes the approach outlined above. Also, review carefully **CCA 200203009** found in **CHAPTER #7**, the Service's latest detailed analysis about various types of depreciable assets, especially real vs. tangible personal property.

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[36] See **CCM 199921045**.

CHAPTER #2. REV. PROC. 87-56: PROPERLY CLASSIFYING A CLIENT'S DEPRECIABLE ASSETS

A. INTRODUCTION

1. **MACRS RECOVERY PERIODS:** The MACRS depreciation rules are generally applied to depreciable property first placed into service after December 31, 1986. In order to use these rules correctly to compute a client's depreciation deductions, one needs to know the recovery period (i.e., the number of tax years over which the depreciable asset's basis is to be written off) and the applicable convention (i.e., the half-year convention or the mid-quarter convention for tangible personal property, or mid-month convention for real property).

2. **REV. PROC. 87-56:** The various **recovery periods** for MACRS depreciable property are listed in **Rev. Proc. 87-56** (i.e., as modified by **Rev. Proc. 88-22**). However, an easier way to obtain recovery period information is by referring to the tables in **Appendix B** of **IRS Publication #946, "Depreciation."** The MACRS recovery periods are shown in the second column (i.e., labeled GDS/MACRS) of these tables (the *first* column lists the "midpoint" of the particular asset and the *third* column lists the life to be used for the ADS (Alternative Depreciation System) which applies for AMT purposes).[37]

3. **MACRS RECOVERY PERCENTAGES:** The MACRS depreciation **percentages** for each year of the recovery period can then be found by referring to **Rev. Proc. 87-57**. One only needs to locate the appropriate table, given the MACRS depreciation convention being used, and then find the column for the applicable recovery period. These sets of depreciation percentages are also published in **Appendix A of IRS Publication #946**.

Example 1: Suppose you need to locate the second-year depreciation percentage under the MACRS half-year convention for property with a five-year recovery period. According to **Table A-1** in **Appendix A**, the appropriate percentage would be 32%. So, if the property originally cost $100,000, the second-year depreciation deductions would be $32,000.

4. **ASSET CLASSIFICATION:** Well, given that this process is fairly basic and your tax prep computer software will automatically spit out the correct answer every time, what's the problem? The key issue continues to be not the mechanics of applying the depreciation percentages, but rather, correctly identifying the MACRS classification in the first place.[38] A very important Tax Court opinion[39] highlights that the issues in this area, especially when it comes to correctly classifying a client's depreciable asset, are not always cut and dry. In fact, the people behind the writing of your tax prep software might not know nearly as much as you will after going through this chapter! At the very least, having this knowledge will allow you to ascertain if the depreciation software is doing its job correctly. Also, you should be able to identify planning opportunities (e.g., through "cost segregation" studies) for your client thereby enabling them to get the best write-off possible when it comes to depreciating their business assets (or, possibly "catching up" on missed depreciation because of the initial misclassification of assets).

Comment: The number one mistake that we continue to see in practice, especially with younger staff, is that

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[37] IRS **Pub. #534** deals with ACRS property; IRS **Pub. #946** deals with MACRS property; while IRS **Pub. #225** summarizes the rules for depreciable property used in farming businesses.

[38] A secondary issue might also involve short tax years (e.g., a new business starting up or a business that is being liquidated). In such instances, it is not possible to use the set percentages indicated in Rev. Proc. 87-57. Instead, one needs to refer to **Notice 89-15** which deals with "short tax years" and how to depreciate property placed into service during that time frame. **Chapter #5** explores this issue in more detail.

[39] *Norwest Corporation and Subsidiaries v. Commr.*, 111 T.C. No. 5 (8/10/1998) (Cf. page 76 onward) held that the ADR Classification 0.11 for "Office Furniture and Fixtures" takes precedence over ADR Classification 57.0 "Distributive Trades and Services (Cf. **Issue IV.** in the Tax Court's opinion). This is why furniture and fixtures used in a professional practice that does not require "hands on" treatment of the client (e.g., legal, accounting, engineering, etc.) must be depreciated over 7 years, whereas such assets (e.g., examination tables, dentist chairs, etc.) used in the actual treatment of patients (e.g., medical or dental) can be depreciated over just 5 years. Furniture and fixtures used in a residential setting (e.g., rental property) are also included in the 5-year recovery class since they are not being used in an "office" setting.

depreciation software is being blindly followed and no one sits back and questions whether it is doing its job correctly! If the wrong classification is initially given to a particular asset, how can the tax prep software possibly do its job correctly?

5. **MULTIPLE ASSETS GROUPED AS ONE:** Sometimes multiple assets may be so integrated that they should be treated as just one asset for depreciation purposes, as the following case demonstrates.

B. WHAT ABOUT DEPRECIABLE PROPERTY USED FOR SPECIFIC PURPOSES?

1. As mentioned above, the MACRS depreciation recovery periods for various types of property are listed in **Rev. Proc. 87-56** and are reprinted in **Appendix B** of **IRS** **Pub. #534**. In reality, there are actually *two separate* recovery period lists, and this is when matters can get interesting.

2. **ASSETS USED GENERICALLY:** The *first* list includes depreciable assets used for general purposes (i.e., these are "generic" classifications) in "all business activities." In **IRS Pub. #534**, this list is labeled as **Table B-1** of **Appendix B**. As an example, office furniture and fixtures used for *general* business purposes are included in **ADR Asset Class 00.11**. Property which is included in this asset class is given a *seven-year* MACRS recovery period.

a. By way of explanation, these "general" asset classes are designated as classes **00.11** through **00.4**. Another way of expressing this distinction is by noting that if the asset class is "less than a whole number" (i.e., it starts off with a decimal point), then the classification refers to a "general" asset classification. This is opposed to the "whole-number" ADR classifications which are *specific to the use to which the asset is being put* and are discussed next.

3. **ASSETS USED IN SPECIFIC INDUSTRIES & ACTIVITIES:** The second list which appears as **Table B-2** in **Appendix B** of **IRS Pub. #534** includes depreciable assets used in *certain specific* industries and activities. As an example, **ADR Asset Class 57.0** includes depreciable assets used in so-called "distributive trades and services." This covers property used in wholesale and retail trade, as well as in rendering personal and professional services (e.g., dental or medical practices). Property which falls within **ADR Asset Class 57.0** is assigned a recovery period of *five years*. Another example would be **ADR Asset Class 57.1** which covers depreciable property used in "marketing petroleum and petroleum products" and which is included in the classification "retail motor fuel outlets" and is assigned a 15-year recovery period.[40]

a. These "specific" asset classes are designated as **ADR Classes 01.1** through **80.0**

b. **ADR Asset Class 57.0**, and the often overlooked planning opportunities that surround it, are the subject of a comprehensive summary which is discussed below in **CHAPTER #9**.

4. **OFFICE FURNITURE & FIXTURES:** What should a client do, however, if they use office furniture and fixtures in a "distributive trades or business" setting (e.g., an accounting or legal practice where they are rendering professional services)? Could the client use the more favorable 5-year recovery period for property in "specific" **ADR Asset Class 57.0** or should the less favorable 7-year recovery period for property in "general" **ADR Asset Class 00.11** be used? Until recently, there existed no clear-cut guidelines dealing with issues such as this. But, as is discussed in the ***Norwest*** case below, the Tax Court decided that the "generic or general use" of these furniture and fixture items should control (i.e., and therefore the 7-year recovery period had to be used).

5. **CASES & RULINGS:** The following cases and rulings cover some of the issues which arise when attempting to properly classify depreciable assets.

6. **FARM MACHINERY AND EQUIPMENT:** Farm machinery and equipment, grain bins, and fences (but no other land improvements) used in specified agricultural activities are classified as MACRS **7-year property** and have

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[40] Be careful to distinguish between items such as the gas station canopies and pumps which are included in **ADR Asset Class 57.0** and are therefore given a MACRS 5-year recovery period.

a 10-year ADS recovery period (**ADR Class 01.1**). However, any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business (as defined in **Code Sec.§263A(e)(4))**,[41] the original use of which commences with the taxpayer after December 31, 2008, and which is placed in service before January 1, 2010 is *automatically* classified as MACRS **5-year property** (**Code §168(e)(3)(B)(vii)**) and has a 10-year ADS recovery period (**Code §168(g)(3)(B)**). But, because farmers are *not* subject to the uniform capitalization rules, property used in a farming business must be depreciated using the 150 percent declining balance method. (**Code §168(b)(2)(B)**)

> **Comment:** Neither the **Small Business Jobs Act** or the **2010 Tax Relief Act** extended this special 5-years MACRS recovery for farm equipment and machinery placed into service after 2009.

7. **USE OF ASSET CHANGES DURING RECOVERY PERIOD:** What is the taxpayer changes the use to which the property is put sometime during its recovery period (i.e., before all of its basis has been depreciated)? To answer this question, the IRS has issued regs which dictate that the recovery period would actually have to be switched at this point in time and the asset's remaining basis be recovered over this new time frame. However, it is key to understand that the taxpayer is **permitted to elect out of these regs** and therefore **continue to write off** the asset's cost **over its original recovery period**.

☞**Final Regs Clarify Depreciation of MACRS Property When Use Changes** (**T.D. 9132**)
When the use of depreciable property changes, for instance, from business or income-producing purposes to personal, or vice versa, what impact would this have for cost recovery purposes? These regs have now been finalized and explain how to compute depreciation after the aforementioned changes.

> **Comment:** These regs take a pro-taxpayer approach insomuch as they **give the option to treat the change in the use of the asset as if it had never occurred** if the taxpayer wishes to ignore it. So, the only time that the taxpayer would want to utilize the regs is if the change in the use of the asset would result in a faster write-off of the remaining basis of the asset by being able to either decrease the recovery period or increase the depreciation method that had otherwise been used up unto that point in time.

C. KEY TAX COURT DECISION SHEDS LIGHT ON DEPRECIABLE ASSET CLASSIFICATION

1. **NORWEST CORPORATION:** In ***Norwest***,[42] the taxpayer operated banking and financial service centers around the country. During the period 1987 to 1989, Norwest purchased and placed into service more than $57 million worth of office furniture and fixtures at locations throughout the Midwest. Norwest took the position that the property should be classified using the "specific" **ADR Asset Class 57.0** instead of the generic or "general" **ADR Asset Class 00.11**. Taking the approach that the *former* class was correct, the bank assigned a *5-year* recovery period to all of these assets.

2. The Service countered that the "general" classification instead should be used for depreciation purposes and therefore a *7-year* recovery period was appropriate.

3. The Tax Court sided with the IRS and determined that a "desk is a desk and a fixture is a fixture" and therefore should be placed into the "general" **ADR Asset Class 00.11**, unless the taxpayer could show that the assets were "unique to the particular business of the taxpayer" (i.e., such as a chair used by a dentist to examine a patient's teeth; which is why accounting and law firms are also stuck with the "generic" classification of their office furniture and

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[41] A farming business is defined as the trade or business of farming, which is an activity that must involve the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Thus, a farming business includes the trades or businesses of (1) operating a nursery or sod farm, (2) raising or harvesting trees bearing fruit, nuts, or other crops, or ornamental trees and (3) raising, shearing, feeding, caring for, training, and managing animals.

[42] *Norwest Corporation and Subsidiaries v. Commr.*, 111 T.C. No. 5 (8/10/1998) held that the ADR Classification 0.11 for "Office Furniture and Fixtures" takes precedence over ADR Classification 57.0 "Distributive Trades and Services (Cf. **Issue IV.** in the Tax Court's opinion starting on page 76).

fixtures, even in the conference rooms where client meetings are generally conducted and professional services are rendered). Given that was *not* true for the business that Norwest was involved in (i.e., general banking services such as processing loans approvals and customer transactions at the teller windows), their arguments to the contrary fell on deaf ears.

> **Comment:** Consider a medical clinic where 80% of the square footage is used for patient care, while the other 20% is used for administrative and support functions. One might argue that the rugs, along with any furniture and fixtures, in this space should be in the 5-years MACRS recovery period (i.e., under **ADR Asset Class 57.0**). On the other hand, the furniture and fixtures in the administrative (i.e., "office") area would be 7-year MACRS property (i.e., as **ADR Asset Class .11**) But, according to the decision in ***Norwest***, all of the furniture and fixtures should be 7-year property, except for those items "unique to the business of the taxpayer" (e.g., examination tables and patient-related equipment).

4. Arguably, this should also be the case if a taxpayer attempts to include any other property described in the "general" **ADR Asset Classes 00.11** through **00.4** into one of the "specific" asset classes to gain more favorable tax depreciation treatment. One must be able to show (as covered in **CHAPTER #9** below on **ADR Asset Class 57.0**) that the property was unique to the type of activity covered by that "specific" class.

5. In other words, the rule seems to be that a "general" asset class takes precedence over a "specific" class for depreciable property that could fall within *either* classification.

☞**Light Trucks, Mini-vans & SUVs to Get Increased Depreciation Write-offs as "Qualified Nonpersonal Use Vehicles" (T.D. 9069)**

Caving in to pressure from the Small Business Administration and other lobbyists representing smaller companies, the IRS has announced that it will extend a break to those firms making use of vans or light trucks. The breaks are part of both temporary and proposed regs which are *effective immediately* and which will give increased limits for purposes of the luxury car rules.

> **Comment:** There has been some misinformation that the caps were going to be dropped completely, but the Service has made it clear that it will employ increased limits for these types of vehicles. As explained below, only those vehicles *not* capable of "significant personal use" would be free of the caps entirely.

☞**Final Regs Clarify Rules for "Nonpersonal Use Vehicles" (T.D. 9133)**

These regs deal with a new category of vehicles which will also *not* be subject to the luxury car caps under **Code §280A** (i.e., along with those passenger vehicles and light trucks and vans exceeding the 6,000# test). As a result, a **Code §179** immediate expense election can be made without being limited by the $2,960 cap (i.e., effective for 2004 while $3,060 was the cap for 2003), as well as taking advantage of the 50% bonus depreciation rules through 12/31/04.

> **Comment:** One major change from the proposed regs is that this exception may be applied to "qualified nonpersonal use vehicles" (QNUVs) placed into service before 7/7/2003. This means that *practitioners may* either amend, by the end of 2004, all open return years, or file a Form 3115, Application for Change in Accounting Method, to take advantage of this new provision contained in the final regs.

GAS STATION/FAST FOOD - CONVENIENCE STORES:

1. The '96 Tax Act clarified that depreciable real property used as a "retail motor fuels outlet" can be written off over 15 years using the 150% DB method (i.e., almost as good as the 15-year, 175% DB method with "old" ACRS real estate). This pales in comparison with the 39-year S/L method normally reserved for commercial realty.

2. However, for this special 15-year classification to be valid, "petroleum product sales" must equal 50% or more of total sales <u>or</u> 50% or more of the building's floor space must be devoted to "petroleum product sales."[43]

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[43] See Rev. Proc. 97-10 for additional details when applying this test.

    a. Even when *neither* 50% test is met, the 15-year MACRS classification is still available for convenience stores that are 1,400 square feet or less.

3. The Service released a coordinated issue paper (CIP) on Petroleum and Retail Industries Convenience Stores on 4/2/97 which details how to meet either of the 50% tests mentioned above.[44]

4. For purposes of meeting the "50% of total sales test," the IRS has instructed its auditors and agents to include all excise and sales taxes in the revenue number and to analyze gross revenue over a full 12-month period when possible.

    a. Temporary fluctuations in revenue percentages (e.g., due to sales promotions for non-petroleum products) should be factored out.

    b. Based on the instructions contained in the CIP, revenue should be analyzed on a building-by-building basis.[45]

5. For purposes of the "50% of floor space test," areas allocable to "traditional" service station functions should be counted as allocable to "petroleum product sales."

    a. This would include areas such as garage space, restrooms, checkout counters, and display space devoted to petroleum product sales.

☞**IRS Concedes Gas Station Canopies Qualify as 5-Year Property (Rev. Rul. 2003-54)**
This ruling confirms that certain gasoline pump canopies are *not* "inherently permanent structures" (i.e., which have to be grouped with other 39-year commercial realty) and are classified as tangible personal property. Depending upon the depreciation system used (i.e., GDS or ADS), their cost can be recovered over *either* a 5-year MACRS recovery period (i.e., **ADR Guideline Class 57.0 "Distributive Trades or Services**) or a 9-year ADS midpoint. Nevertheless, the IRS still insists that the supporting concrete footings used to anchor the gasoline pump canopies are in fact "inherently permanent structures" which should be classified as 15-year MACRS "land improvements" (or, 19-year ADS midpoint). **(Code §168; Gas Station Canopies)**

Comment: The IRS stance on the concrete bases seems to fly in the face of the ***Walgreen Co. and Subsidiaries*, TC Memo 1996-374 (1996)** which stated that the MACRS classification **ADR Asset Class 57.0** was found to include "restaurant decor items such as a decorative canopy system along with its related concrete foundation, concrete piers, lumber, and attached signs.**"**

Comment: The Service finally capitulated on this issue involving canopies after losing a recent court case. It also stated it will drop open audits on this issue, although it does continue to insist[46] that the underlying concrete footings for these canopies be treated as real estate (15-year "land improvements").

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[44] The IRS has also issued an Audit Techniques Guide for gas station/convenience stores.

[45] Cf. *IA 80 Group, Inc. v. U.S.*, No. 02-3012 (8th Cir.) discussed below where the taxpayer attempted to group all of the service plaza's building together in order to qualify for a 15-year write-off for the group and failed.

[46] Cf. The IRS Audit Technique Guide for "Cost Segregation" on their website; in it, with regard to restaurant signs, the Service has stated that concrete footings or pilings holding up the signs should be treated as 15-year "land improvements."

CHAPTER #3. REV. PROC. 87-57: “DEPRECIATION PERCENTAGES FOR REGULAR TAX & AMT”

B. MACRS DEPRECIATION “CHOICES” FOR REGULAR TAX & AMT PURPOSES[47]

1. For regular and AMT tax purposes, the following are the depreciation choices[48]:

TANGIBLE PERSONAL PROPERTY[49]

Regular Tax	AMT Tax
1. MACRS - 200% DB over classlife[50]	**(200% DB *not* available for AMT)**
2. AMT - 150% DB over classlife[51]	**1. AMT - 150% DB over classlife**
3. Modified AMT - 150% DB over midpoint	**2. Modified AMT - 150% DB over midpoint**
4. S/L over classlife	**3. S/L over classlife**
5. ADS - S/L over midpoint	**4. ADS - S/L over midpoint**

2. **ACCELERATED METHODS: “Choices 1 or 2"** for regular tax are considered to be “accelerated” methods and would require the use of AMT - **150% DB over midpoint** for purposes of figuring one’s AMT tax adjustment for assets placed into service *before* 1/1/99. However, for any assets placed into service *after* 12/31/98, the AMT method has adopted the *same* recovery period as that used for regular tax purposes (i.e., instead of requiring that the asset’s midpoint be used). Thus, only if the taxpayer used **“Choice 1"** (i.e., MACRS 200% DB over the asset’s classlife or recovery period would there be an adjustment for AMT purposes equal to this method vs. 150% DB over classlife). Remember that the declining balance method (i.e., either 200% or 150% DB) switches over to the straight-line method at the optimal point. Therefore, there could be a “positive” or “negative” adjustment for purposes of calculating the allowed AMT depreciation amount for a particular tax year. This is especially true if the taxpayer were to select **“Choices 3, 4** or **5"** for regular tax purposes (i.e., they would instead be entitled to **“Choice 1"** for AMT purposes).

3. **STRAIGHT-LINE METHOD: “Choices 4 or 5"** (i.e., S/L over either the classlife or midpoint) being used for regular tax purposes would *not* mean that a potential “positive” depreciation adjustment would have to be made for AMT tax purposes (even for the earlier years in the recovery period since **150% DB over classlife** is otherwise allowed for AMT). In other words, even if the taxpayer chose to use the S/L method for regular tax purposes (i.e., either over the normal recovery period of the asset, or over its midpoint) where the more generous AMT 150% DB method over the classlife could have been used, they are still *not* allowed a “positive” adjustment in calculating their AMTI.

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[47] According to IRS **Pub. #946**, MACRS is *not* available for the following assets: 1)pre-ERTA assets (i.e., placed into service prior to 1981); 2) ACRS assets (i.e., assets placed into service from 1981-86); 3) assets placed into service after 1986, but subject to anti-churning rules; 4) intangible assets; 5) films, video tapes and recordings; 6) certain corporate or partnership property acquired in a nontaxable transfer; and 7) property the taxpayer elected to exclude from MACRS.

[48] Since personal property placed into service prior to 1987 (i.e., MACRS) would now be fully depreciated, a detailed discussion of ACRS is omitted. Basically, though, asset class lives were somewhat shorter with most tangible personal property being placed in either the 3- or 5-year classes. However, ACRS employed the 150% DB method v. the 200% DB method utilized by MACRS. For a complete discussion of ACRS, see IRS **Pub. #534**.

[49] Remember that acquired *intangible* assets are normally written off over 15 years using the S/L method pursuant to Code §197.

[50] If farm property is involved, then the 150% DB method must be used. This was the result of the uniform cap rules being repealed for farm activities. Also, only the 150% DB method is available for property in the 15- and 20 year MACRS classes.

[51] For assets placed into service for tax years beginning after 1998.

4. **AMT CONFORMITY METHOD:** As discussed below, for assets placed into service for tax years beginning after 1998, there is **"Choice 2"** which allows taxpayers to use the *same* class life (i.e., recovery period) for *both* regular and AMT tax purposes, if they are willing to forgo the normal MACRS 200% DB method for regular tax and instead use the 150% DB method for *both* regular and AMT tax purposes. Also, for real property, the *same* 27.5-year or 39-year recovery period can be used for both regular and AMT tax purposes.[52]

Practice Pointer: Remember, this choice is made on a class-by-class basis for any particular tax year with regard to tangible personal property and the election does *not* affect anything you might decide for the ensuing tax year (let alone tangible personal property in other MACRS classes that you might be placing into service for that *same* year) regarding how to depreciate a particular class of property. Therefore, a trucker who found himself falling into AMT because of using the 200% DB method for regular tax on a new tractor or trailer rig, might consider using the 150% DB method the next time a new truck is placed into service. This is especially worth considering where a substantial minimum tax credit (MTC) exists from prior years and it is apparent that sufficient regular tax will *not* exist in the near future to use up this tax attribute.

Comment: Remember, for tax years starting in 2007, there is a 5-year period for utilizing "long-term" minimum tax credits (i.e. they become refundable credits and can be used subject to phaseout rules based on a taxpayer's AGI). And, for tax years starting in 2008, there is a 2-year period for utilizing any "long-term" minimum tax credits which still remain after 2007. Furthermore, they are treated as refundable credits regardless of the taxpayer's AGI (i.e., the AGI phaseout rules were abolished).

Practice Pointer: Where bonus depreciation has been used on a particular asset, there is no need to make this "AMT Conformity" election (i.e., using 150% vs. 200% DB for regular tax purposes) since the *entire* bases of such assets are exempt for any AMT addback due to a depreciation adjustment. So, this special election would only have to be considered where the taxpayer opted *not* to take bonus depreciation on a new asset (i.e., for assets placed into service after 9/11/01 and before 1/1/05, and for 2008 and 2009), or bonus depreciation is no longer available (i.e., generally for assets placed into service after 12/31/04, absent a special transition rule which extends this deadline to 12/31/05 and before 2008, or after 2009).[53]

REAL PROPERTY - (Assets Placed in Service Before 1999)[54]

Regular Tax	AMT
1. S/L over 27.5 (Residential rental)	**1. ADS (S/L over 40 years)**
2. S/L over 39 years (Commercial)	" " "
3. ADS (S/L over 40 years)	" " "

Comment: For real property placed into service **after 1998**, the *same* recovery period can now be used for AMT purposes (i.e., 27.5 or 39 years) as that used for regular tax. That is, there is no longer a requirement to use ADS (S/L over 40 years) for any realty placed into service after 1998.

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[52] However, the 40-year recovery period must still be used for real property placed into service before 1999.

[53] Once again, assuming that Congress does not act to extend bonus depreciation beyond 2009.

[54] Certain land improvements, gas station/convenience stores, billboards and car washes fall into the MACRS 15-year class; Single-purpose farm structures fall into the 10-year class and multi-purpose farm structures fall into the 20-year class. Also, be careful to distinguish between certain "fixtures" which can be classified as tangible personal property vs. realty which falls into one of the normal (i.e., 27.5- or 39-year) classifications. Finally, remember "qualified leasehold improvements," if otherwise classified as 39-year commercial realty, can instead be treated as 15-year MACRS property (and, therefore also eligible for bonus depreciation) if they were first placed into service after 10/22/04 and before 1/1/13 and other special rules are met (e.g., a related party lease is *not* involved). This topic is discussed fully later on in the manual.

Example: A 100-unit residential apartment complex was first placed into service in 1998. As such, it would be 27.5-year MACRS property for regular tax purposes. However, there would be a significant depreciation adjustment required for AMT purposes since a 40-year ADS recovery would have to be used (i.e., almost 50% less depreciation). However, if the apartment complex had first been placed into service in 1999 or thereafter, there would be no depreciation adjustment at all for AMT since the *same* recovery period (i.e., 27.5 years for regular tax) could be used. The same is now true of 39-year commercial real estate placed into service after 1998 with regard to any AMT adjustment.

5. **ACRS REALTY:** ACRS realty was placed into either 15-, 18-, or 19-year classes, depending on when it was first put into service for the period 1981-86. Although, after 12/31/2005, all 15-, 18- or 19-year ACRS realty would now be *fully depreciated*. And, either the 175% DB or the straight-line methods could be used based on a property-by-property election by the taxpayer.[55]

Comment: Remember, there is a tremendous difference in the application of the Sec. 1250 depreciation recapture rules where accelerated depreciation was allowed on *commercial* property placed into service *before* 1987. Even though use of the accelerated method did *not* yield any more depreciation when compared to what the S/L method would have generated (i.e., the basis of the commercial real estate is fully recovered under either method for such property as of 12/31/2005), Sec. 1250 would treat *all* of the gain due to the depreciation as ordinary income. Whereas, had the S/L method been elected, there would only be "unrecaptured Sec. 1250 gain" (i.e., which is taxed at a 25% rate).

Comment: With regard to any residential real estate placed into service before 1987, it would *not* matter for purposes of the Sec. 1250 recapture rules if an accelerated method such as 175% DB (i.e., ACRS) vs. S/L had been used since all such depreciation would have been claimed as of 12/31/2005 (i.e., the asset would have been fully depreciated under either method). The only consideration would be that "unrecaptured Sec. 1250 gain" due to any depreciation claimed (i.e., regardless of method) would still have to be taxed at 25%.

11. **MACRS CONVENTIONS:** Under MACRS, "averaging conventions" establish when the recovery period is deemed to have begun and ended. The actual convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

a. **MID-MONTH CONVENTION:** Use this convention for all nonresidential real property and residential rental property. Under this convention, you treat all property placed in service or disposed of during a month as placed in service or disposed of at the midpoint of the month. This means that a one-half month of depreciation is allowed for the month the property is placed in service or disposed of.

b. **MID-QUARTER CONVENTION:** Use this convention if the mid-month convention does *not* apply and the total depreciable bases of MACRS property you placed in service during the *last three months* of the tax year (*excluding* nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) are *more than 40%* of the total depreciable bases of all MACRS property (except real property otherwise depreciated under either a 27.5-year or 39-year MACRS recovery period) you placed in service during the entire year.[56]

Practice Pointer: Although making an election under **Code §179** for immediate expensing would help to avoid

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[55] In order to avoid the Code §1250 recapture rules on any dispositions of real property, many taxpayers went with the S/L method instead of 175% DB, especially where *commercial* (vs. residential) real estate was involved.

[56] As discussed below, all real and tangible personal property contained either the 3-, 5-, 7-, 10-, 15- or 20-year MACRS classes and which is placed into service during the last quarter of the tax year is therefore considered in determining whether the mid-quarter convention applies. For example, if significant 15-year "land improvements" are placed into service during the last quarter and this causes more than 40% of all MACRS property with a classlife of 20 years or less to fall into this last quarter, then the mid-quarter (i.e., vs. the half-year) convention to apply for that tax year. Furthermore, since this is real property, Sec. 179 immediate expensing cannot be used to help avoid the imposition of the mid-quarter convention.

the imposition of the mid-quarter convention, electing either 30% or 50% bonus depreciation would not.[57]

1) **BASIC ASSUMPTION:** Under this convention, you treat all property placed in service or disposed of during any quarter of the tax year as placed in service or disposed of at the midpoint of that quarter. This means that 1.5 months worth of depreciation is allowed for the quarter the property is placed in service or disposed of.

2) **EXCEPTION:** If you are a calendar year taxpayer, or a fiscal year taxpayer whose third or fourth quarter of your 2001 tax year included September 11, 2001, then you could have elected to apply the half-year convention, discussed next, to all property (other than nonresidential real property and residential rental property) placed in service during your 2001 tax year. To make this election, you had to write **Election Pursuant to Notice 2001-70** across the top of your Form 4562 for 2001.

☞**Certain Real Estate Assets Can Cause Mid-Quarter Convention to Apply**

If more than 40% of a taxpayer's tangible assets (i.e., either real or personal property) falling in any of the 3-, 5-, 7-, 10-, 15- or 20-year MACRS classes are first placed into service during the last quarter of their tax year, then the mid-quarter convention would apply instead of the normal half-year convention rules for MACRS. For purposes of this calculation real estate included in either the 27.5-year (i.e., residential) or 39-year (i.e., commercial) MACRS does *not* count. However, any other real estate that is included in *any* of the other MACRS classes (and which, therefore, would face the half-year convention rules) would have to be included. Common examples would be 15-year land improvements, qualified leasehold improvements (at least for those put into service before 2011), gas station/convenience stores or car wash buildings, 10-year single-purpose or 20-year multi-purpose agricultural or horticultural structures, or any other realty (e.g., billboards) included in a MACRS recovery class of 20 years or less. **(Code §168; Mid-Quarter Convention)**

Comment: Although such real estate might cause the mid-quarter convention to apply, it is still eligible for a much faster write-off than the normal 27.5- or 39-year periods. The key is to be aware of this rule and therefore coordinate the acquisition of other tangible personal property and this type of real estate so that the mid-quarter convention does *not* come into play. Nevertheless, despite being classified in a MACRS recovery class of 20 years or less, it is still *not* eligible for Sec. 179 immediate expensing because it is, in fact, real estate (exceptions exist for single-purpose ag structures, railroad gradings and tunnel bores). So, using Sec. 179 for these types of assets, if placed into service during the taxpayer's 4th quarter, will *not* be available as an alternative (i.e., so as to avoid the possible imposition of the mid-quarter convention).

Comment: Recent tax law changes have reinstated the 50% bonus depreciation rules for 2008 and 2009. So, correctly identifying such realty as being in a MACRS class of 20 years or less would qualify these assets for this additional immediate deduction (once again, it's *automatic* unless you elect out on a class-by-class basis) of 50% of its cost (given the taxpayer is the original user of the property in question).

c. **HALF-YEAR CONVENTION:** Use this convention if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, all property placed in service or disposed of during a tax year is treated as placed in service or disposed of at the midpoint of the year. This means that a one-half year of depreciation is allowed for the year the property is placed in service or disposed of (i.e., regardless of the actual dates in question).

☞**Practice Pointer:** Before 1987, there was no depreciation allowed in the year that the property was disposed. Now, with the rule change as cited above, depreciation is allowed for the year of disposition. However, all this does is to create more potential **Code §1245** depreciation recapture and possibly ordinary income as opposed to more **Code §1231** gain (i.e., which could be treated as capital gain).

12. **FARMING BUSINESSES:** If you place personal property (e.g., trucks or other equipment) in service in

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[57] Since bonus depreciation technically falls under Code §168 (i.e., specifically, Code §168(k)), as opposed to a separate code section, such as Code §179, it is *not* considered when making the 40% calculation for the last quarter.

a "farming business" after 1988, you can depreciate it under GDS (i.e., over the recovery period vs. the asset's midpoint) using any method other than the 200% declining balance method (i.e., either 150% DB or S/L). As for real property (e.g., single-purpose or multi-purpose agricultural or horticultural structures), you can only depreciate them using the straight line method under *either* GDS or ADS.

C. 50% or 100% BONUS DEPRECIATION FOR CERTAIN ASSETS

Practice Point: The 2003 Tax Act still permitted the election, on a *class-by-class basis*, for new assets purchased after 5/5/03 and placed into service before 2005 of *either* 30% bonus depreciation, 50% bonus depreciation or no bonus write-off at all (i.e., one could just take Sec. 179 immediate expensing, if desired, along with any MACRS depreciation). However, absent a special transition rule, bonus depreciation was *not* available for assets placed into service after 12/31/04. Then, it (50% bonus depreciation) was reinstated for assets placed in service during 2008, 2009 and 2010.[58] If that was not enough, the **2010 Tax Relief Act** (signed into law on 12/17/10) increased the bonus depreciation provision to 100% for assets placed into service after 9/8/10 and before 1/1/2012).

Comment: The 100% first-year bonus depreciation deduction is permitted without any proration based on the length of time that an asset is in service during the tax year. As a result, a 100% first-year writeoff is available even if qualifying assets are in service for only a few days in 2011.

Example: Manufacturing, Inc., a calendar-year business, intends to buy an additional $500,000 of new five-year MACRS property. Assume that it is *not* eligible for the Sec. 179 immediate expensing election (e.g., it was purchased from a related party). If the company makes the purchase *before* Jan. 1, 2012, and places the property in service before that date, it may write off the entire $500,000 cost in 2011. On the other hand, if it waits to buy the property and place it in service until 2012, it may only claim a first-year depreciation allowance of $300,000 [($500,000 × .50 = $250,000 bonus first-year allowance) + ($500,000 - $250,000 × .20 table percentage for 5-year MACRS property = $50,000)].

Comment: Accelerating a purchase into 2011 may *not* always be advisable from a tax standpoint. For instance, it may not make sense for a taxpayer that has an about-to-expire net operating loss and otherwise need profits to use it up (i.e., before the expiration of the 20-year carryforward period). Furthermore, if tax rates do increase dramatically in future years, it might be advisable to forgo rapid write-offs such as Sec. 179 and bonus depreciation in the year that the assets are first placed in service.

☞**Detailed Guidance on New 100% Bonus Depreciation Rules Released** (**Rev. Proc. 2011-26**)
The IRS has issued detailed guidance on the 2010 Tax Relief Act's 100% bonus depreciation rules for qualifying new property generally acquired and placed in service *after* Sept. 8, 2010 and *before* Jan. 1, 2012. Overall, the rules are very taxpayer friendly. For example, they permit 100% bonus depreciation for components where work on a larger self-constructed property began *before* Sept. 9, 2010, allow a taxpayer to elect to "step down" from 100% to 50% bonus depreciation, confirm that 100% bonus depreciation is available for "qualified restaurant property" or "qualified retail improvement property" that also meets the definition of "qualified leasehold improvement property," and provide relief for some business car owners who are otherwise subject to the luxury car caps and how their second year write-off would have been affected.

Background: In general, under the 2010 Tax Relief Act, an asset qualifies for the 100% bonus depreciation allowance if:

- It is: property to which the MACRS rules apply with a recovery period of 20 years or less; computer software other than computer software covered by **Code §197**; "qualified leasehold improvement property;" or certain water utility property;

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[58] This latest extension for tax years beginning in 2010 was part of the **Small Business Jobs Act** signed into law on 9/27/10.

- It is acquired and placed in service *after* Sept. 8, 2010 and *before* Jan. 1, 2012 (placed in service before Jan. 1, 2013 for certain "long production property" and aircraft); and

- Its original use commences with the taxpayer. (**Code §168(k)(5)**)

☞**Practice Pointer:** Once again, as is discussed in the ***Hospital Corporation of America*** case covered in **CHAPTER #7** below, these new bonus depreciation rules gave a taxpayer even more reason to be aggressive when deciding if a particular "fixture" falls into the 5- or 7-year MACRS class, or is really a "structural component" properly classified as 27.5- or 39-year realty. Besides a faster recovery period and a chance at **Code §179** immediate expensing, 50% or 100% of the cost could now be written off up-front (with no limit or phaseout rules).

Qualified Restaurant Property and Qualified Retail Improvement Property: Code §168(e)(7)(B) and **Code §168(e)(8)(B)** specifically exclude "qualified restaurant property" and "qualified retail improvement property" from the bonus depreciation rules. Therefore, neither type of property was eligible for either the 50% or 100% bonus depreciation allowance. But, based on the legislative intent of the Congress as demonstrated in the Joint Committee of Taxation (JCT) reports on this issue, the IRS has concluded that an asset that is "qualified restaurant property" or "qualified retail improvement property" also may fall within the definition of "qualified leasehold improvement property" under **Code §168(e)(6)**, which is eligible for bonus deprecation. If that is the case, such "dual character" property qualifies for 100% bonus depreciation (or, at the taxpayer's election, 50% bonus depreciation).

Electing 50% v. 100% Bonus Depreciation: An election to take a reduced bonus depreciation deduction was specifically authorized under prior law (i.e., when a taxpayer could elect 30%, instead of 50%,bonus first-year depreciation). However, current law failed to specially address whether an election to step-down from 100% to 50% bonus first-year depreciation would be allowed. Thus, at first glance, it appeared that the only choice for a taxpayer that did *not* want 100% bonus depreciation was to completely elect out of bonus depreciation altogether. But, in reviewing the JCT in its **"General Explanation of Tax Legislation Enacted in the 111th Congress"** (i.e., "the Blue Book"), it clearly indicates that it was Congress's intent that a taxpayer may elect 50% (v. 100%) bonus depreciation with respect to *all* assets on a MACRS class-by-class basis of otherwise "qualified property" placed in service during a taxable year. Now, with this revenue procedure, the IRS has decided to follow the JCT's guidance on this issue as well, thus permitting a "step-down election" from 100% to 50% bonus depreciation.

Comment: This is the opposite of what the IRS had stated in the original Instructions to **Form 4562 (Depreciation and Amortization)** for 2010, where there would be no "step-down election" (i.e., 100% to 50% bonus depreciation) available.

Rev. Proc. 2011-26: Sections 4 and 5 of **Rev. Proc. 2011-26** carry somewhat involved procedures for those taxpayers that claimed 100% bonus depreciation, or that elected out of 100% bonus depreciation but now want to elect to claim a stepped-down 50% bonus depreciation allowance.

Impact on Luxury Car Caps: Under the 2010 Tax Relief Act, the otherwise applicable **Code §280F** "luxury car cap" for *new* (i.e., "qualified property") business autos (as well as light trucks and vans) bought and placed in service *after* Sept. 8, 2010, and *before* Jan. 1, 2012, is increased by $8,000 (i.e., the *same* amount that applied when the 50% bonus rules were in effect). But, the interaction of the **Code §280F** rules with the **Code §163(k)(5)** bonus depreciation guidelines initially lead to some unusual results. Business-car owners subject to the luxury car caps would be limited to a first-year depreciation deduction amount capped at $11,060 (i.e., for an auto) or $11,260 (i.e., for a light truck or van). Furthermore, the depreciation of the remainder of the vehicle's basis would have to be deferred until *after* the normal MACRS recovery period (i.e., 5 years, but effectively 6 tax years, because of the half-year convention).

IRS Safe Harbor: Fortunately, the Service in **Rev. Proc. 2011-26** provides a safe harbor which serves to mitigate what it calls an "anomalous result." It essentially amounts to an "as-if" calculation that determines the unrecovered basis of the vehicle as if 50%, instead of 100%, bonus depreciation had originally been claimed.

Comment: It appears that this method may be adopted on a vehicle-by-vehicle basis. Under the safe harbor method, no adjustments are made to the first-year deduction claimed on the return. However, the unrecovered basis at the end of the first year will be determined as if the taxpayer had claimed bonus depreciation at the

50 percent rate. Thus, in the second year, the depreciation deduction (computed without regard to the second-year cap) is determined as if a 50% bonus depreciation rate applied in the first year.

Comment: The bottom line is that depreciation of cars placed into service after Sept. 8, 2010 is calculated as if the 50% bonus depreciation rules that were in effect before that date were still applicable. Of course, if the taxpayer actually elects to use the 50% bonus rules (which is elected on a MACRS class-by-class basis) instead of the 100% rules, then this "safe harbor" becomes a moot point. **(Code §280F; Luxury Car Caps)**

d. **ORIGINAL USE (i.e., MUST BE FOR "NEW" PROPERTY):** According to the Joint Tax Committee explanation, the term "original use" means the *first* use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the former investment tax credit rules would apply.[59] Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the underlying cost of reconditioned or rebuilt property acquired by the taxpayer would *not* satisfy the "original use" requirement.

1) Unlike the **Code §179** immediate expensing rules[60], these new bonus depreciation provisions do *not* prohibit the purchase of otherwise qualifying property from a disqualified (i.e., related) person (Cf. excerpt from **Code §179** above dealing with the issue of what a "purchase" is for immediate expensing purposes).

Example: On December 1, 2012, Jack buys from X for $20,000 a machine that has been previously used by X. Jack then makes an expenditure on the property of $5,000 of the type that must be capitalized. Regardless of whether the $5,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the "original use" requirement and would be "qualified property" (assuming all other conditions are met). However, no part of the original $20,000 purchase price would qualify for the additional first year depreciation since the "original use" of the machine did *not* commence with Jack.

☞**Practice Pointer:** Stated even clearer, the new bonus depreciation rules do *not* applied to "used property." In a fashion similar to the "old" ITC rules, the use of the property must have commenced with the taxpayer seeking the break. But, as pointed out in the example above, if the taxpayer was to make capitalizable improvements to previously acquired "used" property, then the cost of the improvement could qualify for bonus deprecation (e.g., a new engine or transmission is placed into a used truck that was purchased in 2005 to 2007; then the capitalizable improvement was added in 2008 through 2012).

2. **ALLOWED FOR BOTH REGULAR & AMT TAX PURPOSES:** Both the 50% and 100% bonus depreciation amounts (along with any of the remaining depreciable basis of the asset) are treated like a Code §179 immediate expensing amount in that it is *not* considered an adjustment for AMT purposes for the tax year that the asset is placed into service, as well as for all subsequent tax years.

☞**Practice Pointer:** Even the normal MACRS depreciation deductions for the remainder of the basis on this asset will *not* be an adjustment for AMT purposes throughout the life of the asset. Therefore, this exception whereby the *entire* basis of an asset for which bonus depreciation has been elected is *not* subject to the AMT depreciation adjustment was even more of a reason to make the election where the taxpayer is *either* in an AMT position or could become subject to AMT with depreciation associated with the investment in this new asset. Of course, the taxpayer could always make the "AMT conformity election" (i.e., using the 150% DB method instead of the normal 200% DB method) for that class of new assets (i.e., including the entire cost of the asset which would otherwise qualify for bonus depreciation) for the tax year in which the item was first placed into service. But, electing to instead take the bonus depreciation amount would preclude the need to

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[59] See Reg. §1.48-2.

[60] Code §179(d)(2).

make the AMT conformity election. But, at least the AMT conformity election can be made on an asset-by-asset basis vs. a MACRS class-by-class basis, which is the case with bonus depreciation).

☞**Practice Pointer:** Unlike the situation with any **Code §179** immediate expensing amount, *both* of these bonus depreciation amounts would be counted toward the 40% of the taxpayers assets which are tested to see if the mid-quarter convention should otherwise apply for a particular tax year. And, if it is a tangible personal property asset, the entire basis of the asset in question (i.e., not the net amount after any bonus depreciation deduction is considered) should be included in determining the threshold for the appropriate phase-out rules for **Code §179** purposes.

6. **ADJUSTMENT TO BASIS:** The basis of the property and the depreciation allowed for the first year that the asset is placed into service must be adjusted to reflect the additional bonus depreciation (i.e., along with any **Code §179** immediate expensing amount otherwise taken on the asset).

Example: John purchased a truck (or, a passenger vehicle with a unloaded gross curb weight of over 6,000 #'s) costing $40,000 and placed it into service before 9/9/2010. After taking an allowable **Code §179** immediate expensing amount of $25,000 (i.e., the special limit for "heavy" vehicles), he was left with a basis of $15,000. Under the bonus depreciation provision, he elected to write-off an additional 50% of the asset's basis, or $7,500 (50% x $15,000). Finally, on the remaining basis of $7,500 ($40,000 - ($25,000 + $7,500)), he took his normal MACRS deduction of $1,500 (40% DDB x ½ x $7,500). As a result of this $40,000 expenditure made late in the tax year, John received a total write-off of $34,000 ($25,000 + $7,500 + $1,500), or nearly 85% of the asset's original cost in the first tax year! And, with 100% bonus depreciation (i.e., if the heavy vehicle was instead placed into service after 9/8/2010 and before 1/1/2012), the entire cost could be written off (without the need to even used Sec. 179 and/or MACRS depreciation).

7. **NO OVERALL CAP ON BONUS DEPRECIATION:** Unlike **Code §179**, where there are various phase-out caps if excess property is put into service for a particular tax year, the bonus depreciation provisions are void of any such requirement, thus allowing even the largest of taxpayers to take advantage of the break.

Comment: With the availability of 100% bonus depreciation for assets placed into service after 9/8/2010 and before 2012, it essentially renders the use of Sec. 179 somewhat moot. There would be no limits on the total write-off, as well as the $25,000 limit for "heavy" vehicles.

Example: Huge, Inc. purchased and placed into service new 5-year equipment costing $3 million in on 9/8/10. The company could elect bonus depreciation of $1.5 million (50% x $3 million) for the first year in addition to the normal MACRS depreciation amount allowed on the remaining $1.5 million of basis in these assets. And, unless an election out of the bonus depreciation rules was made, all other 5-year assets purchased and placed into service for 2010 would also have to be reduced for the appropriate 50% bonus amounts (100% for any assets placed into service after 9/8/2010 and before 1/1/2011).

Example: Same as above, except Huge, Inc. purchases and places into service new 5-year equipment costing $3 million after 9/8/10 and before 1/1/2012. The company could elect 100% bonus depreciation on the total cost of $3 million. And, unless an election out of the bonus depreciation rules was made, all other 5-year assets purchased and placed into service during this same time period would also be entirely deducted.

Comment: Of course, Sec. 179 immediate expensing (within the appropriate limits of $500,000 and a $2 million phaseout threshold) could be elected first, leaving less basis for either bonus depreciation and MACRS depreciation. But, the taxpayer would have to have sufficient trade or business profits to take advantage of the Sec. 179 write-off (something not necessary with the bonus depreciation rules).

Practice Point: The taxpayer must elect out of bonus depreciation for a particular class of new assets in a given tax year or they would otherwise be deemed to have elected bonus depreciation.

8. **BONUS RULES AUTOMATICALLY APPLY UNLESS AFFIRMATIVE "ELECTION OUT" MADE:** As stated above, the 50% or 100% bonus depreciation rules apply to otherwise qualifying property unless the taxpayer attaches a statement to Form 4562 electing out of the provisions for *each class* of property.

☞**Practice Pointer:** A supplement to **IRS Pub. #946, "How to Depreciate Property,"** was released to explain these bonus depreciation rules. And, a supplement to **IRS Pub. #463, "Travel, Entertainment, Gift, and Car Expenses,"** deals with the changes specific to autos.

the "original use" requirement. **(Code §168(k); Bonus Depreciation)**

D. UNDERSTANDING DEPRECIATION ON REAL PROPERTY ASSETS

1. **SEGREGATION OF PROJECT COSTS:** Obviously, the recovery periods for depreciable real property are quite lengthy and the prescribed use of the straight-line method for real property leaves much to be desired. And, no depreciation may be claimed for the costs associated with the underlying land. Therefore, it behooves the client to accurately classify as much cost as possible to depreciable buildings and as little to the land it sits upon. Furthermore, if at all possible, an attempt should be made to identify those fixtures (e.g., removable floor tiles and wall coverings, track lighting, special wiring for equipment, movable partitions, etc.) that are tangible personal property. The best way to do this is to secure the services of a professional appraiser to determine the proper allocation (i.e., especially where the dollars involved are significant, or the project is complex). Or, if the client is building and developing the property themselves, then to keep detail records of the costs associated with the various components of the building.[61]

a. Keep in mind when assets can properly be classified as tangible personal property, they become potentially eligible for **Code §179** immediate expensing as well, besides the faster write-offs available for 5- and 7-year MACRS property. Moreover, even if the asset is still classified as a type of "real estate" (e.g., land improvement, convenience store which also sells gas, etc.), once it was properly assigned a recovery period of 20 years or less, up to 50% or 100% of its cost could have been written off in the year that it is placed into service under the bonus depreciation rules.

Comment: Sec. 179 has also been expanded for 2010 and 2011 to include "qualified real property" so that up to $250,00 (out of the $500,000 limit) can now qualify for immediate expensing.

Comment: Is there an issue where a detailed cost segregation study is done and a significant amount of the assets contained in the building are broken out as other then real estate (i.e., tangible personal property)? Specifically, if the taxpayer were to later do a LKE, have they *solely* relinquished "real estate" which can then be exchanged for other "like kind property" (i.e., realty). Or, has a combination of assets (i.e., both real and tangible personal property) been the subject of this LKE? Maybe, the taxpayer could argue that such tangible personal property which had been "broken out" years earlier in a cost segregation study now has little or no value to the person who is now coming into possession of the building? Also, where a LKE had taken place and the taxpayer supposedly reinvested in "qualified replacement property" (i.e., solely real estate), would it matter if a short time later, pursuant to a new cost segregation study, they were now breaking out 20 to 25% of the new building as being "tangible personal property" (e.g., 5- or 7-year MACRS property)?

Comment: Another potential issue is where a significant portion of a building is broken out as 5- or 7-year tangible personal property, and it involves a rental property, will the local taxing authorities insist that sales tax is due since this involves the rental of personal property vs. realty?

2. **LAND COSTS V. IMPROVEMENTS:** With regard to land, do *not* forget the availability of the MACRS class for "land improvements." Such assets qualify for 15-year write-off using the 150% DB method.[62] **Rev. Proc. 87-56** specifically lists the following items as constituting "land improvements:"

a. Sidewalks
b. Roads
c. Canals

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[61] Refer to the IRS **Audit Technique Guide on Cost Segregation** studies and how they should be compiled. There are a variety of methods, depending on the level of detailed information that the taxpayer has on file.

[62] Rev. Proc. 87-56; Code §168(b)(2)(A).

d. Waterways
e. Drainage facilities
f. Sewers
g. Wharves
h. Docks
i. Bridges
j. Fences
k. Landscaping
l. Shrubbery[63]

3. **OTHER "LAND IMPROVEMENTS:"** In addition, driveways, parking lots, artificial lakes, retention ponds, retaining walls, berms, embankments, and similar assets would also qualify as "land improvements" for purposes of the 15-year MACRS classification.

a. Once again, the use of a professional appraiser to break down these costs when a improved site is purchased or developed should be considered.

4. **NONSTRUCTURAL COMPONENTS:** As to *nonstructural* components of a building, special care should be taken to break out these costs as well. A building and its *structural* components are deemed to be a *single unit* subject to a recovery period of either 27.5 or 39 years. But, any nonstructural components can be written off over the "normal" recovery period for that type of property (i.e., most likely as 5- or 7-year fixtures). **Rev. Proc. 87-56** identifies various "Asset Classes" for that purpose (**Note:** See the chart below in **CHAPTER #4** for a more detailed analysis).

☞**Cost Segregation Studies & Correct Classification of Assets Critically Important**

Businesses interested in maximizing their first-year writeoffs have an important incentive when placing new assets into service this year. Namely, under **Code §168(k)**, they are permitted to deduct 100% of the cost of otherwise qualifying assets immediately (and, unlike Sec. 179, there are no caps or phaseout mechanisms). On one hand, most realty would be classified as "Section1250 property" and generally would be ineligible for the 100% first-year writeoff. One exception would "qualified leasehold improvement property" which, given its 15-year MACRS recovery, qualifies for bonus depreciation. And, based on **Rev. Proc. 2011-26**, "qualified restaurant property" and "qualified retail improvement property" would also qualify, given that they also met the definition of "qualified leasehold improvement property."

Comment: There are also six other types of realty that do *not* fall into the traditional 27.5- or 39-year MACRS classes reserved for Section 1250 property. And, because they have a MACRS recovery period of 20 years or less, they can take advantage of the 100% bonus depreciation rules. These assets include: 1) single-purpose agricultural or horticultural structures as 10-year property; 2) billboards, car wash buildings; gas station/convenience stores (which meet the more-than-50% test for marketing petroleum products) and land improvements as 15-year property; and 3) multi-purpose agricultural or horticultural structures as 20-year property.

Comment: Consider the significant write-off, for instance, with a proposed gas station/convenience store. Even if the underlying debt had to be personally guaranteed, a highly-leveraged situation where, perhaps, only 10% was put down by the investors, would yield a 100% write-off on all of the assets involved! That is, both the structure, as well as the 5-year "Distributive Trades or Services" property (canopies, pumps, and, literally, any tangible property such as shelves, refrigerator units, etc. within the store), as well as the 15-year land improvements (e.g., paving, landscaping, curbs, entrances, etc.) could be completely written off in the first year. Even the write-offs under ACRS which existed from 1981 to 1986 only, at best, allowed a 15-year write-off (at least for the underlying realty)!

Comment: Given that the owners materially participated, then even the passive loss rules would *not* come into play (unfortunately, the investors might well be limited, though, by the PAL rules unless they had other

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[63] The Service has taken the position in **Rev. Rul. 74-265** that the only depreciable landscaping and shrubbery is that which is *close enough* to a building to be destroyed when the building is replaced. Therefore, the cost of any other landscaping becomes a part of the taxpayer's land basis.

significant sources of passive income). Basis rules, however, should *not* be a problem (at least with an LLC v. an S corporation), if the debt were to be personally guaranteed. Only the land, which is never depreciated regardless of the tax rules in play, would have to be capitalized.

Assets Eligible for Faster Write-Off: The following summary lists some of the more common types of assets which are classified as having shorter recovery periods by the Field Directives. And, therefore, are eligible for a 100% first-year write-off if they otherwise qualify under **Code §168(k)** (as discussed above). The following assets generally are recoverable over a 5- or 7-year MACRS period, depending on the type of industry, unless otherwise indicated.

Comment: Keep in mind that this is the IRS speaking and, of course, their take on asset classification is fairly conservative. In most instances, the correct MACRS recovery period is given. But, make sure to read the comments below to see where a different (and, more aggressive) might be taken in the case of certain assets.

- Canopies and awnings: Readily removable equipment or apparatus used for providing shade or cover. Includes canopies that are largely decorative, but *not* canopies that are an integral part of a building's structural shell (which is why canopies over gas pumps are never connected to the building, even though there might be a “rubber flap” covering the last 12 inches or so at the entrance).

- Decorative millwork: This is decorative finished carpentry, examples of which include detailed crown moldings, lattice work placed over finished walls or ceilings, and cabinets. A key factor of decorative millwork is that it serves to enhance the overall décor of the business (e.g., restaurant, casino) and is *not* related to the operation of the building.

Comment: According to the IRS (as demonstrated by a number of recent audits), cabinets and counters in a restroom are excluded from this category.)

- Doors: Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area (e.g., "Eliason" type door). For example, flexible doors, clear curtains, or strip curtains used between stock areas and selling areas.

- Electrical outlets: Only those outlets specifically associated with particular items of machinery and equipment (i.e., as opposed to general operation of the building as a whole).

- Electrical connections: Special electrical connections “which are necessary to and used directly with” a specific item of machinery or equipment, or connections between specific items of individual machinery or equipment, such as dedicated electrical outlets, wiring, conduit, and circuit breakers by which machinery and equipment is connected to the electrical distribution system.

- Facades in interior of building: Facades, such as a false storefronts, made primarily of synthetic materials (foam, fiberglass, cast stone, or glass reinforced concrete) that are *not* permanently attached and *not* intended to be permanent. This category would include false balconies, as well as finishes on interior columns that are *not* permanently attached nor intended to be permanent.

- Fire protection equipment: This includes special fire detection or suppression systems directly associated with a piece of equipment. For example, a fire extinguisher designed and used for protection against a particular hazard created by the business activity (e.g., a restaurant).

- Floor coverings: Only if *not* permanently attached and *not* intended to be permanent, such as vinyl composition tile installed with strippable adhesive, sheet vinyl, and carpeting.

- Foundations or footings, concrete: Foundations or footings for signs, light poles, canopies and other land improvements have a 15-year MACRS recovery period.

- Heating, ventilation, and air conditioning (HVAC): The HVAC unit must meet the “sole justification” test (i.e., machinery the sole justification for the installation of which is that it is required to meet temperature or humidity requirements that are essential for the operation of other machinery (e.g, lifts in a car dealership) or the processing of materials or foodstuffs (in a kitchen setting)). A HVAC unit may meet this test "even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are *not* essential."

- **Kiosks:** These are small, often prefabricated, retail outlets that are *not* permanent.

- **Landscaping & shrubbery:** This would include landscaping (including irrigation systems) that will be replaced contemporaneously with a related depreciable asset or that will be destroyed when the related depreciable asset is replaced. Examples: depreciable landscaping, shrubbery, trees, plant foliage, or sod placed around a parking lot. Such assets have a 15-year MACRS recovery period.

> **Comment:** What the IRS has said in the past that the landscaping, for instance, has to be close enough to a building that, if or when the building is demolished, then the landscaping would have to be replaced as well.

- **Light fixtures, interior:** This would include light fixtures that are decorative in nature and *not* necessary for the operation of the building. In other words, if all the decorative lighting were turned off, the other sources of lighting would provide sufficient light for the building. These fixtures are 5- or 7-year MACRS property depending on the type of industry.

- **Lighting, exterior:** Lighting that highlights only the landscaping or building exterior (but *not* parking areas or walkways), as well as plant grow lights, and that does *not* relate to the operation or maintenance of the building.

> **Comment:** Distinguish between outdoor lighting used for the security of a building, or for general lighting of sidewalks and parking lots. As mentioned below, these would be classified as 15-year land improvements. On the other hand, consider the lighting which accents and encourages potential buyers to a car dealer's lot and thus spurs sales activity. This lighting is arguably an 5-year asset. Besides the impact on retail or wholesale activities, it is also needed to illuminate the lots at night so as to protect the dealer's vehicle inventory.

- **Lighting, exterior, pole mounted:** Outdoor lighting systems that are pole mounted or freestanding and serve to illuminate sidewalks, parking or recreation areas have a 15-year MACRS recovery period.

- **Music and public address (PA) system:** Equipment and apparatus used to provide amplified music or sound; also includes wiring. Does *not* include a PA system that is an integral part of a fire protection system.

- **Parking lots:** Grade level surface parking areas built of asphalt, brick, concrete, stone or similar material have a 15-year MACRS recovery period. This category includes bumper blocks, curb cuts, curb work, striping, landscape islands, perimeter fences, and sidewalks.

> **Comment:** Keep in mind that once these parking lots are in place and then need to be resurfaced, such costs should most probably be charged off as repairs since: 1) they do not significantly (or, at all) prolong the useful life of the original lot; and 2) they do not materially increase the underlying value of the parking lot (arguably, these costs simply preserve the real estate that the lot is in placed to serve).
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> **Comment:**: Be aware that, in a Coordinated Issue Paper, the IRS has insisted that open-air parking structures providing multi-level parking accessed by a ramp system are structures for **Code §168** purposes and therefore should be classified as 39-year commercial property. IRS's stance on stand-alone open-air parking structures is to be contrasted with its more favorable view of parking towers consisting of an auto carousel mechanism and supporting tower structure. PLR 9751010 says that such towers are tangible personal property for purposes of the Code §168 depreciation rules.

- **Poles and pylons:** Light poles for parking areas and poles used in concrete footings or bolt-mounted for signage have a 15-year MACRS recovery period.

- **Plumbing and similar hookups:** Water, gas, or refrigerant hook-ups, if directly connected to appliances or equipment needed for a particular type of business (e.g., restaurant or hair salon) have a recovery period equal to the assets there are associated with (mostly, 5- or 7-years).

- **Security equipment:** Includes electronic article surveillance systems including surveillance cameras, recorders, monitors and related equipment, that have as a primary purpose the minimization of theft in retail areas would have a 5-year MACRS recovery period.

- **Signs:** Interior and exterior signs used for display or theme identity, and any signage *not* pertinent to the operation of the building. But, it does *not* include exit signs (or, the other emergency lights leading occupants to these exits) which are considered to be part of the surrounding real estate.

- **Site grading:** All of the following assets have a 15-year MACRS recovery period under the classification of "land improvements:"

1) Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements.

2) Site work, including site drainage, sewers, roads, sidewalks, paving, curbing, general site improvements, site fencing and enclosures, and other site improvements not directly related to the building.

3) Patio stonework embedded in the ground and applied to exterior half walls that are *not* an integral part of the building's structural shell.

- **Walls, if movable:** These are interior (partition) walls built so that they can be: (1) readily removed and remain in substantially the same condition after removal as before, or (2) moved and reused, stored or sold in their entirety. A typical example would be hotel meeting rooms which can be configured by using these movable walls.

- **Wall coverings:** Includes strippable wall paper and vinyl that causes no damage to the underlying wall or wall surface, if and when removed.

- **Window accessories:** Window accessories such as drapes, curtains, louvers, post-construction tinting that is readily removable, and interior decorative theme decor. **(Code §168; Depreciation)**

Reference Links on IRS Website:

- Cost segregation field directive on **casinos**.

- Cost segregation field directive on **restaurants**.

- Cost segregation field directive on **retail industries**.

- Cost segregation field directive on **pharmaceutical and biotechnology industries**.

- Cost segregation field directive on the **auto dealership industry**.

☞Cost Segregation and Mini-Storage Facilities

Normally building doors on such structures are considered "structural components" and depreciated over 39 years. How about with a new self-storage facility? Can these doors be considered personal property and be depreciated over 5 or 7 years? There is an argument being advanced here for such treatment, especially by the manufacturers of these storage units. But, the IRS is adamant about these doors being an "integral part" of the overall structure and without which the "structural integrity" would be rendered meaningless. They will fight on this issue and have won a huge case on the new magnetic key code locks for hotel doors. A major hotel chain had to spend millions to re-fit their doors around the country from an old-fashioned key system (which had the hotel name and room # on each key, etc.). They argued, under the 7-factor ***Whiteco Industries*** test that the locks could be changed "without substantial damage to the door" , etc. The Tax Court, however, agreed with the IRS that without the door, let alone the lockset, the security of the room with be worthless. Therefore, 39 years was upheld as the correct recovery period. **(Code §168; Mini-Storage Facilities)**

CHAPTER #4. PROPERLY CLAIMING CODE §179 IMMEDIATE EXPENSING ELECTION

A. CODE §179 EXPENSING ALLOWANCE INCREASED[64]

1. **ANNUAL LIMITS:** The 2003 Tax Act dramatically *increased* the current-law small business **Code §179** expensing limitation from the $17,500 level set in 1993 (which had increased due to annual inflation adjustments as listed below) to $100,000 for tax years beginning in either 2003, 2004 or 2005, 2006 and 2007[65] in the increments set out below. But, the **Small Business and Work Opportunity Tax Act** then extended and enhanced the Section 179 write-off even more, increasing it to $125,000 (it would have been $112,000 for 2007) and the phaseout to $500,000 (it would have been $450,000 for 2007) effective for tax years beginning after 2006. If that wasn't enough, the **2008 Stimulus Act** also significantly enhanced the Sec. 179 deduction only for tax years beginning in 2008 which was extended to 2009). Then again, for tax years beginning in 2010 and 2011, the Sec. 179 were increased to $500,000 with a $2 million phaseout. But, for tax years beginning in 2012, the maximum Sec. 179 deduction will be decreased to $125,000 ($139,000 with the adjustment for inflation) and with a $500,000 phaseout (also adjusted for inflation). Finally, for tax years beginning after 2012, Sec. 179 decreases to $25,000 with a phaseout limit starting at $200,000.

For tax years beginning in:	Expensing allowance:
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001	$24,000
2002	$24,000
2003	$100,000[66]
2004	$102,000
2005	$105,000
2006	$108,000
2007	$125,000 (had been $112,000)
2008	$250,000 (had been $128,000)
2009	$250,000 (had been $133,000)
2010	**$500,000 (had been 250,000)**
2011	**$500,000**
2012	**$125,000** (indexed for inflation = **$139,000**)
2013 and after	**$25,000**

Comment: There is no pro rata reduction of the Sec. 179 expensing deduction depending on the portion of the year the asset is held. In other words, if the deduction is allowable, the amount that may be expensed is the same regardless of when the property is acquired during the year. (**Reg. §1.179-1(c)(1)**) And, as with bonus depreciation, Sec. 179 is *not* considered an addback for AMT purposes (since the write-off is *not* expressed in terms of years). Finally, the mid-quarter convention (i.e., where depreciation deductions may be limited if more than 40% of the taxpayers assets falling in the MACRS classes of 20 years or less are placed into service during the last quarter of the tax year) is avoided to the extent that either Sec. 179 and/or bonus depreciation is used to write off the cost of an acquired asset.

2. **FORMER PHASE-OUT RULES:**

- For tax years commencing in **2002, or before**, the phase-out had been $100,000 (i.e., and had ended at $224,000

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[64] Part I of Form 4562 is used to calculate the overall limits.

[65] In May of '06, Congress added two more years (2008 & 2009)as being eligible for the increased Sec. 179 amount. Then, in March, 210, it extended the $250,000 limit to 2010 with the phaseout threshold remaining at $800,000 (otherwise, the limit would have reverted to $134,000 with a phaseout threshold of $525,000).

[66] The old limit for tax years beginning in 2003 had been $25,000 with the phase-out commencing at $100,000. And, a number of states, because of budget deficits, have retained this "old" limit.

for 2002).

- However, for **tax years beginning in 2003**, not until the cost of the qualifying section 179 property placed in service in a year was over $400,000, must the taxpayer reduce the dollar limit (but not below zero) by the amount of cost over $400,000 (i.e., on a dollar-for-dollar basis). Therefore, not until the cost of your section 179 property placed in service during 2003 was $500,000 or more, were you *denied* the ability to take a section 179 deduction. And, as was previously the law, you *cannot* carry over the cost that is more than $500,000.

- For **2004**, the phaseout range started at $410,000 and extended to $512,000 (i.e., since the immediate expensing amount for 2004 was $102,000).

- For **2005**, the phaseout range started at $420,000 and extended to $525,000 (i.e., since the immediate expensing amount for 2005 was $105,000).

- For **2006**, the phaseout range started at $430,000 and extended to $538,000.

- For **2007**, before the changes made by the **Small Business and Work Opportunity Tax Act**, the phaseout range was scheduled to start at $450,000 and extend to $562,000. Following the changes, it started at $500,000 and extended to $625,000.

- For **2008 through 2009**, the phaseout range starts at $800,000 and ends at $1,050,000.

> **Example:** In **2006**, Jane placed in service machinery costing $437,000. Because this cost was $7,000 more than $430,000 (i.e., the beginning of the phase-out threshold), she had to reduce her dollar limit to $101,000 ($108,000 - $7,000). But, for **2007**, the phase-out rules would *not* have applied at all (i.e., since they did *not* commenced until the $500,000 threshold had been exceeded).
>
> **Example:** In **2007**, Jane placed in service machinery costing $507,000. Because this cost was $7,000 more than $500,000 (i.e., the beginning of the phase-out threshold), she had to reduce her dollar limit to $118,000 ($125,000 - $7,000). But, for **2008**, the phase-out rules would *not* apply at all (i.e., since they do *not* commenced until the $800,000 threshold has been exceeded.
>
> **Example:** In **2008** or **2009**, Jane placed in service machinery costing $807,000. Because this cost was $7,000 more than $800,000 (i.e., the beginning of the phase-out threshold), she must reduce her dollar limit to $243,000 ($250,000 - $7,000).

- For **2010** and **2011**, the phaseout range starts at $2,000,000 and ends at $2,500,000.

- For **2012**, the phaseout range starts at $560,000 and ends at $699,000 (after considering the inflation adjustment)

> ☞**Practice Pointer:** Once again, any Sec. 179 immediate expensing amount has to be taken into account *before* any deduction for bonus depreciation. As a result, bonus depreciation cannot be used to first to get a taxpayer below the beginning of the phase-out threshold (for 2008 and 2009, the threshold was $800,000; for 2010 and 2011, the threshold is $2 million).
>
> ☞**Practice Pointer:** Estates and trusts are *not* eligible for the **Code §179** election. And, remember on flowthrough entities (i.e., Form 1065 and 1120S entities), it might *not* always be advantageous to elect **Code §179** where it will *not* otherwise yield an tax benefit (i.e., the owner inadvertently receives more than the $250,000 (for 2008 or 2009) or $500,000 (for 2010 or 2011) maximum amount via a Schedule K-1 amount), yet it must still always be used to reduce an owner's basis. Or, as is discussed below, the owner does *not* otherwise have sufficient "trade or business taxable income" to cover the amount being passed out to him or her on their Schedule K-1.
>
> ☞**Practice Pointer:** An extremely important question must be asked as we approach the 2013 tax year. Namely, there is a good chance that marginal tax rates may increase by 20% (i.e., from 35% to effectively 42% or more when the phaseout rules for itemized deductions and personal/dependency exemptions are

considered)! So, is it better to capitalized an asset and thereby "save" more of the write-off by way of depreciation deductions in future tax years versus getting an immediate deduction through Sec. 179 and/or bonus depreciation in 2010 through 2012 when the rates will be significantly lower. Therefore, take time to consider some of the following issues, as illustrated by these examples:

Example: The taxpayer's flowthrough business (i.e., LLC or S corp) is currently struggling and is in desperate need of cashflow. It had been profitable in 2005 - 2007, but had significant NOLs for both 2008 and 2009. Nevertheless, in 2009, it did make some asset acquisitions which are eligible for both Sec. 179 immediate expensing and bonus depreciation. But, if it elected to expense up to $250,000 under Sec. 179, it would only result in a carryover since it lacked the sufficient trade or business taxable income to cover the write-off. On the other hand, if it took the 50% bonus depreciation deduction, it could immediately generate a $125,000 write-off which could then be used to create (or, increase) an NOL carryback. And, with the option to carry it back up to 5 years (i.e., assuming it was a "qualified small business"), it could garner a sizable refund (with interest) thereby supplying it with some critical cashflow.

Example: The taxpayer's flowthrough business (i.e., LLC or S corp) had sizable profits for the period 2005 - 2007. However, for 2008 and 2009, it barely managed to break even. Nevertheless, it does anticipate returning to being slightly profitable in 2010, with prospects for more significant profits in 2011 and thereafter. Once again, it did have up to $250,000 of asset acquisitions in 2009. If it took a Sec. 179 immediate expensing of $250,000 it would still *not* have the necessary trade or business taxable income to benefit from the deduction until 2010 when it had additional profits. It could instead take $125,000 of bonus depreciation (i.e., 50% x $250,000) and, perhaps, create an NOL carryback and obtain a refund (with up to the special 3-, 4- or 5-year carryback option). But, would it be better to "store up" these depreciation deductions for the 2013 and thereafter when the marginal tax rates might be much higher (and, therefore, would yield more of a tax benefit)? Yet, taking normal MACRS deductions would mean that the write-off would be spread over 6 or 8 tax years (i.e., 5- or 7-year MACRS recovery period with the half-year convention).

Comment: The best approach to securing the largest write-off, at least in the second example above might be to take a Sec. 179 write-off in 2009 which would then have to be carried over (i.e., due to the lack of profits in 2009). Being only "slightly profitable" in 2010 would mean that most of the deduction's tax benefit would be taken in 2011 (and, in later tax years). But, the write-offs would come sooner than those resulting from the 6 or 8 years to take the normal MACRS depreciation deductions associated with these assets (i.e., as 5- or 7-year property). On the other hand, with 100% bonus depreciation for the latter part of 2010 and all of 2011, perhaps we should forgo the Sec. 179 immediate expensing election (with its various restrictions and phaseout rule which are applied at both the entity and owner levels for flowthrough businesses) and instead elect bonus depreciation. In this latter instance, the owner would still need sufficient basis to take either a Sec. 179 deduction, or the bonus depreciation amount. But, at least you would not have to worry about the "trade or business taxable income" limitation (or, the phaseout rule).

☞**Practice Pointer:** Sec. 179 assets must be aggregated for all members of a "controlled group" (e.g., brother/sister corporations, or parent/sub entities) when determining if the overall phaseout limit had been exceeded. And now, according to the recently-issued regs, S corporations can also be considered "component members" of a controlled group.[67]

Example: Before the issuance of recent regs, Eric owned 100% of the stock of three C corporations. He had been considering making an S election for one of the entities (possible to save on some employment taxes since maybe it was a service based business). In 2008 or 2009, each of the C corporations makes a $350,000 investment in section 179 property. As a result, the section 179 election is *not* available (i.e., because the "controlled group" invested over $1,050,000 in such property and the phase-out mechanism eliminated the break entirely) But, if Eric were to make an S election for one of his companies, the $700,000 invested by the other two C corporations would *not* affect the potential to qualify for **Code §179** by this S corporation given the other requirements are met. But, now that the IRS has issued these new regs, this planning strategy would be lost since S corporations are considered "component members" of a controlled group.

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[67] Reg. §1.1563-1(b)(2)(ii)(c); however, the Service has proposed new regs which would now treat S corporations as "component members" of a controlled group.

3. **"ENTERPRISE ZONE BUSINESSES:"** Such businesses are already entitled to a larger expensing amount. The maximum is increased by the *lesser* of $20,000 or the cost of **Code Sec. 179** property that is qualified zone property placed in service during the tax year.[68]

4. **ADDITIONAL LIMIT FOR AUTOS:** For passenger automobiles (i.e., otherwise subject to the "luxury car" caps under **Code §280F**) placed in service in 2001, 2002 and 2003, the total of the section 179 and depreciation deductions generally *cannot* be more than $3,060[69] unless either the 30% or 50% bonus depreciation election were made. In such cases, the cap increased to $7,600 and $10,710, respectively.[70] As discussed below, for 2004, the respective amounts above are decreased by $100 each. Then, in 2005 - 2007, the car caps remained basically the same, except that there were no longer higher caps allowed (i.e., because of bonus depreciation being eliminated). But, in 2008 and 2009, with the reintroduction of bonus depreciation, the caps were once again increased (i.e., from $2,960 to $10,960). And, in 2010 through 2012, the cap was increase again by $8,000 (from $3,060 to $11,060).

Comment: With the introduction of 100% bonus depreciation for "luxury cars" placed into after 9/8/2010 and before 1/1/2012, will the increase to the first year cap continue to be $8,000 (as it was with 50% bonus depreciation), or will it be doubled to $16,000? The answer, according to the IRS, is just $8,000.

a. **"HEAVY" CARS & TRUCKS:** Vehicles with "gross vehicle weight ratings (GVWRs) exceeding 6,000 pounds are *not* subject to the **Code §280F** "luxury car" caps[71]. To ascertain exactly what vehicles qualify for this exception, to **http://www.alphaleasing.com/businessaspects/over6000gvwr.asp** to check out any particular item. However, owners should always make sure of this exception by examining the sticker normally found on the vehicle's door jamb on the driver's side.

Comment: Once again, remember that the 2004 Tax Act capped the **Code §179** amount to $25,000 for such "heavy vehicles" placed into service after 10/22/04. But, bonus depreciation (especially 100% bonus for assets placed into service after 9/8/2010 and before 1/1/2012) has no such limit.

☞Service Reminds Taxpayers to Keep Business Use of "Heavy Vehicles" at More Than 50% for at Least 5 Years to Avoid Sec. 179 Recapture Rules on Immediate Expensing (INFO 2004-0193)

Under **Code §179(d)(10)**, if the business use of such vehicles falls below to 50% or below during the MACRS recovery period (i.e., with the mid-year convention rules, this would extend from the middle of the first tax year to the middle of the sixth tax year, given the 5-year recovery period assigned to such assets), any immediate expensing amount is subject to possible recapture. The law requires that a comparison be made between the Sec. 179 write-off originally taken and what the taxpayer would have received had they simply use the S/L method over the same 5-year period (i.e., the ADS system must be used instead and without the benefit of any bonus depreciation as well). Given up to $100,000 might have been written off with regard to such vehicles (i.e., at least for the 2004 tax year, if placed into service before 10/23/04), this could result in a significant recapture amount. So, personal use for long commutes or other vacation/family use, for example, could cause the taxpayer to run afoul of this business use restriction. Another scenario might be where the vehicle is simply converted over to personal use (i.e., it is given to another family member for their own personal use with the business simply buying a replacement vehicle *before* the end of the 5-year recovery period). And, remember even if the vehicle was purchased and placed into service on 12/28/03, for instance, the half-year depreciation convention would deemed this asset to have been placed into service as of the middle of the 2003 tax year (i.e., assuming that the taxpayer was on a calendar yearend). So, with a 5-year MACRS recovery

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[68] See **IRS Pub. #954**, Tax Incentives for Empowerment Zones and Other Distressed Communities.

[69] Once again, if the unloaded gross curb weight of an auto exceeds 6,000 pounds, or the rating of a truck exceeds this limit as well, then the $3,060 cap is avoided and a special $25,000 Sec. 179 limit otherwise applies.

[70] Code §168(k)(2)(E)(i).

[71] For trucks, it is *not* simply a particular weight (i.e., 6,000 #'s), but rather the load weight rating for the vehicle (the sum of what the vehicle weighs added to what it is capable of carrying).

period, the more-than-50% business use test would have to be met until at least the middle of the 2008 tax year. **(Code §179; Depreciation Recapture)**

> **Comment:** The Service takes the position in this ruling that any 30% or 50% bonus depreciation taken on such a vehicle would also be subject to the recapture rules. Some taxpayers had argued that since "heavy vehicles" are *not* subject to the luxury car rules contained in **Code §280F**, any recapture should only apply to the Sec. 179 amount. However, in the opinion of the IRS, these SUVs are nonetheless "listed property" under **Code §280F(d)(4)(A)(ii)**, and, therefore "the remainder of the provisions of **Code §280F** still apply."

B. ELECTION MUST BE PROPERLY CLAIMED ON FORM 4562

> 1. The immediate expensing election is *not* a formal election (i.e., that would otherwise require a "white-paper statement" to be attached to the return) and can be done be simply deducting the §179 amount on **Form 4562**. **(Code §179(c))**[72] However, as indicated in the ***Fors*** decision below, it is *not* enough to just take the deduction on a Schedule C, for instance, without including the information on a properly-filed Form 4562. For a partnership or S corporation, this election is made at the entity level, *not* the partner or shareholder level.[73]

> **Comment:** Keep in mind that the Sec. 179 election is *not* available for either estates or trusts (i.e., on Form 1041).[74] So, if any of the members of an LLC (or, even an S corp) are estates or trusts, the allocable portion of a Sec. 179 write-off would be wasted even though the basis of the underlying asset would be fully reduced.

☞**Affirmative Action Needed to Secure §179 Election** (***Fors*, TC Memo. 1998-158**)
Those smaller businesses (i.e., ones with less than $224,000 of depreciable assets placed into service in a given tax year *before* 2003) had to *affirmatively* elect to expense depreciable assets. And, the election had to be made by the extended due date of the tax return for the year that the asset was placed into service.[75] The expensing election had to be made on Form 4562, *not* merely by taking a corresponding expense deduction on Schedule C, for instance, for the asset in question. The Tax Court here denied the immediate expense deduction to a businessman who simply listed a $2,000 office equipment acquisition as an "office expense" on Schedule C. As a result, the opportunity to expense this asset was lost (i.e., since the extended due date for the return had passed) and it had to be set up for depreciation over the proper recovery period.

> **Comment:** As discussed below, starting in 2003, an amended return can be filed *to make or revoke* a Sec. 179 expensing election. In other words, it is no longer necessary to make this election by the extended due date of the original tax return.

C. TIMELY ELECTION MUST BE MADE[76]

> **Comment:** Because of the changes made by the 2003 and 2004 Tax Acts (as well as other more recent tax acts), a taxpayer is now free to amend a prior year's return and *either* revoke or elect **Code §179** immediate expensing for a particular asset without the prior approval of the IRS, so long as the tax year involved is 2003 through 2011. And, now, Congress has extended this to cover tax years beginning through 2013 as well. Consider this change in the law when reviewing the examples below and how a different result might have

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[72] Keep in mind, though, that the election out of *either* 50% or 100% bonus depreciation must be made on a formal statement attached to and filed with Form 4562 for that particular tax year. Otherwise, the taxpayer is automatically deemed to have elected bonus depreciation for all new property placed into service for that tax year.

[73] Reg. §1.179-1(h)(1).

[74] Reg. §1.179-1(f)(3)

[75] Even if the taxpayer had *not* formally filed an election to extend that year's tax return.

[76] Prior to the changes made by the 2003 Tax Act.

been reached had these changes been in effect.

1. As stated in the regs, a **Code §179** immediate expensing election is permitted to be made only on the *original* return (even if filed late) or on an amended return filed *within* the due date of the return, including extensions, for the original return (**Reg. §1.179-5(a)**).

Example 1: In ***La-Pointe v. Commr,* 94 TC 451**, the taxpayer misclassified building improvements (i.e., that were otherwise classified as tangible personal property) as a "repair expense." When audited, the taxpayer argued that the §179 expense amount should instead be allowed. However, the Tax Court disagreed since the §179 election was *not* made on the original return.

Query: We know that if a taxpayer purchases a $10,000 computer in a year that the businesses net income (i.e., "trade or business taxable income) is $8,000, and elected §179, the tax benefit of the immediate expensing is limited to the business' taxable income of $8,000. What happens if, in a subsequent IRS audit, it is determined that the taxpayer had "taxable trade or business taxable income" of $10,000. Can the taxpayer increase the §179 write-off at that later date? The answer would be "yes" since Sec. 179 may now be elected on an amended tax return.

Example 2: In ***Steinberg*, TC Memo 1995-116**, the case concerned certain medical equipment that was purchased for the wife's medical practice. The taxpayers did *not* elect the Sec. 179 expensing allowance on the original return and, therefore, the Court agreed with IRS and disallowed the use of Sec. 179. The taxpayers argued that they did *not* know about **Code §179** when they filed their returns for the year at issue. The court said that this ignorance did *not* relieve the taxpayers of the requirement to make the election on their return.

Comment: Once again, the result in ***Steinberg*** would be different today if the taxpayer could have filed an amended return to fix the problem.

D. REVOCATION OF ELECTION

1. **IRS PERMISSION NO LONGER NEEDED:** *Prior to* tax years beginning in 2003, an immediate expensing election could only be revoked with the consent of the IRS Commissioner **(Reg. §1.179-5(b)**). As stated above, however, the taxpayer can now *either* revoke or elect **Code §179** at any point within the 3-year statute of limitations period for the tax years 2003 through 2013.

Practice Pointer: One might wonder why a taxpayer would revoke or elect **Code §179** in a tax year other than the one when the qualifying asset was first placed into service. Some of the suggestions that have come out of tax workshops so far include: (1) the taxpayer was experiencing NOLs when the asset was first acquired, but now has had unexpected profits which would mean an immediate expensing election would yield a tax benefit sooner than writing off the asset over the normal MACRS recovery period; (2) the taxpayer was applying for loan or line of credit and had submitted tax-basis financial statements to the potential lender; then, after being approved for the loan, the taxpayer could conceivably go back and amend that year's tax return and now claim **Code §179** for otherwise qualifying assets; (3) other unforeseen situations arise that affect the decision to either elect or revoke **Code §179** that were *not* apparent in the tax year that the assets in question were first placed into service.

Comment: If one was to study a literal reading of **Code §179(c)(2)**, you would only find that the law only speaks of the ability to "revoke" an immediate-expense election. However, the conference agreement for the 2003 Tax Act (at H.R. Conf. Rep. No. 108-126, at 35 (2003)) states that "a taxpayer may make or revoke an expensing election on an amended federal tax return without the consent of the Commissioner." Therefore, taxpayers will now be able to take advantage of §179 even if they missed the extended due-date deadline for the tax year in question. This is a dramatic change from the previous law. Therefore, practitioners should review client returns for the tax years specified above (i.e., 2003 onward) and decide whether an immediate expense election should stay in effect, or whether one should be made where, perhaps, the taxpayer had *not* done so previously. And, remember, with an immediate expense election, it can be made on an asset-by-asset basis, or even for a portion of an asset (i.e., unlike bonus depreciation, which applied for an *entire* class of otherwise "qualified assets" for a particular tax year unless an affirmative election out is made for that MACRS recovery class).

☞**Regs Issued on Making/Revoking Sec. 179 Immediate Expensing Election** (**T.D. 9146**)

These regs were issued to clarify the changes made by the 2003 Tax Act. Specifically, they provide guidance not only as to how a taxpayer may revoke a previously-made immediate expense election, but also reiterate the fact that such an election can automatically be made on an amended return for any tax year beginning after 2002 and before 2006 (i.e., the consent of the IRS requested by a filing of a Form 3115 is *not* needed; and, now, this option has been extended through 2013). All that is needed is that the taxpayer specify which asset(s) and what portion of their cost that they now want to either expense, or for which a revocation of a previously-made election is now desired. According to Acting Treasury Assistant Secretary for Tax Policy Greg Jenner, "The ability to expense up to $100,000 of the cost of depreciable property will significantly reduce the record-keeping burden imposed on small business taxpayers. In addition, the regulations greatly simplify the manner in which taxpayers may make or revoke these elections and provide flexibility to small business taxpayers to ensure the election is to their advantage." **(Code §179; Immediate Expensing)**

Effective Date: Originally, this was only for tax years beginning after 2002 and before 2006 .[77] However, it has recently been extended through the 2013 tax year.

F. TAXABLE INCOME LIMITS APPLY AT BOTH THE ENTITY AND INDIVIDUAL OWNER LEVELS

1. **DEFINITION:** **Code §179(b)(3)(A)** provides that the Sec. 179 deduction "shall *not* exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the 'active conduct' by the taxpayer of *any* trade or business during such taxable year." For purposes of this limit, taxable income derived from the conduct of a trade or business shall be computed without regard to the deduction allowable under **Code §179**.

2. "FROM ANY TRADE OR BUSINESS:" The taxable income limitation was added by the Tax Reform Act of 1986. While the Senate version of the taxable income limitation was limited to taxable income of the business in which property was used, **Code §179(b)(3)(A)**, as enacted, applies to taxable income from *any* "trade or business" of the taxpayer. As a result, a Sec. 179 deduction from a sole proprietorship operating at a loss may still be deducted on an individual tax return on which wages (or, self-employment income) in excess of the deduction are included. In other words (especially on a joint return), the "qualifying taxable income" limit can be satisfy by looking at *either* spouse's source of such monies from wages, Schedule C or F net profits, K-1 income from a partnership or S corporation, or *net* section 1231 gains.

a. **FORM 1040 ADJUSTMENTS:** In addition to be able to look to "any trade or business income" on a joint Form 1040, "taxable income" must be calculated *without regard* to any of the following:

- The section 179 deduction,

- The self-employment tax deduction[78],

- Any net operating loss carryback or carryforward, and

- Any unreimbursed employee business expenses.

b. **FORM 1065 ADJUSTMENTS:** Net income or loss at the bottom of page 1 (i.e., the amount that will otherwise be shown on either line 1 or 2 or Schedule K) must be *increased* by adding back any

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[77] Even though these regs initially stated that this exception could only be used for tax years 2003 through 2005, the 2004 Tax Act added the 2006 and 2007 tax years, and now the Tax Act passed in May, '06 extended it for two more years through 2009. Now, Congress has recently acted to extend this break through 2011.

[78] The 50% S/E tax deduction taken for AGI.

"guaranteed payments" paid to the owners, along with being further adjusted (i.e., increased or decreased, as the case may be) by any *net* section 1231 gain or loss.

c. **FORM 1120S ADJUSTMENTS:** Taxable income from page one must be *increased* by an salaries or compensation paid to the officers or shareholders (i.e., line 7), along with being further adjusted (i.e., increased or decreased, as the case may be) by any *net* section 1231 gain or loss.

Comment: For purposes of the "active trade or business" income limit, the Service takes the position that the taxable income of a partner engaged in the active conduct of one or more of a partnership's trades or businesses includes his or her allocable share of taxable income derived from the partnership's active conduct of *any* trade or business. On the other hand, if a flowthrough entity owner is merely a *passive* investor in the underlying entity, then *none* of the flowthrough income from *any* of its trades or businesses can be used for meeting this limitation. As a result, that *passive* investor better have other adequate sources of "trade or business taxable income" on their personal tax return to cover the Section 179 being passed through on their Schedule K-1, or the deduction must be carried (even though the basis of their ownership interest is otherwise reduced in full for the tax year in question).

3. **TAXABLE INCOME REQUIREMENT APPLIES AT BOTH ENTITY & OWNER LEVEL:** In the case of a partnership, the taxable income applies to the partnership as well as each partner. A similar rule applies in the case of an S corporation and its shareholders (**Code §179(d)(8)**).

4. **REG. §1.179-2(c)(2):** The IRS clarified the above rules in **Reg. §1.179-2(c)(2)**:

Application to partnerships and partners--(i) In general. The taxable income limitation of this paragraph (c) applies to the partnership as well as to each partner. Thus, the partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's taxable income limitation for that taxable year, and a partner may not deduct as a section 179 expense deduction for any taxable year more than the partner's taxable income limitation for that taxable year.

Comment: This last part of the reg is a bit misleading though. If the partner otherwise had sufficient "trade or business taxable income" from *another source* on their own tax return, this could be used to make up the shortfall, thus allowing the full tax benefit of a passed through **Code §179** amount to be realized in a given tax year.

☞Sec. 179 & "Active Trade or Business Income" Requirement for Flowthrough Entity Owners

Facts: An S Corp. has 20 shareholders, most of whom are retired, over 70 years old and who have no wages or earnings from other than investment income (e.g. interest & dividend) sources and social security benefits. The S Corp. is profitable and income is derived from manufacturing. For simplicity purposes, let's say that none of the shareholders actually work at the S Corp. and only a few shareholders (4) serve on the Board of Directors which meets monthly/quarterly and does meaningful work as a board of directors. The S Corp. will soon acquire a $300,000 machine to be used in the manufacturing process.

Issue: Would the Sec. 179 requirement for sufficient "active trade or business taxable income" be met so as to satisfy the amount (i.e., $300,000) which would be expensed at the S corp level and which would then be passed through to the shareholders on their K-1s?

Law: **Code §179 (b)(3)(A)** which discusses the "Limitation based on income from trade or business" states that "The amount allowed as a deduction .....shall *not* exceed the *aggregate* amount of taxable income of the taxpayer for such year which is derived from the *active conduct* by the taxpayer of *any* trade or business during such taxable year." Here, the concern is that the retired shareholders might *not* have any taxable income derived from the "active conduct" by the taxpayer of any trade or business during such year. Clearly, should any S Corporation owner here have wages (or, any other trade or business income) from some other source, they would be able use the Sec. 179 benefit passed through on their respective K-1s from the S Corporation. However, most of the shareholders have no wages or other "trade or business income" which would give them the active conduct needed. There is no question that the S Corp. can "take" Sec. 179 and put the amount on the Schedule K-1. So, the determination is ultimately at the shareholder level whether Sec. 179 can be used to create a tax benefit on the owners' Form 1040s.

Holding: Many practitioners count on the Schedule K-1, Line 1 trade or business income for purposes of satisfying this test at the owner level. Pursuant to **Code §179(d)(8)**, each of the tests (i.e., this overall $112,000 limit, $450,000 to $562,000 phaseout rules and "active T/B income" which were the applicable numbers for the tax year in this example) is apply at *both* the entity level as well as the owner level. This particular issue involves the third test which mandates that adequate "active trade or business income" also exist on the owners return to cover the **Code §179** immediate expense amount which is separately stated on the owner's Schedule K-1. Most of the time, the owner might independently have sufficient "trade or business income" to cover the Sec. 179 amount being passed through because of their own W-2 income, or that of their spouse. Any source of self-employment income would also count as well. But, what if the investor is elderly, or a child, who has no other source of "active trade or business income?" **Reg. §1.179-2(c)(2)** and **(3)**, which is an "interpretative reg" (i.e., vs. a "legislative reg"), takes the position that the owner must be "active" in at least one of the trades or businesses of the flowthrough entity to be able to count the entity's trade or business income as his or her own for purposes of satisfying the "active trade or business income" test on their tax return. If the owner is "active," then *any* trade or business income of the flowthrough entity can be used for these purposes. However, if the owner does *not* participate in any way with the flowthrough entity's businesses, then it is the position of the Treasury in this reg that *none* of the Line 1, Schedule K-1 income can be used on the owner's return to satisfy this particular test. And, if the owner does *not* have an independent source of "active T/B income," the basis of his or her ownership interest is nevertheless reduced immediately, even if there is little prospect of having any such income in the near future. **(Code §179; Immediate Expensing)**

Comment: Most practitioners seem to be unaware of this interpretative reg and count on the K-1 trade or business income shown on Schedule K-1 to satisfy the test. However, since this position technically goes against the Treasury's position, a **Form 8275R** should be files with the owner's tax return to disclose the deviation. And, according to a number of court decisions, there is a presumption that such a reg would be valid unless one could demonstrate that the statute was "ambiguous and did *not* represent a permissible construction of the statute."

Comment: This reg section was written back when the **Code §179** was significantly less than then the present amount of over $500,000. Still, until revised, it represents the Treasury's position with regard to this issue and could cause a problem for elderly investors with only portfolio income and/or social security benefits on their personal tax returns (or, minor children of the entity's owner who might also have been gifted interests in such businesses).

Comment: Of course, "active trade or business income" (i.e., flowing through on one particular K-1) could still be eliminated (or, at least offset) if there was some other "negative" source of trade or business loss (e.g., "negative" K-1s or net **Code §1231** losses from other flowthrough entities or net losses from Schedule C or F proprietorships of either the K-1 owner or his or her spouse on a joint return).

Comment: This "active" test imposed by the regs under **Code §179** was written *before* the "material participation" standards contained in passive loss rules under **Code §469**. However, it would seem that they would *not* be as onerous (e.g., 500 hours per year), for example, and they would also be mutually exclusive of each other.

5. **CARRYOVER ALLOWED:** You can carry over the cost of any section 179 property you elected to expense but were unable to because of the trade or business taxable income limitation.[79] This disallowed deduction amount is shown on line 13 of Form 4562. You then use the amount you carry over to determine your section 179 deduction in the next year. Enter that amount on line 10 of your Form 4562 for the next year. If costs from more than one year are carried a subsequent year in which only part of the total carryover can be deducted, you must deduct the costs being carried from the earliest year first.

Comment: For "qualified real property" in 2010 or 2011, up to $250,000 (out of the overall $500,000 limit) may

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[79] But, only because of this particular limitation and not because of the other two limits contained in Code §179 (i.e., over $250,000 in elected assets, or because over $800,000 was placed into service in a particular tax year; here, the 2008 or 2009 tax years).

be immediately expensed. However, if sufficient "trade or business taxable income" does not exist (at either the entity or owner level), none of this type of carryover (i.e., v. any carryover for other tangible personal property) is allowed for a tax year beginning after 2011. Instead, such property would be considered to have been placed into service as of 1/1/2012.[80]

☞**Practice Pointer:** Even if sufficient taxable income from one's trades or businesses is lacking, it might still make tax sense to make the **Code §179** election, given that the there will be enough taxable income in the near future. This compares to capitalizing the property and have to wait 6 or 8 tax years (i.e., with the half-year convention on 5-, or 7-year property). Thus, it could pay to forgo any recovery of the property's cost in the first year in order to be able to write off the entire cost soon thereafter. On the other hand, some consideration should be given to the 100% bonus depreciation which is available for assets placed into service after 9/8/10 and before 1/1/2012. With bonus depreciation you can create (or, increase) and NOL carryforward which can then be used without the restrictions (e.g., "trade or business taxable income" at both the entity and owner levels) imposed by Sec. 179.

Comment: With the recent change which allowed "small businesses" to carry back NOLs up to 5 years, along with the current economic conditions which might mean significant losses for 2008 and 2009, it might have made more sense to forgo the $250,000 Sec. 179 election (at least for these two tax years) and instead taken 50% bonus depreciation (at least for "qualified leasehold improvements") (i.e., $125,000). This was true since sufficient "trade or business taxable income" is needed to reap a current benefit from a Sec. 179 election. However, for bonus depreciation, this is *not* a requirement. Therefore, a current year's NOL could have been created (or, increased) and then carried back up to 5 years when the business last had profits, with a tax refund bringing welcomed cashflow to the starving business.

☞**Practice Pointer:** If there is a sale or other disposition of your property (including a transfer at death) before you can use (i.e., receive the tax benefit relating to) the full amount of your disallowed section 179 deduction, neither you nor the new owner can deduct any of the unused amount. Instead, you must **add it back to the property's basis** in determining the overall gain or loss from the transaction.

☞Effect of the K-1 Information on the Sec. 179 Phase-out Rules

A client had a Schedule C business that placed into service assets which exceeded the $700,000 limit of eligible section 179 property during 2007. Additionally, he has an S-corp that has passed through a deduction of $105,000 for section 179. There is adequate "trade or business taxable income" to cover the flowthrough deduction on the K-1, so there is only one limitation at issue – the $500,000 placed-in-service phaseout. It is fairly clear in the law that he does *not* need to combine the total eligible 179 assets placed in service (i.e., look to the S corp's Sec. 179 assets, information that he might *not* even have in the first place) to measure against the cap. And, it is clear that his schedule C activity limits his available deduction for 2007 to zero, at least for the $700,000 of Sec. 179 property that he placed into service for that particular business. In fact, IRS **Pub. #946** states that in the case of partnership, "each partner adds the amount allocated from partnerships (shown on Schedule K-1) to his or her non-partnership section 179 costs and then applies the dollar limit to this total. To determine any reduction in the dollar limit for costs over $500,000, the partner does *not* include any of the cost of section 179 property placed in service by the partnership. After the dollar limit (reduced for any *non-partnership* section 179 costs over $500,000) is applied, any remaining cost of the partnership and non-partnership section 179 property is subject to the business income limit." It appears that the "dollar limit" is reduced by the *total* of *all* Sec. 179 property that the taxpayer may be putting into service on their Form 1040. In other words, all of the Sec. 179 property from *any* Schedule C or F business would have to be aggregated when testing to see if the $500,000 phaseout cap was exceeded for 2007.

Example #1: John has a Schedule C and decides to place $580,000 of Sec. 179 property into service during 2007. Assume this is the only business on his Form 1040 and he does *not* receive any Sec. 179 deductions on any K-1 from a partnership or an S corporation. It is clear that he would have exceeded the phaseout limit of $500,000 by $80,000 ($580,000 - 500,000) for 2007 and would therefore be limited to claiming no more that $45,000 ($125,000 - 80,000) as a Sec. 179 deduction for the 2007 tax year.

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[80] If this were to occur, then an amended return should be filed for either 2010 or 2011 (i.e., when the original election was made to expense up to $250,000 of "qualified real property") and some or all of this Sec. 179 election should be revoked (resulting in additional basis for either bonus depreciation or MACRS depreciation).

Example #2: John is married to Mary and each of them has a Schedule C business. Assume that each of their businesses places into service $290,000 in Sec. 179 property for 2007. In applying the Sec. 179 phaseout limit of $500,000, the "taxpayer" here would be the joint return. Therefore, you would need to combine the total of Sec. 179 assets placed into service for the tax year, namely $580,000, and you would get the same result as in **Example #1** about. That is, the couple would be limited to just $45,000 as a Sec. 179 deduction for the tax year which they could split among the two Schedule C businesses as they saw fit.

Example #3: Assume the same facts as originally stated in the initial paragraph of this article. Namely, John has received a K-1 from either a partnership or an S corporation that lists $105,000 in total Sec. 179 deductions for 2007. Also, in his Schedule C business, he decides to place into service $700,000 of Sec. 179 property. Even though he need *not* consider any Sec. 179 property placed into service by any of the flowthrough entities (i.e., from which he is receiving a K-1), he does need to consider the $700,000 of Sec. 179 property placed into service by his Schedule C business when applying the overall $500,000 phaseout test. And, in this instance the overall Sec. 179 dollar limit of $125,000 normally available for 2007 would be reduced to zero. Therefore, he would *not* be allowed to claim any Sec. 179 amount for his Schedule C business. Furthermore, he would *not* be allowed to claimed any of the $105,000 Sec. 179 amount passed through from the S corporation on the K-1. **(Sec. 179; Phaseout Rules)**

Comment: In this instance, none of the $105,000 passed through from the S corporation could be used on the shareholder's Form 1040. Furthermore, since it was the phaseout rule that caused this limitation, there would be no carryover of the $105,000 Sec. 179 amount passed through on the K-1. And, this $105,000 would be treated as a "nondeductible" amount just as much as the 50% of any meals or entertainment expense which is otherwise disallowed. Nevertheless, his basis in his S corp stock would still have to be reduced by the entire $105,000 amount (i.e., given he has at least this amount of basis available), but not below zero. If his basis in his S corp stock was less than $105,000, the excess nondeductible amount of the Sec. 179 amount would *not* have to be carried over. The only exception to this general rule would be if the taxpayer made an election to take "deductible" K-1 items against any available stock basis first. Then, given such an election was made, then any "nondeductible" items would have to be carried over and used against any stock basis in future tax years.

Comment: The "proof" that the answer in **Example #3** is correct is the fact that you should *not* get a "different" answer just because the Sec. 179 amount is coming through a K-1 instead of just resulting from a business that the taxpayer might already have on their Form 1040 as shown in **Examples #1** and **#2** above. In addition, bonus depreciation (if otherwise applicable for a given tax year) could not be used to get below the phaseout threshold (here, $500,000 for the 2007 tax year).

☞**$25,000 Cap on Sec. 179 for SUVs and Effect on the Phaseout Rules**

The '04 Tax Act (which was effective as of 10/22/04 for "heavy" SUVs) placed a $25,000 cap on the immediate write-off for purposes of Sec. 179 (unless they otherwise met the exception as "qualified nonpersonal use vehicles" such as a pick-up truck, or hotel/commuter van). However, when considering the effect of their overall cost for when applying the phaseout rules for Sec. 179, the entire cost of the vehicle must be considered (i.e., *not* just the $25,000 amount which was actually allowed for the Sec. 179 write-off). In other words, say a SUV cost $45,000, but only $25,000 was allowed as an immediate deduction for Sec. 179. The *entire* $45,000 cost would still have to be factored into the phaseout threshold of $500,000 for 2007 ($800,000 for 2008 and 2009; $2 million for 2010 and 2011). **(Code §179; Phaseout Rules)**

H. LOST CODE §179 DEDUCTIONS FROM FLOW-THROUGH ENTITIES

1. **ANNUAL LIMIT:** As mentioned above, the annual dollar limit on **Code §179** expensing ($500,000 for 2010 and 2011) also applies at *both* the flow-thru entity and individual levels. Thus, a partnership or S corporation may *not* elect to expense more than $500,000 in either 2010 or 2011. The individual taxpayer must also limit his or her **Code §179** deduction to these same overall limits (i.e., whether the Sec. 179 write-offs are coming from a K-1, or from a Schedule C/F business on their personal return).

Comment: The Sec. 179 amount otherwise available for a particular tax year is *not* affected by any carryover from prior tax years that was the result of the taxpayer having inadequate "trade or business taxable income." For example, a taxpayer with an NOL could still make a Sec. 179 election for up to $500,000 of qualifying assets in 2010. And, even though this would result in a carryover of the entire expensed amount, this same taxpayer could again make an election to expense another $500,000 in 2011. Of course, this same taxpayer could have possibly used the 100% bonus depreciation rules to avoid this "T/B taxable income" issue entirely. In other words, bonus depreciation deductions can be used to create or increase a taxpayer's NOL for a particular tax year.

2. **FORM 1040 LIMIT:** An individual with **Code §179** deductions from several sources may lose deductions and still be forced to reduce basis if combined **Code §179** deductions exceed the annual dollar limit.

Example: Dan owns 60% of "S" (an S corporation) and "P" (a partnership). Assume that both "S" and "P" purchase and place in service $125,000 of equipment during 2007. Furthermore, both "S" and "P" elect to expense the maximum amount otherwise allowed under **Code §179**. Dan is allocated $70,000 of **Code §179** deductions from each entity for a total of $140,000. However, he may only deduct a total of $125,000 on his individual tax return. And, he may *not* carry over the unused amount of $15,000. Yet, he must reduce his ownership basis in *both* "S" and "P" by $70,000 each. Clearly, if at all possible (i.e., to the extent that the particular owner(s) have control over such decisions), flowthrough entities should *not* always elect the maximum **Code §179** deduction. Or, at the very least, these owners would have to coordinate any potential section 179 amounts that they might otherwise have on their personal returns with what might be flowing through from a Schedule K-1. Of course, for 2010 and 2011, Dan would have the higher $500,000 limit to consider.

3. **EXCEPTED PROPERTY:** Even if the requirements explained in the preceding discussions are met (along with the definition of "qualified property" immediately below), you still *cannot* elect the section 179 deduction for the following property:

a. Certain property you lease to others (if you are a *noncorporate* lessor),[81]

b. Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging,[82]

c. Air conditioning or heating units,[83]

d. Property used predominantly outside the United States (except property described in **Code §168(g)(4)**),

e. Property used by certain tax-exempt organizations,

f. Property used by governmental units, or

g. Property used by foreign persons or entities.

4. **LEASED PROPERTY:** Generally, you *cannot* claim a section 179 deduction based on the cost of property

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[81] Unless a special test set out in Code §179(d)(5) is met (Cf. **"4. LEASED PROPERTY"** below for more information).

[82] This would preclude the use of Code §179 in connection with residential rentals shown on Schedule E since it is *not* considered to be the "active conduct of a trade or business;" However, with hotels and motels providing lodging on a transient basis (i.e., average stays are 30 days or less), or for commercial rentals, such as office space, Sec. 179 is allowed.

[83] Even if the central air unit is sitting on a slab outside of the building, at least according to the IRS in its publications. However, an argument can be mounted that certain replacements of air conditioning units, furnaces and/or hot water heaters are in the nature of a "repair" and are therefore currently deductible. See **Chapter #1** for more information on this issue.

you lease to someone else, if you are a *noncorporate* lessor (e.g., an individual or LLC). However, an exception is provided in such situations whereby you can claim a section 179 deduction for the cost of the following property:

a. Property you manufacture or produce and lease to others, or

b. Property you purchase and lease to others if *both* the following tests are met:

1) The term of the lease (including options to renew) is *less than half* of the property's class life, and

2) For the first 12 months after the property is transferred to the lessee, the total business deductions (e.g., insurance, etc.) you are allowed on the property (other than rents and reimbursed amounts) are more than 15% of the rental income from the property.

Comment: Pursuant to **Code §179(d)(5)**, if a *noncorporate* lessor is involved, the property's **Code §162** business expenses (i.e., "ordinary and necessary" expenses other than (1) taxes; (2) interest; and (3) depreciation) must exceed 15% of the gross rents generated from the property during the first 12 months of the lease. The following are examples of **Code §162** expenses for these purposes: advertising, auto, travel, cleaning, maintenance, supplies, repairs, insurance, legal fees, other professional fees, management fees, utilities, entertainment, telephone, office supplies, postage, salaries, publications on real estate (or, related to the tangible personal property that you might instead be renting), equipment rental, eviction costs, due for investor associations, etc.

Example: Three doctors formed an LLC to purchase certain equipment (e.g., CAT scan, MRI or X-ray equipment) which they intend to lease back to their medical clinic. Assume that the cost is *not* in excess of the current Sec. 179 amount (e.g., $125,000 for 2007; $250,000 for 2008 and 2009; $500,000 for 2010 and 2011). If their medical clinic purchased the equipment instead, there would be no question that it could claim the Sec. 179 immediate expensing deduction (and, with an LLC, this amount would be separately stated on their respective K-1s and would flow through to their personal returns) However, as stated above, this newly-formed LLC makes the purchase instead. Assume that the lease term, including any options to renew, is *not* more than 50% of the normal MACRS recovery period of such equipment (i.e., with a medical clinic, which is providing professional services to patients, this equipment would be included in **ADR Guideline Class 57.0 "Distributive Trades and Services"** as 5-year property). Would the **Code §162** business expenses mentioned above exceed 15% of the gross rents derived from the property during the first 12 months of the lease? If not, then the immediate expense deduction might have been lost under such an arrangement. And, what was the net tax savings? Assuming that the doctors were above the current FICA cap (i.e., $106,800 for 2011), the only savings would be on the 2.9% Medicare tax in that rent payments would *not* be subject to employment taxes (i.e., as opposed to the profits flowing through Schedule K-1 for a partnership/LLC, or an S or C corporation). But, that employment tax savings might have come at the expense of losing up to a $500,000) immediate expense election.

Comment: Although real estate is typically kept outside of the business in a separate entity (such as an LLC) and then rented back to it by the company's owners, does it make sense where tangible personal property is involved? Especially, where it might mean the lost of the Sec. 179 immediate expensing deduction? Make sure the requirements of **Code §179(d)(5)** are considered before doing such an arrangement. Of course, liability exposure might be a sufficient reason to keep expensive equipment outside of the medical practice in a separate LLC (and, it could generate additional sources of non-FICA income). The other consideration might be possible sales tax which most local/state governments imposed for rentals of tangible personal (v. real) property.

☞Sec. 179 Deduction Denied to Noncorporate Lessor Due to Oral Lease Arrangement (*Ross Thomann*, TC Memo 2010-241(11/1/2010))

In this instance, the taxpayers were *not* allowed to expense farm-related property that was leased pursuant an *oral* lease. Under **Code §179(d)(5)**, a *noncorporate* taxpayer is normally prevented from claiming a Sec. 179 deduction if the property is purchased for leasing purposes. However, an exception is provided under **Code §179(d)(5)(B)** if, in part, the term of the lease, taking options to renew into account, is less than 50% of the class life of the leased property. But, since there was no written agreement, the Tax Court concluded that the lease "was for an indefinite period of time," and was not for a term of less than 50% of the class life of the property. **(Code §179; Noncorporate Lessors)**

Comment: Although it might seem a bit surprising, S corporations are also considered to be "noncorporate lessors" for purposes of Sec. 179. (**Code §46(e)(3)** before repeal by Sec. 11813(a), PL 101-508, 11/5/90)

Comment: Code §179(d)(5) also requires that the deductions incurred during the first 12 months of the lease derived solely from **Code §162** (i.e., "trade or business" expenses) such as insurance, maintenance or repairs (and *not* from **Code §163** interest expense, **Code §164** taxes, or **Code §168** depreciation) exceed at least 15% of the rental income paid.

5. **PROPERTY USED FOR LODGING:** Generally, you *cannot* claim a section 179 deduction for property used predominantly to furnish lodging or in connection with the furnishing of lodging.[84] However, this does *not* apply to the following types of property:

a. Non-lodging commercial facilities that are available to those *not* using the lodging facilities on the *same* basis as they are available to those using the lodging facilities,

b. Property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients (i.e., lodgers whose stays, on average, on 30 days or less),

c. Any certified historic structure to the extent its basis is due to qualified rehabilitation expenditures,

d. Any "energy property"

1) **ENERGY PROPERTY:** Energy property is either of the following types of equipment:

- Equipment that uses solar energy to generate electricity, to heat or cool a structure, to provide hot water for use in a structure, or to provide solar process heat.

- Equipment used to produce, distribute, or use energy derived from a geothermal deposit. For electricity generated by geothermal power, this applies only to its production, distribution, or use up to (but not including) the electrical transmission stage.

K. CHART OF COMMON TYPES OF PROPERTY & ELIGIBILITY FOR IMMEDIATE EXPENSING

Note: The chart below adopts the more "conservative approach" outlined in **IRS Pub. #946** that any realty, regardless of whether it is part of a building, should *not* be eligible for **Code §179**.

Asset	**Depreciation**		**§§179 and 1245**		
	MACRS Life	**Authority**	**Qualifies?**	**Reason**	**Authority**
Airplanes and helicopters (except commercial airlines)	5	Table B-1 Class 00.21	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A)

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[84] A technical correction added to the law in the 1996 Tax Act generally prohibits the use of Code §179 immediate expensing used in connection with the furnishing of lodging (subject to the exceptions noted above). (Code §179(d)(1), via cross-reference to Code §50(b))

Automobiles	5	Table B-1, Class 00.22	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Calculators, copiers, typewriters, and duplicating equipment	5	Table B-2, Class 00.13	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub.946
Computer and peripheral equipment	5	Table B-1, Class 00.12	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub.946
Office furniture, desks, files, safes, telephones	7	Table B-1, Class 00.11	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Office fixtures that are not structural components of a building, such as carpeting, vinyl floor coverings, vinyl wall coverings, and movable partitions	7	Table B-1. Class 00.11	Yes	Personal Property	Rev. Rul. 67-349, 1967-2 C.B. 48, *Hospital Corporation of America.* 109 T.C. 21 (1997)
Buses	5	Table B-1, Class 00.23	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Light general-purpose trucks (actual weight less than 13,000 lb.)	5	Table B-1, Class 00.241	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Heavy general-purpose trucks (unloaded weight 13,000 lb. or more)	5	Table B-1, Class 00.242	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Tractor units for over-the-road use	3	Table B-1, Class 00.26	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Trailers and trailer-mounted containers	5	Table B-1, Class 00.27	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Distributive trades and services - Assets used in wholesale and retail trade and personal and professional services	5	Table B-2, Class 57.0	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946
Distributive trades and services - Billboards (if installed to be easily moved)	15	Table B-2, Class 57.1	Yes	Personal Property	*Alabama Displays Inc.,* 75-1 USTC 9116 (Ct. Cls., 1974), Rev. Rul. 80-151, 1980-1 C.B. 7
Billboards (if extremely difficult to move)[85]	15	Table B-2, Class 57.1	No	Real Property	Rev. Rul. 80-151, 1980-1 C.B. 7
Distributive trades and services - Service station buildings and car wash buildings	15	Table B-2, Class 57.1	No	Building	Rev. Rul. 79-406 1979.2 C.B. 18

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[85] Arguably, the computer controlled electronics of these new LED billboards should be treated as 5-year property eligible for Sec. 179.

Recreation - Assets used in entertainment services for a fee or admission charge, such as the operation of bowling alleys, pool establishments, theaters, miniature golf courses (*excludes* "buildings")	7	Table B-2, Class 79.0	Yes	Personal Property	§179(d)(1), §1245(a)(3)(A)
Land improvements such as sidewalks, roads, bridges, fences, landscaping shrubbery	15	Table B-1, Class 00.3	No	Not Personal Property	*Kenneth L. LaCroix,* 61 T.C. 471 (1974)
Movable trailers	7	Table B-2, Personal property with no class life	Yes	Personal Property	*Joseph Henry Moore,*58 T.C. 1045 (1972); Rev. Rul. 77-8, 1977-C.B. 3; and Rev. Rul. 77-291, 1977-2 C.B. 7
Trailers that are not mobile - Wheels detached and permanent utilities attached	27.5 or 39	§168(c)	No	§1250 Real Property	Rev. Rul. 77-8, 1977- C.B3 and Rev. Rul. 77-291, 1977-2 C.B. 7
Elevators and escalators	27.5 or 39	§168(c)	No	Structural component of a building; relating to operation or maintenance of building	Treas. Reg. §1.48-1(e)(2)
Oil and gas well equipment	7	Table B-2, Class 13.2	Yes	Tangible Personal Property	Rev. Rul. 67-99, 1967-1 C.B. 68
Oil and gas drilling equipment	5	Table B-2, Class 13.1	Yes	Integral	Treas. Reg. 1.48-1(d)
Apple Storage	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 74-451, 1974-2 C.B. 10
Barns	20	Table B-2, Class 01.3	No	Building (i.e., not "single purpose")	Rev. Rul. 66-89, 1966-1 C.B. 7
Citrus Trees	10	§168(e)(D)(ii)	Yes	Integral	Rev. Rul. 69-249, 1969-1 C.B. 31
Drain Tile	15	Pub.225	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7
Fences	7	Table B-2, Class 01.1	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7
Fish raising facilities	20	Table B-2, Class 01.1	Yes	Integral	Rev. Rul. 80-341, 1980-2 C.B. 24
Fruit Trees and orchards	10	§168(e)(3)(ii)	Yes	Integral	Rev. Rul. 67-51, 1967-1 C.B. 68, PLR 8108007
Fruit cooling room	20	Table B-2, Class 01.3	Yes	Integral	*Gianni Packing Corp v. Commr.,* 83 T.C. 526 (1984)

Gasoline Storage Tanks	20	Table B-2, Class 01.3	Yes	Personal Property (and, specifically included under Code §1245(a)(3))	Rev. Rul. 74-602, 1974-2 C.B. 12, revoking Rev. Rul. 74-152, 1974-1 C.B. 11
Grain Storage	7	Table B-2, Class 01.1	Yes	Storage (and, specifically included under Code §1245(a)(3))	*Schuyler Grain Co., Inc. v. Commr.,* 50 T.C. 265 (1968)
Grain Storage, flat	20	Table B-2, Class 01.3	No	Building	*Bundy v. United States,* 87-1 USTC 87,084 (D. Neb. 1986)
Greenhouses	10	§168(e)(3)(D)(i)	Yes	Single Purpose	Rev. Rul. 79-343, 1979-2 C.B. 18, modifying Rev. Rul. 66-89, 1966-1 C.B. 7
Hay storage and feeding facility	10	§168(e)(3)(D)(i)	Yes	Single Purpose	*Lesher v. Commr.,* 73 T.C. 340 (1979)
Hay and grain storage barn	20	Table B-2, Class 01.3	No	Building	*Sherwood v. Commr*., T.C. Memo 1988-544
Dairy and breeding cattle	5	Table B-2, Class 01.21	Yes	Personal Property	IRS Pub. 225
Breeding or milking goats	5	Table B-2, Class 01.24	Yes	Personal Property	IRS Pub. 225
Horses:[86]			Yes	Personal Property	IRS Pub. 225; Treas. Reg §1.1245-3(a)(4); and Senate Report, Section 1111 of Small Business Jobs Protection Sct of 1996
breeding of working (12 yrs. old or less)	7	Table B-2, Class 01.221			
breeding of working (more than 12 yrs.)	3	Table B-2, Class 01.222			
any race horse (more than 2 yrs. old)	3	Table B-2, Class 01.223			
any horse more than 12 yrs. old that is not a race horse or in Class 01.22	3	Table B-2, Class 01.224			
any horse not described above	7	Table B-2, Class 01.225			
Breeding sheep	5	Table B-2, Class 01.24	Yes	Personal Property	IRS Pub. 225
Poultry	None		No	Not §1245 property; treated as expense	Rev. Rul. 60-191, 1960-1 C.B. 78

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[86] For property placed in service after 2008 and before 2014, all racehorses are now assigned a **three-year recovery period** under MACRS (i.e., regardless of their age). However, for property placed in service after 2013, only those racehorses that are more than two years old when placed in service by the purchaser are in the three-year recovery period. (Code §168(e)(3)(A))

Ostriches, emus, rheas	7	Table B-2, Personal Property with No Class Life	Yes	Personal Property	PLR 8817003, PLR 9615001
Exotic game animals	7	Table B-2, Personal Property with No Class Life	Yes	Personal Property	PLR 199615001, PLR 198817003
Hog facility	10	I.R.C. §168(e)(D)(i)	Yes	Single Purpose	Rev. Rul. 66-329, 1966-2 C.B. 16, as modified by Rev. Rul. 79-343, 1979-2 C.B. 18
Horse Facilities	10	I.R.C. §168(e)(D)(i)	Yes	Single Purpose	Senate Report, §1111 of Small Business Jobs Protection Act of 1996; Treas. Reg. §1.1245-3(b)(4)
Kennel, dog and cat	5		No	Not livestock	*McKensie v. Commr.,* 85 T.C. 875 (1985)
Macadamia trees	10	I.R.C. §168(e)(D)(ii)	Yes	Integral	Rev. Rul. 71-488, 1971-2 C.B. 60
Machinery and equipment[87]	7	Table B-2, Class 01.3	Yes	Personal Property	IRS Pub. 225; Rev. Rul. 72-573, 1972-2 C.B. 12
Manure storage facility	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 66-89, 1996-1 C.B. 7
Milk Parlor	10	I.R.C. §16(e)(3)(i)	Yes	Single Purpose	PLR 198324009, PLR 198323011
Mushroom beds and conveyors	7	Table B-2, Class 01.1	Yes	Personal Property	Rev. Rul. 66-156, 1966-1 C.B. 11, as modified by Rev. Rul. 79-183, 1979-1 C.B. 44
Onion shed	20	Table B-2, Class 01.3	No	Building	*Tamura v. United States,* 734 F.2d 470 (9th Cir. 1984)
Paved barnyard	15	Table B-2, Class 01.3	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7
Peanut Storage	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 71-359, 1971-2 C.B. 61

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[87] Any machinery or equipment (other than any grain bins, cotton ginning assets, fences, or other land improvements) which is used in a farming business where the original use begins with the taxpayer after Dec. 31, 2008, and is placed in service before Jan. 1, 2010, will be treated as **5-year property** for GDS purposes (10-year property for purposes of the Alternative Depreciation System (ADS)) (Code §168(e)(3)(B))

Potato Storage	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 68-132, 1968-1 C.B. 14, as modified by Rev. Rul. 71-359, 1971-2 C.B. 61; PLR 197107221
Poultry facility - Broiler house	10	§168(e)(D)(i)	Yes	Single Purpose	*Satrum v. Commr.,* 62 T.C. 413 (1974); Rev. Rul. 79-343, 1979-2 C.B. 18, modifying Rev. Rul. 66-89, 1996-1 C.B. 7; but *Starr Farms v. U.S.,* 447 F.Supp. 580 (W.D. Ark. 1997)
Stable (with working space)	20	Table B-1, Class 01.3	No	Building	Rev. Rul. 66-89, 1966-1 C.B. 7
Storage Facility	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 66-89, 1966-1 C.B. 7
Tobacco storage shed	15	Table B-1, Class 00.3	Yes	Storage	*Brown and Williamson Tobacco Corp.,* 369 F.Supp. 1283 (W.D. Kent 1973); Rev. Rul. 66-89, 1966-1 C.B. 7
Tobacco barb (used for storing, curing and processing tobacco)	20	Table B-2, Class 01.3	No	Working Space more than incidental	*Gary G. Hart v. Commr.,* T.C. Memo. 2002-236
Tractor	7	Table B-2, Class 01.1	Yes	Personal Property	Rev. Rul. 72-573, 1972-2 C.B. 12
Vineyard	10	§168(e)(D)(ii)	Yes	Integral	Rev. Rul. 67-51, 1967-1 C.B. 68; PLR 198108007
Warehouse	20	Table B-2, Class 01.3	No	Building	Rev. Rul. 66-89, 1966-1 C.B. 7
Water wells	15	Table B-2, Class 00.3	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7, clarified by Rev. Rul. 72-222, 1972-1 C.B. 17
House trailers for farm laborers - mobile, has wheels, history of being moved	7	Table B-2, Class 01.1	Yes	Personal Property	IRS Pub. 225, p. 47 (2002) *Joseph Henry Moore,* 58 T.C. 1045 ; (1972); Rev. Rul. 77-8, 1977-1 C.B. 3

House trailers for Farm Laborers, not mobile, wheels detached, permanent utilities attached	20	Table B-2, Class 01.3	No	§1250 Real Property	IRS Pub 225; Rev. Rul. 77-8, 1977-1 C.B. 3, Rev. Rul. 77-291, 1977-2 C.B. 7

L. ADDITIONAL CASES & RULINGS ON SEC. 179

☞Proper Treatment of Rental of Hair Salon Chairs and Equipment

The taxpayer ran her own hair styling salon but had an “old” location where she still own the building and the equipment which she leased out to eight other unrelated hair stylists. She stated to her accountant that she rented out these “chairs” and the issue was how this should be reported on her tax return. Also, she inquired as to whether she could take Sec. 179 immediate expensing on some new equipment that had been purchased and placed into service at this rental location.

Discussion: Even though she spoke in terms of rented out the “chairs” (along with some other equipment), it was actually the rental of the underlying real estate (at least as far as the space around the chairs). As a result, Schedule E would be used to report the rental of this personal property in connection with real estate. And, since this was the rental of commercial (i.e., vs. residential) real estate involving the active conduct of a trade or business, Sec. 179 would generally be available. The only catch would be that there is a “noncorporate lessor” in this situation (i.e., whether the taxpayer owned the real estate personally or through a SMLLC). And, **Code §179(d)(5)** states that in the first 12 months of the lease the deductions otherwise allowable under **Code §162** (i.e., ordinary and necessary trade or business expenses such as maintenance and repairs, utilities, etc.) must exceed 15% of the rents received during that same time period. In other words, you *cannot* use the deductions allowed by other Code sections such as **Code §163** (i.e., interest), **Code §164** (i.e., taxes) or **Code §168** (i.e., depreciation) to meet this “15% test.” **(Code §179 & 1402; Immediate Expensing)**

Comment: The question was raised as to whether Schedule C would have been used if it was strictly the rental of tangible personal property (i.e., hair stylist chairs and equipment and no real estate). The answer is probably “no.” Since no real estate would be involved, Schedule E could definitely *not* be used. But, whether Schedule C would have to be used is a question of fact as to whether a “trade or business” was being conducted. And this, in turn, depends on how “regular, continuous or substantial” the activity was. There are cases on-point, but this is probably *not* a trade or business given this is the only location at which she rents space to other stylists and she does *not* provide “significant personal services” in connection with the rental of the equipment (i.e., outside of the normal upkeep to insure the location is maintain in ordinary, operating efficient condition). In fact, these stylists probably bring most of their own equipment to do their job (e.g., scissors, combs, hair dryers and other supplies). Furthermore, she does *not* hold herself out to the general public as having this space available (i.e., *not* listed in the yellow pages, or has letterhead devoted to this specific “business” of renting tangible personal property). The counter argument is that there are *eight* separate stylists using the space and paying her rent. If just *one* stylist had rented the *all* of the equipment, there would have been less of an issue as to whether this constituted a Schedule C business on which S/E tax should be paid.

Comment: If this was *not* a “trade or business” requiring the filing of a Schedule C (and, the payment of S/E tax on any net profit), it would instead be reported as “Other Income” (with the acronym “PPR” for personal property rental” on Line 21 of Form 1040. This issue is covered in both IRS Pub. #17 and Pub. #525.

☞Assets Deemed Purchased With Sec. 338(h)(10) Election Eligible for Sec. 179 Immediate Expensing and Bonus Depreciation

Background: **Code §338** allows for a deemed purchase of assets where a corporate buyer of stock acquires at least 80% of the target’s outstanding shares within a 12-month period. Nevertheless, it is the selling corporation which makes the election and therefore is responsible for the resulting tax stemming from the one-day deemed liquidation of these assets. As a result, the target is going to ask, if possible, for an increased purchase price for its shares to cover the tax liability involved with the election. And, with the repeal of the ***General Utilities*** doctrine by the

‘86 Tax Act, it doesn’t make much sense from a tax standpoint for a regular C corporation to agree to a **Code §338** election unless it has significant tax attributes to offset the resulting tax (at least at the corporate level). If instead the purchase of the stock is from S corporation shareholders, then a **Code §338** election can make a lot of tax sense, especially where the corporation does *not* have significant appreciated assets except goodwill (this is *not* uncommon where the real estate is kept off the balance sheet and a service based business is involved; the only ordinary income would normally be cash-basis receivables).

> **Comment:** Purchases of stock vs. an asset purchase may be necessary where the corporation must be kept alive (e.g., there are sizable contractual rights outstanding which are otherwise *not* assignable, or the corporate name is especially valuable). And, since the ‘97 Tax Act and the creation of QSUBs, S corps are allowed to own 100% of another S corp. Therefore, instead of individuals buying the S corp stock directly, a newly-formed S corp can be capitalized with the same purchase price dollars and this entity carries out the purchase. Of course, asset purchases are normally preferred whereby the buyer can chose which particular assets to purchase, there is a step-up in basis to the purchase price paid (i.e., without the necessity of a Sec. 338 election having to be made) and contingent liabilities are not an issue. But, the **Code §338** election can essentially put a purchaser of stock in the same position (i.e., at least regarding the step-up in basis in the assets deemed purchased). And, if goodwill is the major asset purchased, then **Code §197** will allow for its amortization over 15 years (a deduction which can more then make up for the extra purchase price paid for the stock because of the buyer agreeing to make a **Code §338** election).

Issue: The question arose as to whether this deemed asset purchased under a **Code §338** election is equivalent any other purchase for depreciation purposes and, therefore, Sec. 179 immediate expensing. **Reg. §1.338-1(b)(1)** which mentions adopting new depreciation methods indicates that this is the case. That is, the step-up in the assets because of the deemed one-day liquidation are entitled to “fresh-start” depreciation. And, given that the seller and buyer are *not* related, **Code §179** would provide for immediate expensing (i.e., up to $250,000 for 2008 along with 50% of this new basis being eligible for bonus depreciation). **(Code §179; Immediate Expensing)**

☞Inapplicability of Sec. 179 for Assets Used in Connection With Lodging or for Air Conditioning or Heating Units

Although **Code §179** provides a generous write-off for certain assets ($112,000 for 2007; $250,000 for 2008 and 2009, and $500,000 for 2010 and 2011), it is *not* always available for assets used in connection with the furnishing of lodging (absent certain exceptions), or for air conditioning or heating units.

Property Used in Connection With the Furnishing of Lodging: For example, a taxpayer purchased appliances, rugs and furnishings for used in the residential apartment complex that he owned. In addition, a pick-up truck was bought which would be used exclusively by the maintenance staff who looked after the buildings and grounds at the complex. Under **Code §179(d)(1) “Definitions and Special Rules,”** the law specifically states that “such term shall *not* include *any* property described in **Code §50(b)**.” And, looking to **Code §50(b)**, with regard to property used for lodging this would include “*any* property which is used predominantly to furnish lodging *or in connection with the furnishing of lodging*.” An exception is carved out for hotels and motels which furnish lodging to “transient dwellers” defined as those who stay, on average, 30 days or less at the premises (taken from the “old” ITC rules). Therefore, let alone the rugs, appliances or other furnishings, other assets, such as the pick-up truck, lawn mowers, snow blowers, etc. would *not* be allowed the immediate expensing election under **Code §179** (even though they would be depreciated as 5-years MACRS property pursuant to ADR Class 57.0 “Distributive Trades and Services”).

> **Comment:** Be careful when reading certain tax services, such as Kleinrock, which simply states that only property “used in furnishing lodging” is disqualified from being Sec. 179 property eligible for immediate expensing. This would appear to limit the prohibition to only those assets actual found within the residential units. But, a literal reading of **Code §50(b)** specifically states that *any* asset used “in connection with the furnishing of lodging” is also excluded.

Air Conditioning and Heating Units: Another example would be a window air conditioning unit for use either in a residential apartment unit or a business office, or a free-standing hot-air heating unit located on the floor of a warehouse. Although these assets would *not* be considered part of the building’s structure and, therefore, could be written off as either 5- or 7-year MACRS assets, there is a question as to whether they would be eligible for immediate expensing under **Code §179**. This is because, under the definitions and special rules mentioned above pertaining to **Code §179**, the law again specifically states that such property "shall *not* include air conditioning and heating units."

> **Comment:** In 1990, the definition of qualifying Sec. 179 property changed from being listed under **Code §38** (i.e., the "old" ITC rules whereby the *same* property that qualified for the investment tax credit also qualified for immediate expensing) to now being defined under **Code §1245(a)(3)**. In fact, **Code §38** was actually repealed and is now the code section used for the general business credit. However, in making the change, Congress inadvertently opened the door for more property to qualify (e.g., residential rental furniture and fixtures and free-standing HVAC assets) since this could arguably be classified as **Code §1231** property used in a trade or business and whose disposition would be properly reported on Form 4797 (although, it might *not* have been an "active conduct of a trade or business and certainly *not* one where any self-employment tax would have to be paid on net rental income reflected on Schedule E). Then, in 1996, Congress enacted a change (i.e., the insertion of the language found at the end of **Code §179(d)(1)**) which was intended to correct the inadvertent inclusion of such property, and restore the pre-1990 restrictions.

So, the bottom line is to referenced back to ascertain what, if any, HVAC assets (e.g., window air conditioners, free-standing hot-air heaters, etc.) might have qualified for the "old" investment tax credit in order to determine how strictly the prohibition now listed in **Code §179(d)(1)** needs to be construed. Furthermore, the regs under **Reg. §1.179-4 "Definitions"** which were last updated 7/13/2005 still refer to qualified "Section 38 property" (as defined in **Code §48(a)** and the regs thereunder, even though these sections which referred to the "old" ITC rules have long been repealed). Thus, given the reg writers have chosen to leave in the former "Section 38 property" language, and the fact that the old ITC rules would have allowed ITC for stand-alone (i.e., nonstructural) heating and air conditioning *not* used in lodging, one could take the position that Sec. 179 immediate expensing should be allowed for such assets. Nevertheless, the new language contained at the end of **Code §179(d)** is fairly blunt. And, more importantly, the IRS has seized upon this language to specifically state in **Pub. #946, "How to Depreciate Property" - Chap. 2, "Electing the Section 179 Deduction"** that "even if the requirements explained earlier under **'WHAT PROPERTY QUALIFIES'** are met, you *cannot* elect the section 179 deduction for the following property: Air conditioning or heating units." **(Code §179; Immediate Expensing)**

CHAPTER #6. 15-YEAR AMORTIZATION WRITE-OFF FOR ACQUIRED INTANGIBLE ASSETS

A. INTRODUCTION

1. **15 YEAR LIFE FOR QUALIFYING INTANGIBLES:** To help eliminate the controversy of handling goodwill, and other intangibles, (e.g., taxpayers attempting to disguise previously nondeductible goodwill as office furniture), **Code §197** allows the ratably amortized capital costs of specified intangible assets (now called "§197 intangibles") over a 15-year period beginning in the month of acquisition or when business begins. Generally, §197 intangibles are eligible for the amortization deduction if acquired after August 10, 1993 (or after July 15, 1991, if a valid retroactive election was timely made) and held in connection with a trade or business or in an activity engaged in for the production of income (**P.L. 103-66 (1993); §197(c)(1)**).

2. §197 INTANGIBLES DEFINED:

The following items are eligible for 15-year amortization:
1. Goodwill (continued customer patronage)
2. Going-concern value (existence of an ongoing business)
3. Work force in place (existence of trained workers)
4. An information base (business books, training manuals, list of customers, patients or advertisers)
5. Any patent, copyright,[88] formula, process, design, pattern, know-how, format, or similar item
6. Any customer-based intangible (market share, existence of circulation base)
7. Any supplier-based intangible (relationship with suppliers, e.g., good credit rating)
8. Any license, permit, or other right granted by a governmental unit or agency (e.g., liquor license)
9. Any covenant-not-to-compete (or similar arrangement) entered into in connection with the acquisition of a trade or business or a substantial portion of a trade or business
10. Any franchise, trademark, or trade name (including future renewals) [**Code §197(d)(1)**].

The following items are *specifically excluded* from §197:
1. Interests in a corporation, partnership, trust or estate
2. Interests under certain financial contracts (e.g., futures contracts, interest rate swaps)
3. Interests in land (e.g., fee simple, easements, mineral rights)
4. Certain computer software (e.g., readily available to public)
5. Certain interests in films, sound recordings, video tapes, books, or similar property
6. Certain rights to receive tangible property or services
7. Certain interests in patents or copyrights
8. Interests under leases of tangible property (e.g., rights of lessor or lessee in existing lease)
9. Interests under indebtedness
10. Professional sports franchises
11. Mortgage servicing rights
12. Certain transaction costs
13. Most self-created intangibles (e.g., a technological process developed for business by another)

3. **AMORTIZATION CALCULATION:** The adjusted basis of an amortizable section 197 intangible acquired after August 10, 1993, and held in connection with a trade or business or income producing activity generally is amortized ratably over a 15-year period beginning on the first day of the month of the acquisition.[89] The amortization period begins on the *first* day of the month in which the active conduct of the trade or business begins, if later than the acquisition date. However, property is *not* eligible for amortization in the month of

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[88] IRS **Pub. #946** still states that you can use the straight-line method over the useful life (i.e., usually 17 years). The useful life of a patent or copyright is the *lesser* of the life granted to it by the government or the remaining life when you acquire it. But, if the patent or copyright becomes valueless before the end of its useful life, you can deduct in that year any of its remaining cost or other basis. However, this latter statement is only true if there are no other Code §197 intangible assets to which the remaining unamortized basis of the now worthless patent or copyright can be reallocated to. Most taxpayers, though, would now probably opt for the shorter 15-year life now permitted under Code §197.

[89] Code Sec. 197(a); Reg. §1.197-2(d)(1)

disposition. In determining the amortizable basis of the property, salvage value is disregarded. The amortization deduction for a short tax year is based on the number of months in the short tax year.[90] Some other important factors to consider when properly calculating any amortization include:

- An increase in the underlying FMV of an amortizable section 197 intangible is *not* included in the amortizable basis if the increase is properly taken into account in determining the costs of assets that are *not* amortizable section 197 intangibles.[91]

- In the case of a covenant-not-to-compete or other similar arrangement (a covenant), amortizable basis generally includes all amounts that are required to be paid pursuant to the covenant. This rule applies regardless of whether the amount would be deductible as a trade or business expense if the covenant were *not* an amortizable section 197 intangible.[92]

- Any amount paid or incurred by the transferee on account of the transfer of a right or term under contracts for the use of, and term interests in, a section 197 intangible is chargeable to capital account and treated as amortizable basis. This rule applies regardless of whether the amount would be deductible as a trade or business expense if the covenant were *not* an amortizable section 197 intangible ("use payment rule"). The payment rule applies to payments by the owner of the property to which the right or interest relates and as part of a purchase of a trade or business.

4. **COVENANT-NOT-TO-COMPETE:** As stated above, such covenants are to be amortized over 15 years (i.e., 180 months) regardless of the actual terms of payment (e.g., 3- or 5-years).

EXAMPLE: As part of the acquisition of an accounting firm from Edward, Brian and Edward enter into an agreement containing a covenant-not-to-compete. Under this agreement, Edward agrees that he will not compete with the business acquired by Brian within a prescribed geographical territory (i.e., based on the surrounding zip codes) for a period of three years after the date on which the business is sold to Brian. In exchange for this agreement, Brian agrees to pay Edward $100,000 per year for each year in the term of the agreement (i.e., a total of $300,000). The agreement goes on to state that, in the event of a breach by Edward of his obligations under the agreement, Brian may terminate the agreement, cease making any of the payments due thereafter, and pursue any other legal or equitable remedies available under applicable law. Furthermore, the amounts payable to Edward under the agreement are *not* contingent payments under the OID rules. The present fair market value of Brian's rights under the agreement is $250,000. The aggregate consideration paid for all assets acquired in the transaction (including the covenant-not-to-compete) exceeds the sum of the amount of Class I assets and the aggregate fair market value of all Class II, Class III, Class IV, Class V, and Class VI assets by $50,000 (i.e., pursuant to the **Code §338** "residual regs" used for determining the assets in each class).

Because the covenant is acquired in an "applicable asset acquisition,"[93] the basis that Brian's business takes in the covenant is determined pursuant to the "asset acquisition rules." As a result, Brian's basis in the covenant is *not* permitted to exceed its fair market value and he therefore takes a basis in the covenant immediately after the acquisition equal to $250,000. This basis is amortized ratably over the 15-year period beginning on the first day of the month in which the agreement is entered into. Although the payments under the agreement ($300,000) exceed the amount allocated to the covenant by $50,000, all of the remaining consideration ($50,000) is allocated to Class VII assets (goodwill and going concern value).[94]

5. **WEBSITES:** How should the costs (sometimes quite substantial in amount) of developing a website be

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[90] Reg. §1.197-2(f)(1)

[91] Code Sec. 197(f)(8)

[92] Reg. §1.197-2(f)(3)(i)

[93] Code Sec. 1060(c)

[94] Reg. §1.197-2(k), Ex. 6

treated? Are they a **Code §197** "intangible" or are they just "software?"

a. The Service has now indicated[95] (i.e., as is discussed in the insert below) that website development costs may be treated as "software." Therefore, the costs may be recovered over a 36-month period, starting in the month that the asset is first "placed into service." And, it is clear that **Code §197** would *not* apply, since these were *not* "acquired" intangibles but rather ones which the taxpayer created themselves.

b. Distinguish that any on-going costs to revise or update the website would be probably be currently deductible"period costs".

☞IRS Issues Guidelines on Accounting for Software Costs (Rev. Proc. 2000-50)

The Service has indicated that it will *not* disturb the accounting treatment of computer software development, acquisition or leasing costs under certain conditions. Effective for tax years ending *after* November 30, 2000, **Rev. Proc. 2000-50** states that costs for developing software "for the developer's own use or for sale or lease to others may continue to be treated as *current expenses* under rules similar to **Code §174(a)**." On the other hand, developers may also continue to treat the costs as capital expenditures amortizable over 60 months from completion of development under **Code §174(b)** *or* over 36 months under **Code §167(f)(1)**. In addition, the Service will *not* disturb software costs that are included in the capitalized and depreciable cost of hardware. Finally, software leasing or licensing costs may continue to be deducted as rental payments under **Reg. §1.162-11**.

Comment: However, the Service pointed out that *any* change in a taxpayer's treatment of software costs is a "change in accounting method," subject to the "automatic change provisions" of **Rev. Proc. 99-49**[96] with some modifications. **Rev. Proc. 2000-50** applies to a broad definition of software that does *not* include software subject to amortization under **Code §197** or to research and experimentation costs deducted subject to **Code §174**. **Rev. Proc. 2000-50** *supercedes* **Rev. Proc. 69-21** and *modifies* **Rev. Proc. 99-49** and **Rev. Proc. 97-50**. **(Code §167(f)(1); Websites)**

☞Properly Handling Website Development Costs After Rev. Proc. 2000-50

As some sizable amounts have been committed to the development of business websites, the focus has been on the proper treatment of these costs for tax purposes. If the site is nothing more than an "electronic business card" (i.e., only the basic information for a firm or company is listed on the website), then much like one would expense the ordering of business cards, these costs should also be currently deductible. But, if a considerable sum is expended, for instance, to create a "virtual reality store" instead of investing in another "bricks-and-mortar" location, then how such the costs be treated? There could definitely be a benefit to the company extending well beyond the current tax year (i.e., arguably an indefinite useful life). Of course, there would be "period costs" to update the site, create new or additional links, or to change the mix of inventory listed for sale on the site, and these should be currently deductible. Here, though, we are discussing the up-front costs to get the site created and functioning as intended. For example, it is not unusual for companies to spend tens of thousands to create a website. For sure, these costs are *not* **Code §197** intangibles (i.e., to be amortized over 15 years), since they are "self-created" (i.e., as opposed to being a purchased asset). So, given their potentially unlimited useful lives, should the costs simply be capitalized (i.e., until abandoned or sold)? The answer in **Rev. Proc. 2000-50** gives a taxpayer-friendly answer that these websites can possibly be treated as "software" that can be taken over 36 months starting with the first month that the site is operational. Or, if reasonable (e.g., for the equivalent of a website that is an "electronic business cared" as discussed above), the costs could be deducted currently. **(Code §167; Website Developing Costs)**

Comment: As to periodic costs incurred to modify the website or to otherwise make adjustment to its content, these could be deducted currently.

6. **TAX TREATMENT OF OFF-THE-SHELF SOFTWARE AFTER 2003 TAX ACT:** The new law now allows immediate expensing for such software for tax years beginning in 2003 through 2012. There might be some

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[95] Rev. Proc. 2000-50.

[96] Rev. Proc. 99-49 was replaced, first by Rev. Proc. 2002-9, and then Rev. Proc. 2008-52.

disputes with the Service, however, on exactly what is "off-the-shelf software." One could argue that any software that is readily available to the general public should qualify.

EXAMPLE: Kurt's Manufacturing, Inc. purchased a software package to keep track of its inventory for $36,000. It took over 2 months for their information technology specialist to get the software up and running and to work out all of the kinks. His professional fees amounted to $14,000. Even though there were some installation costs, the software package, along with the capitalized costs for the technician, should be eligible for immediate expensing. Therefore, the total $50,000 cost for the installed software could be written off immediately.[97]

EXAMPLE: Same as above, except the a software writer created the computer language for this inventory from scratch (i.e., there was no purchase of "off-the-shelf software"). The costs would probably be covered by **Rev. Proc. 2000-50** which would mean a S/L write-off over 36 months, starting with the month the inventory was finally up and running.

C. LATEST CASES & RULINGS ON CODE §197 AMORTIZATION ISSUES

☞**Deduction of Unamortized Goodwill Denied Where Other Intangible Assets of Acquired Business Retained (CCM 20111101f)**

The recent shakeout in the auto industry led to many discontinued models and shuttered franchises, as well as substantial losses for many dealers. In this field attorney advice (FAA), the IRS advised that even though a dealer was significantly affected by the economic downturn, they could still *not* deduct a loss for worthless goodwill. This was due to the fact that such a deduction was barred by the **Code §197(f)(1)** rule prohibiting deductions for worthless amortizable 197 intangibles, such as goodwill, where *other* 197 intangibles bought as part of the *same* transaction or transactions are retained.

Comment: When a purchase of assets otherwise constitutes the acquisition of a trade or business (and, therefore, Form 8594 is needed to set out a mutual breakdown of the total purchase price paid under **Code §1060**), an allocation is made pursuant to the "residual regulations" found under **Code §338**. Furthermore, after all other tangible property is identified, the "residual" of the purchase price otherwise paid is, by default, allocated to goodwill. However, this "goodwill" can be made up of a number of different elements, such as workforce in place, going concern value, patents, trademarks, etc. which are then amortized over a 180-month period. But, even though one or more of these intangible assets might become worthless within that time frame, a current deduction is *not* allowed for the unamortized basis remaining, if any, as of that point in time. Instead, if an intangible, such as workforce-in-place, were to become worthless, any unamortized basis remaining would be re-allocated to the other **Code §197** assets that were still on-hand and written off over the remainder of the 180-month period.

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[97] Note, since the law would include now this particular type of intangible asset as eligible for Code §179 immediate expensing, would it also be eligible for bonus depreciation, or is the exception limited to just immediate expensing?

CHAPTER #7: SERVICE CONCEDES FASTER WRITE-OFFS ALLOWED FOR SOME DEPRECIABLE REALTY

☞ **Treasury Report Confirms Depreciation System Is Outdated**
The Treasury in a recent study stated that "the tables which list the useful lives for depreciable assets have been in place for years and fail to reflect the technological changes that have made certain items of equipment obsolete much faster." Consequently, many assets "are being written off at an unrealistically slow rate." For example, computers are given an average life span of 30 months before advancements can make them unable to run the latest applications. Certainly, they fail to last, at least from a technological standpoint, for the six tax years (i.e., when considering the half-year convention) that it takes to fully recover their cost. Another big problem is the life assigned to commercial realty (i.e., 39 years). In reality, most business property is being turned over between 20 and 30 years. Finally, the battle over what is an integral/structural component of a building (i.e., and thus subject to a 39-year write-off) vs. tangible personal property (i.e., eligible for 5- or 7-year write-off) has continued to rage between taxpayers and the IRS. **(Code §168; MACRS)**

A. INTRODUCTION

1. **SAVINGS TO CLIENTS:** Obviously, paying back a long-term note (i.e., a mortgage) incurred with regard to the purchase of a depreciable asset (e.g., a building) does *not* lead to an immediate tax deduction. Instead, the write-off for tax purposes is solely governed by the depreciation rules associated with the recovery class into which the asset is placed. And, if we can maximize the amount of property that falls within either the 5- or 7-year classes (e.g., fixtures), or even the 15-year class (e.g., for certain types of buildings and land improvements), the impact on the bottom line for a company can be dramatic (i.e., especially when some fixtures were eligible for up to 50% (and, possibly, 100%) bonus depreciation prior to 1/1/05, and now again for 2008 through 2011).

2. **TIMING V. PERMANENT DIFFERENCES:** Although one could argue that these savings merely represent "timing differences" (i.e., since any additional depreciation taken up-front will only serve to increase gain or decrease the loss when the property is ultimately disposed of), clients still tend to hold real property for longer periods of time (i.e., vis-a-vis most other types of assets). Therefore, these timing differences sometimes are considered by our clients as being just as valuable as more permanent tax deductions.

3. **COMMERCIAL REALTY V. FIXTURES:** For years, clients attempted to allocate as little as possible to land when purchasing a building, especially when the ACRS rules (i.e., 1981-86) allowed a 15-, 18- or 19-year recovery period with 175% DB method (i.e., regardless of whether the building was residential or commercial). Now, the issue is even more pronounced, given that we are left with a 39-year, straight-line method for commercial real estate. Clients, rightfully so, are scrambling to find any justification so as to place property into either the 5-, or 7-year classifications (i.e., with the 200% DB method), or the 15-year classification as "land improvements" (i.e., with either the 150% DB or S/L methods). And, when you add Sec. 179 immediate expensing, along with bonus depreciation (at least in the tax years that it was otherwise available), it even makes the tax savings up-front more dramatic.

B. *HOSPITAL CORPORATION OF AMERICA* DECISION OPENS THE DOOR

1. **APPLYING "OLD" ITC RULES:** The Tax Court's decision in ***Hospital Corporation of America***[98] in 1997 was one of the first cases that examined the possibility for quicker write-offs by aggressively classifying a certain portion of the assets (i.e., fixtures) connected with developed real property as either 5- or 7-year property. In siding with the taxpayer, the Tax Court determined that property that would have qualified as "tangible personal property" (i.e., vs. real estate) under the former investment tax credit rules would also now

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[98] *Hospital Corporation of America*, 109 T.C. No. 2 (7/24/1997).

qualify under *either* the ACRS or MACRS depreciation rules.[99] As a result, practitioners should continue to refer to these former ITC guidelines, which were developed and further refined by both the IRS and the courts (i.e., over the years leading up to 1981 when it was repealed), when ascertaining whether an asset is properly classified as "realty" (i.e., with a 39-year or 27.5 recovery period) or "tangible personal property" (i.e., with a 5- or 7-year recovery period).

2. **HCA FACTS:** Hospital Corporation of America owned, operated and managed a number of hospitals and medical clinics around the country. Upon completion of several structures that it had built during the period from 1985 to 1988, it decided for tax purposes that numerous fixtures contained therein constituted "tangible personal property" which should otherwise qualified as 5-year MACRS property.[100] The IRS, on the other hand, asserted that these items were actually "structural components." It further contended that by permitting these items to be written off over a *different* recovery period than the buildings to which they were so closely related would be essentially equivalent to "component depreciation,"[101] which had been banished by former **Code §168(f)(1)** (as well as current **Code §168(i)(6)**).[102] The Service also questioned whether the "old" ITC cases that predated the adoption of the ACRS/MACRS rules during the '80s were of "limited usefulness" in determining what constitutes a "structural component."

3. **SERVICE CAPITULATES:** After the government's loss on most of the issues in HCA, there was the obvious question as to how the Service would handle outstanding audits in the field involving these issues. As discussed below, the IRS has responded in the form of an internal legal memorandum.

C. SERVICE'S RESPONSE TO *HOSPITAL CORPORATION OF AMERICA* DECISION

1. **CCM 199921045:** The Service released **Chief Counsel Memorandum (CCM) 199921045**[103], which addressed the position that IRS examiners should take in light of the Tax Court's decision in ***Hospital Corp. of America, Inc. v. Comm.*** **("HCA")**. One needs to keep in mind that even though it is *not* legally binding on the IRS, the discussion contained in the Service's memorandum does provide a good overview of what clients might do to enhance their chances of possibly obtaining faster write-offs for the various fixtures found in any developed real estate project.

2. **REG. §1.48-1(c):** First of all, **Reg. §1.48-1(c)** defines "tangible personal property" to include "any tangible property except land and improvements thereto." For purposes of determining whether property is or is not "tangible" or "personal," local law does *not* control. Also, buildings and "other inherently permanent structures" (including structural components of such buildings and structures) are deemed to fit within the general definition of "improvements" and thus are considered "real property." In making the determination as to whether an asset is "inherently permanent or a structural component of a building" as opposed to "tangible personal property," even the Service admits in its memorandum that this issue is still "a highly factual one, with no bright line tests."

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[99] The Tax Court stated that the precedent that had been developed to ascertain whether property constitutes eligible section 38 property for purposes of old ITC rules was equally applicable to ascertain whether property constitutes section 1245 class property for purposes of ACRS or MACRS.

[100] Pursuant to ADR Asset Classification 57.0 "Distributive Trades or Services."

[101] The component method of depreciation is a method of depreciation that "fragments an item of property, often a building, into its elements (e.g., shell, plumbing, and wiring) and applies individual useful lives and salvage values to each such component." Westin, Lexicon of Tax Terminology 127 (1984); see also Shainberg v. Commr., 33 T.C. 241 (1959); Reg. §1.167-7.

[102] Even though "component depreciation" had indeed been done away with, the Tax Court stated that still does *not* preclude the use of an analysis based on Scott Paper Co. v. Commr., 74 T.C. 137 (1980), and its progeny, and Reg. §1.48-1(1); accordingly such authorities could be applied to assign appropriate recovery classes or recovery periods to the properties in issue.

[103] Contained in the Federal Tax Bulletin dated June 14, 1999.

a. INHERENTLY PERMANENT: Relying on its 1975 decision in ***Whiteco Industries***[104], the Tax Court in ***HCA*** took note of the following factors when determining whether a particular piece of property is "inherently permanent:"

1) Is the property capable of being moved?

2) Has the property in fact been moved?

3). Is the property designed to be moved or constructed to remain permanently in place?

4) Are there circumstances that show the expected or intended length of affixation? Are there circumstances which show that the property may or will have to be moved?

5) How substantial a job is removal of the property and how time-consuming is it? Is it readily movable?

6) How much damage will the property itself (i.e., not just the property which surrounds it, or to which it is attached) sustain upon its move?

7) What is the manner of affixation to the land?

Comment: "Movability" itself, however, is *not* the controlling factor in deciding whether the property lacks permanence.[105]

b. ***WHITECO INDUSTRIES*:** With regard to the factors cited above in ***Whiteco*** concerning an asset's "movability", the Service has ruled with regard to carpeting in **Rev. Rul. 67-349** and movable partitions in **Rev. Rul. 75-178**, stating that they *both* represent assets that will qualify as "tangible personal property." In addition, the Senate Committee Report to the Revenue Act of 1978 stated that removable floor tiles, booths for seating, signs, and exterior ornamentation (e.g., false balconies) will qualify as tangible personal property.[106]

Practice Pointer: Take special note of two items from the paragraph above. First, "movable partitions" in **Rev. Rul. 75-178** have specifically been addressed by the Service. And, today companies have developed construction techniques for interior, non-load bearing walls which are truly movable. They used aluminum studs with holes in them so that wiring can easily be passed through. Sound absorption materials (e.g., styrofoam inserts) are then used with vinyl coverings (i.e., which have fasteners running along the top and bottom with decorative molding covering the edges) being affixed to complete the wall. Company representatives claim that they can shut off the electrical power and then readily move these walls, thereby re-configuring the space, within a matter of hours. Secondly, signs were specifically addressed in the ***Walgreens*** decision which is covered below and were again found to be 5-year property under **ADR 57.0 "Distributive Trades & Services."**

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[104] Whiteco Industries, Inc. v. Commr., 65 TC 664 (1975).

[105] Kramertown Co. v. Commr., 488 F.2d 728, 731 (5th Cir. 1974), affg. T.C. Memo. 1972-239; see also Consolidated Freightways v. Commr., 708 F.2d 1385, 1390 (9th Cir. 1983) (a variety of factors are considered, including, where possible, the function and design of the component in issue, the intent of the taxpayer in installing the component, and the effect of removal of the component on the building), affg. in part and revg. in part 74 T.C. 768 (1980); Everhart v. Commr., 61 T.C. 328, 331 (1973) (movability per se does *not* determine whether or not property is personal property); Dixie Manor, Inc. v. United States, 79-2 USTC ¶9469 (W.D. Ky. 1979) (fact that walls often are removed because of a change in design by itself is not sufficient), affd. without published opinion 652 F.2d 57 (6th Cir. 1981). The fact that an item is *not* readily reusable in another location is evidence supporting the conclusion that it is to be treated as permanent in its present location. Mallinckrodt, Inc. v. Commr., 778 F.2d 402, 403 (8th Cir. 1985), affg. per curiam T.C. Memo. 1984-532

[106] S. Rept. 95-1263, 1978-3 CB 415.

Warning: The IRS has taken the position in a field service advice[107] that hotel's magnetic strip keycard door locking system was nonresidential real property because it is an "integral part" of the doors and the doors are "structural components" of the building. It is interesting to note that such systems are controlled by a CPU (i.e., the computer at the front desk of the hotel). As anyone who has stayed recently in a hotel already knows, they can even regulate what time of the day the key becomes inactive (i.e., within an hour of what the normal checkout time is supposed to be). And, the MACRS 5-year class for "computers" specifically includes any "peripheral equipment." How then do they rationalize that these locking systems should be distinguished? The IRS counters that in this instance the "functionality" of the door would be rendered useless without a lock mechanism and therefore this equipment should be treated as being "more closely associated with the door" (i.e., commercial realty) then the computer that really controls it.

c. STRUCTURAL COMPONENTS: The Tax Court in HCA examined **Reg. §1.48-1(e)(2)** for a definition of a "structural component" explains the meaning of "structural components" by way of example rather than by definition as follows:

The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, *or adjacent to the building*) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

Note: The regs make it clear, however, that the term "structural components" does *not* include machinery "the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs." A good example we often see of this is the false flooring in a computer room where refrigeration and other cooling equipment, along with necessary wiring, is run under the floorboards.

d. PARKING STRUCTURES VS. PARKING LOTS: A large insurance company based out of WI just survived an IRS audit where it argued that a parking structure is *not* a "building." Rather, they successfully convinced the Service that such a structure was a "land improvement" that was erected to enhance the value of the building (i.e., much the same as a surface parking lot). This might seem like an aggressive position, but another IRS audit permitted the 1st floor of a parking structure to be taken as a land improvement where it was on the same level as the asphalt parking lot which surrounded it. In that instance, the Service only required that the structure rising up from the ground floors be treated as a 39-year commercial building.

Comment: A question might arise where there was a walkway constructed so as to connect the parking structure to the building which it served. Nevertheless, if under the ***Whiteco Industries*** standards, it could be removed without significant damage to the building (or, the parking structure), it would not affect the fact that the parking structure was still a MACRS 15-year "land improvement" (it certainly does not seem that the parking structure is a "building" as that term is commonly applied under the tax law as no one ever occupies it).

☞Service Insists Open-Air Parking Structures 39-Year MACRS Property Not 15-Year Land Improvements (LMSB4-0709-029)

A new Coordinated Issue Paper (CIP) concludes that open-air parking structures are "structures" for purposes of **Code §168** depreciation rules. As a result, their cost should be written off over 39 years using the straight-line method. More importantly, the CIP stresses that taxpayers taking the return position that such structures are instead "land improvements" (i.e., depreciable over 15 years) should be assessed an accuracy related penalty for negligence "because they have no support for their position."

Comment: As mentioned above, an insurance company located in Madison, WI recently convinced an IRS

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[107] IRS CCA199924044 (3/24/99).

auditor upon examination that they should be allowed to treat their parking structure as a MACRS 15-year "land improvement." There is probably a good chance that this result (and, any other similar ones around the country) made it back to the IRS National Office which then issued this CIP in response. In reality, the law is written to include permanent "structures" as buildings depreciable over either 27.5 (i.e., residential) or 39 years (i.e., commercial) and this would seem to include high-rise parking structures. An argument could be made (and, has previously been done successfully on IRS audit) that if the first floor of the parking structure is level with the surrounding surface parking lot, and is also covered with the same asphalt, then that portion of the parking structure might be classified as a 15-year asset.

Comment: The IRS's stance on stand-alone (i.e., ones *not* connected with a bridge to a nearby building) open-air parking structures is to be contrasted with its more favorable view of parking towers consisting of an auto carousel mechanism and supporting tower structure. **PLR 19751010** (which is *not* cited in the CIP) concluded that such towers are tangible personal property (i.e., ADR 57.0 "Distributive Trades or Services" 5-year MACRS property) for purposes of the **Code §168** depreciation rules.

e. BUILDING ENTRANCES: It is not unusual for a medical clinic or hospital to have an overhang outside of their front entrance so that patients pulling up in the their cars will be sheltered from inclement weather upon their arrival. Especially, if the overhang is *not* attached to the remainder of the building, there is an excellent argument that this would be 5-year property (much the same as a canopy erected outside of the entrance to a gas station/convenience store, to which the IRS has already agreed is 5-year MACRS property).[108] The key, once again, is that the overhang/canopy is *not* physically attached to the building (though there might be a rubber flap which extends over and covers the 6-inch gap between the edge of the canopy and the outside surface of the building's wall).

f. OVERALL MAINTENANCE OF BUILDING: Accordingly, an item constitutes a "structural component" of a building if the item "relates to the operation and maintenance of the building."[109] The "sole justification" test set forth in **Reg. §1.48-1(e)(1)** *excludes* from the term "structural component" only machinery that is required to meet the temperature and humidity requirements of other machinery and *not* just to maintain the overall environment of a building.[110] However, such machinery would satisfy the "solely because" requirement even if it "incidentally provides for the comfort of employees, or serves, to an insubstantial degree, an area where such temperature or humidity requirements are *not* critical."[111]

Practice Pointer: Here, we see that the Tax Court interprets as a "structural component" of a building those elements of the heating and cooling systems of the building (HVAC), even if they are located outside (i.e., along side an exterior wall, as are a lot of compressor units for central air conditioning). Also, even though furnaces today are getting more compact, the court makes it clear that these should also be treated as 27.5- or 39-year realty. Perhaps, though, items such as a water heater (e.g., for a rental unit) might still be distinguished as *not* being part of the property's "heating system." Especially, where there are simply two lines (i.e., often connected with PVC which can be easily moved, detached or reconnected) for the water flow, along with a gas or electric line, one could make the argument that this should be instead treated as MACRS 5-year property (i.e., and, therefore, eligible for **Code §179** immediate expensing). Or, better still, where a "replacement" of such assets is involved (even when it is a furnace or air conditioning unit), an argument could be mounted to treat the cost as a deductible "repair."

g. **WIRING:** The court in HCA summarized the regulation saying, "an item constitutes a structural component of a building if the item relates to the [overall] operation and maintenance of the

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[108] Rev. Rul. 2003-54

[109] Reg. § 1.48-1(e)(2).

[110] Piggly Wiggly S., Inc. v. Commr., 84 T.C. 739, 750-753 (1985), affd. 803 F.2d 1572 (11th Cir. 1986); Texas Instruments, Inc. v. Commr., T.C. Memo. 1992-306; Morrison, Inc. v. Commr., supra.

[111] Reg. §1.48-1(e)(2).

building.'"[112] The Service went so far as to state emphatically "Be aware, however, that the list may be misleading." The HCA court followed ***Scott Paper Co. v. Commr.*, 74 T.C. 137, 182-3 (1980)** in determining that even though "wiring" is an example under **Reg. §1.48-1(e)(2)**, it is *not* a "structural component" unless it relates to the *overall* operation or maintenance of a building.[113] The focus instead, the court found, should be on its "ultimate use"[114] which is truly dependent on the facts and circumstances in each case. In addition, the Service has stated that it will *not* challenge the Scott Paper approach.[115] Applying these principles, the Tax Court found that "the portion of the cost of the primary and secondary electrical distribution systems allocable to HCA's equipment constituted tangible personal property" (which in HCA's business of rendering personal and professional services) which qualified under **ADR Guideline 57.0** as 5-year MACRS property. This was because the wiring was connected directly to and service only those pieces of 5-year equipment (i.e., it was *not* wiring use to provide electricity for the hospital facilities in general).

Comment: The Service, in this instance, urged the Tax Court to dismiss the ***Scott Paper Co.*** case (and, the cases which followed it) and instead follow the lead in ***A.C. Monk & Co. v. U.S.***.[116] There, the court decided that "there was no justification for allocating a portion of a *single* electrical system and that components of the electrical system should be treated as structural components where they could reasonably be adapted to general uses." But, in HCA, the Tax Court stuck to its guns and decided to focus on the "ultimate uses of power at the taxpayer's facility and distinguished the power used in the *overall* operation or maintenance such as lighting, heating, ventilation and air-conditioning of the building [as opposed to] the power [*specifically*] used to operate the taxpayer's machinery."

i. **EXIT SIGNS:** Another example of an item where the IRS insists that it is part of the building's structure would be exit signs and emergency lighting, especially where it is wired into the general circuitry of the building (i.e., the wiring runs directly off a nearby lighting fixture or electrical outlet).

j. **SUSPENDED CEILINGS:** Even though the panels of a suspended ceiling can be easily move or replaced, the Service has been uniformly successful in insisting that the track in which these panels sit, along with any recessed lighting fixtures, is permanently attached to the structure of the building. Therefore, such fixtures are part of the real estate.

k. **WALL SCONCES & DECORATIVE LIGHTING:** Especially in hotel ballrooms and meeting rooms, you will likely see a decorative chandelier, along with wall sconces. Although these fixtures do provide some lighting, they are *not* considered to be the *main* sources of illumination for the room. Instead, it is the fluorescent lighting provided by the recessed fixtures in the ceiling. Therefore, the latter fixtures are 5-year property under the ADR 57.0 classification.

l. **MOVABLE PARTITIONS:** What are also very common in hotel meeting rooms, are the movable partitions which can be used to turn a massive ballroom into smaller meeting room spaces. And, since these walls are non-load bearing, they are also classified as 5-year property in ADR Class 57.0.

m. **CABINETRY:** Especially in upscale apartment units or condos, a fair amount of cost can be put into kitchen and bathroom areas. One complex outside Dallas, TX recently faced an IRS challenge that the $1 million or so spent for kitchen cabinets should be classified as 27.5-year residential realty. This was in spite of the fact that just a few lag bolts held the units to the walls (and, therefore, they could be moved under the ***Whiteco Industry*** standards fairly easily). A good argument (and, I believe, the

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[112] HCA, 109 T.C. at 58.

[113] Id. at 66.

[114] Id. at 68.

[115] Illinois Cereal Mills, Inc. v. Commr., T.C. Memo. 1983-469, action on decision, 1991-019 (Oct. 22, 1991).

[116] A.C. Monk & Co. v. U.S., 686 F.2d 1058, 50 AFTR 2d 82-5588 (4th Cir. 1982).

correct one) could be made that these are **ADR 57.0** assets with a 5-year life (of course, such fixtures in an office setting would be **ADR 00.11 "Office Furniture and Fixtures."**

n. **ASSISTED LIVING CARE FACILITIES:** As opposed to nursing homes (which are normally not thought of as permanent living or residential facilities) or hospitals which would be MACRS 39-year commercial realty, assisted living care facilities are 27.5-year residential facilities. Furthermore, with the extensive landscaping and other land improvements such as lighted sidewalks, parking lots, etc. put into place around such projects, there is also a great deal of 15-year MACRS property. Finally, each unit contains not only appliances and rugs, etc. but also other 5-year MACRS property such as handrails, emergency cords (for accidental falls or immediate care needed by the occupants).

E. CORRECTING PAST MISCLASSIFICATIONS - "CATCH-UP DEPRECIATION"

1. **NEW CLIENTS:** Obviously, it would be best to properly distinguish between **Code §1245** tangible personal property and **Code §1250** real property when the assets are first placed into service (i.e., at the time of purchase, construction or improvement). But, what can we do when we inherit a client who has *not* properly classified its assets (i.e., on prior years' tax returns, even those where the year is now closed for amending the return)? Doing an immediate overview of how the new client's depreciable assets are classified (i.e., by doing a thorough analysis of Form 4562 and its supporting schedules), especially with realty v. fixtures, can identify obvious mistakes, along with providing a chance for real tax savings.

2. **AUTOMATIC CONSENT:** In a legal memorandum (Cf. **CCM 199921045** cited above), the IRS originally indicated that *any change* in the method of computed depreciation for a particular asset is considered to be a "change in the method of accounting" that would acquire the Service's advanced approval[117]. But, with the issuance of **Rev. Proc. 96-31 (4/26/96)**, which has since been updated with the issuance of **Rev. Procs. 97-37, 98-60, 99-49, 2002-9**, **2004-11**, **2008-52**, **2009-39** and **2011-14** taxpayers are allowed to "catch-up" on missed depreciation deductions under "automatic consent" guidelines spelled out in the respective revenue procedures, even if the tax year in question is now closed!

Comment: When **Rev. Proc. 96-31** was originally issued, **Section 5.04(3) "Manner of Effecting Automatic Change,"** which specifically dealt with how to handle the resulting **Section 481(a)** adjustment, stated that "A taxpayer must take the **entire** negative §481(a) adjustment into account in computing the taxable income in the year of change." This was somewhat of a windfall in that **Code §481** normally requires such adjustments to be spread over a 4-year period, unless the change is less than $25,000. Nevertheless, just one year later when the IRS released **Rev. Proc. 97-37**, this sentence was curiously missing leaving one with the presumption that any catch-up depreciation adjustment had to now be treated by default under the normal rules of **Code §481** (i.e., the Service has indicated that a 4-year spread period should be used to implement the change unless it is under $25,000).

In confirming this (i.e., the ability to take the "catch-up" amount as a deduction in just one tax year, regardless of its size) indeed was changed, we checked with the IRS officials responsible for the revenue procedure. They stated that the one-year rule was only effective from the issuance date of **Rev. Proc. 96-31** (i.e., 5/13/96, as stated in **Section 8.01** in the Appendix) until it was *superseded* by **Rev. Proc. 97-37** (i.e., which had an effective date for tax years ending on or after 8/18/97). However with the recent release of **Rev. Proc. 2002-19**, the Service's position has reverted back so that any *negative* adjustment (i.e., regardless of size) must now be taken in *just one* tax year. So, with this limitation in mind, review the following examples to see where the taxpayer might be ill-advised to even file Form 3115 to apply for a "catch-up" with regard to missed depreciation deductions (i.e., especially for those tax years prior to the effective date of **Rev. Proc. 2001-19**). Meanwhile, be aware that the proper basis (i.e., which reflects all depreciation "allowed or allowable") must still be used in the interim to determine gain or loss for tax purposes upon a sale or exchange. This "immediate basis adjustment" requirement has consistently been included in each of the revenue procedures from the

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[117] But, look at the result in the ***Brookshire*** case discussed below which was a memo decision issued by the Tax Court where the Service's position was overturned.

beginning. For instance, **Rev. Proc. 96-31** specifically states in **Section 5.05 "Basis Adjustment"** that "the basis of depreciable property to which this revenue procedure applies must reflect the reductions required by **Code §1016(a)(2)** for the *depreciation allowable* for the property (as determined under section 7 of this revenue procedure)."

Comment: When a taxpayer either has a misclassification of an asset when it is first placed into service, or a cost segregation study uncovers misclassified assets, a Form 3115 must be filed to "catch up" on this missed depreciation. In addition, if bonus depreciation was in effect for the year that these assets were first placed into service, and the taxpayer did not elect out of the bonus rules for that MACRS class of assets, this missed bonus depreciation is also "caught up" by filing the Form 3115. On the other hand, if the tax year is still open for when the asset was first placed into service, then an amended return would instead be filed if a Sec. 179 election to immediate expense the asset's cost (i.e., you do *not* use the Form 3115 "catch-up" depreciation approach for Sec. 179 immediate expensing elections; instead, Form 4562 is always used for these elections).

EXAMPLE: A controller of regional tire distributor discovered that fixtures throughout the company's outlet stores had been misclassified as 7-year "furniture and fixtures" (i.e., **ADR Classification .11**) instead of 5-year fixtures used in a retail setting (i.e., pursuant to **ADR Classification 57.0 "Distributive Trades and Services"**). If the change in depreciation methods was submitted to the IRS (i.e., via a properly filed Form 3115), an additional "catch-up" deduction of approximately $46,000 would result (i.e., about 1500 assets had been misclassified). Yet, when the practitioner found out that the resulting change would have to be handled under the normal **Code 481(a)** rules so that the *negative* adjustment would be spread *over 4 years* (i.e., for a tax year prior to the issuance of **Rev. Proc. 2002-19**), this would result in a *total* recovery period of more than 7 years (i.e., the classification for these assets would be changed to 5 years, but now an additional 4-year period would have to be tacked on for making the **Code 481(a)** adjustment) since some of the assets were already in their 2nd or 3rd year for MACRS recovery purposes. What should the practitioner do? Leave well alone (i.e., just keep the assets already misclassified as 7-year property and only classified *new* ADR 57.0 fixtures as 5-year assets on a prospective basis)? Or, should he make the adjustment where it will result in the cost of the misclassified assets being recovered over more tax years than if they were just left in the 7-year MACRS class (i.e., even if this was technically not the correct class)?

Comment: As is discussed below, many practitioners facing only a 7- to 5-year change in the misclassification of their client's assets, had formally opted to just leave matters alone and decided to reclassify such assets only on a prospective basis. However, where the change involves 39-year commercial property being re-classified to either 15-, 7- or 5-year property (i.e., with either a 150% or 200% DB method versus the straight-line currently being used), then the Service's 4-year spread requirement would have been required (i.e., prior to the issuance of **Rev. Proc. 2002-19**). Now, however, regardless of the size of the negative adjustment, all of the "catch-up depreciation" amount would be taken in *just one* tax year (i.e., the one affected by the filing of Form 3115), so even a change from a 7- to 5-year recovery might make the filing of a Form 3115 worthwhile if enough assets were involved, or the total dollar value was otherwise large enough (let alone being able to claim the possible benefits of either Sec. 179 immediate expensing and/or bonus depreciation).

Practice Pointer: Now, the IRS has resolved the issue of the required 4-year spread for "negative" **Code §481(a)** adjustments resulting from instances such as where the client is seeking to "catch-up" on missed depreciation deductions stemming from a prior misclassification of assets. With the issuance of **Rev. Proc. 2002-19**, all of the "negative" adjustment would be reflected in income for the current tax year. And, as stated in the "Comment" below, this might also have a favorable impact on the expanded use of the new NOL carryback rules (i.e., for tax years ending in either 2001 or 2002, or those arising in 2008 for "qualified small businesses").

Comment: Set out below are some of the revenue procedures issued thus far pertaining to automatic consent situations, along with a reminder that a revised Form 3115 must be used for all such requests occurring after 5/31/04. Technically, the appropriate revenue procedure should be used and cited which corresponds with the particular tax year in question (i.e., when the Form 3115 is being filed).

3. **CATCHING UP ON MISSED AMORTIZATION DEDUCTIONS:** Based on the wording of **Rev. Proc. 2008-52** (as well as the revenue procedures which followed it, such as **Rev. Proc. 2002-9** and **2009-39**), a taxpayer

may catch up on any missed *amortization* deductions, as well as for missed *depreciation* write-offs.

EXAMPLE: Albert purchases Charles one-third ownership in an LLC for $250,000 in 2008. The partnership, which had a Sec. 754 election in effect, reported the $250,000 step-up as an goodwill asset on the balance sheet (i.e., this was a service-based firm and essentially all of Albert's purchase price was allocable to goodwill) and Albert's capital account. However, the LLC failed to take a deduction for any amortization on this Sec. 754 step-up amount (which would flow through to only Albert on his K-1 for the year in question) for its 2008 or 2009 Form 1065. When the new accountant discovers this mistake in preparing the 2010 Form 1065, what, if anything, could be done to rectify the situation?

Since the LLC had failed to record any amortization for this goodwill for *two consecutive tax years*, it was still deemed to have adopted a method of accounting (i.e., even if erroneous). Therefore, it would be required to file a Form 3115 to catch-up on this missed deduction (and, to get back onto the proper manner in which to account for this amortizable asset). The request would be filed pursuant to **Rev. Proc. 2009-39** (which is effective for applications filed on or after August 27, 2009, for a year of change ending on or after December 31, 2008) and would receive automatic consent. Furthermore, as an automatic consent request, there would be no filing fee charged by the IRS. Finally, a copy of the Form 3115 would be filed with the IRS National Office by the extended due date of the 2010 Form 1065, with the original Form 3115 being included with the filing of the return for that year.

Comment: If the failure to amortize this goodwill asset had occurred for only one tax year (i.e., 2008, when the Sec. 754 step-up was first recorded on the LLC's balance sheet), then a "method of accounting" for this asset would *not* have been deemed adopted (i.e., two or more consecutive tax years of using this erroneous method would *not* have taken place). Therefore, there would *not* be a need to formally request a change in the method of accounting by filing a Form 3115. Instead, an amended return for 2008 could simply be filed correcting this mistake (although **Sec. 6.01(1)(b)** states that a Form 3115 could be instead be filed in the subsequent tax year, if the taxpayer so desired to take this approach (i.e., perhaps, because they found themselves in a much higher tax bracket, or some other favorable reason existed).

Comment: Sec. 6.01(1)(a) of **Rev. Proc. 2008-52** specially states that the filing of a Form 3115 can be for catching up on missed *amortization*, as well as any *depreciation* deductions, that the taxpayer may have failed to properly take on their return. The revenue procedure states that "this change applies to a taxpayer that wants to change from an impermissible to a permissible method of accounting for depreciation or amortization for any item of depreciable or amortizable property for which the taxpayer used the impermissible method of accounting in at least two taxable years immediately preceding the year of change."

☞IRS Offers Revised Rules on Changing Accounting Methods (Rev. Proc. 2011-14)

The Internal Revenue Service has yet again issued new rules for obtaining its consent for obtaining an automatic consent for a change in a taxpayer's method of accounting. This latest revision provides the current procedures for obtaining "automatic consent" for a change in method of accounting, while also *modifying* the procedures in **Rev. Proc. 97-27** for requesting and obtaining "non-automatic" advance consent for a change in method of accounting.

Comment: Rev. Proc. 2011-14 is effective for Form 3115 applications filed on or after January 10, 2011, for a year of change ending on or after April 30, 2010. As a result, the Service will return any application that is filed afer these respective dates that does not list **"Automatic Consent Filed Pursuant to Rev. Proc. 2011-14"** listed in "red" at the top of Form 3115. More detailed information can be found in **Section 13. Effective Date** of **Rev. Proc. 2011-14**.

☞Can Site Lighting Be Treated as 5- or 7-Year MACRS Property Instead of 15-Year Land Improvements?

A recent tax court decision (***PPL Corporation & Subsidiaries v. Commr.***, 135 T.C. No. 8 (07/28/2010)) could have significant cost segregation implications where streetlights for a utility were found to be 7-year MACRS fixtures (instead of 15-year "land improvements"). The key to understanding this case is to realize that the ***Whiteco Industries*** tests (as discussed below) would still have to be satisfied in order to have this argument succeed.

Fixtures Used in Wholesale or Retail Activities: This Tax Court decision should also be reviewed as it relates to the concept of treating an asset as an accessory to the nature of the tax payer's business. An automobile dealership features extensive use of site lighting whose principal function is to provide display lighting for the product. A byproduct of the lighting is an element of security. Both uses of the assets directly relate to the business of selling new or used automobiles. From the IRS Field Directive dated, February 25, 2008 related to cost segregation Issues in the Auto Dealership Industry, the recommended classification of exterior lighting that highlights merchandise such as floodlights, spotlights and up-lighting is 5-year MACRS property. But, specifically *not* included are lighting fixtures "that illuminates parking areas or walkways and pole mounted lighting systems used to illuminate employee parking areas, customer parking areas and product display parking areas." **(Code §168; Land Improvements)**

> **Comment:** The bottom line is that ***PPL*** provides support for classifying the pole mounted lighting as either 5- or 7-year assets, if the lighting is *not* otherwise a MACRS 15-year "land improvement." As a result, determining the specific use of all the exterior lighting fixtures becomes a more difficult but, nevertheless, very important task.

☞ IRS Modifies Procedures for Change of Accounting Method Resulting in Negative Adjustments (Rev. Proc. 2002-19)

The Service has *modified* **Rev. Proc. 97-27** and **Rev. Proc. 2002-9** in order to provide new procedures for obtaining advance consent for a change of accounting method. Under **Rev. Proc. 2002-19**, a change in method of accounting will be allowed prospectively, but without audit protection, if the method to be changed is an issue pending for a tax year under examination or an issue under consideration by either an appeals office or a federal court. The revised procedures also take into account whether a change in method results in a taxpayer-favorable adjustment (*negative* section 481(a) adjustment). If that is the case, the *entire* amount must be taken into account in the year of change. **(Code §446; Change of Accounting Methods)**

> **Comment:** As to the requirement that a "negative" **Code §481(a)** adjustment be taken into account all in the year of change, this represents a favorable change in that it used to be a 4-year spread, if the amount was over $25,000. In one instance where a "catch-up depreciation" adjustment resulted from the original misclassification of 5-year MACRS property (i.e., ADR 57.0) as instead 7-year, the practitioners stated that the $43,000 negative adjustment "wasn't worth it" if it had to be taken over a 4-year spread period. Also, with the change in the NOL carryback period from 2 to 5 years, being able to take a negative adjustment all in one year would mean that the deduction could be taken against 6 possible years of income (i.e., the current year, and then 5 carryback years), instead of just 3 years (i.e., the current tax year, with the "old" 2-year carryback period for most taxpayers).
>
> **EXAMPLE:** An accountant inherited a new business client which had placed a building into service back in 1983 (i.e., which had a 15-year ACRS life). 1999 was the first tax year for which the CPA was preparing the company's tax return. When he examined the depreciation schedule that the former accountant had prepared, he discovered that the building whose cost should have been fully recovered at that point (i.e., since the entire 15-year recovery period would have now run its course) still had $170,000 of basis left. Suppose the accountant filed **Form 3115** which under the guidelines spelled out in **Rev. Proc. 99-49** and mistakenly claimed the *entire* adjustment in just *one* year (i.e., *not* realizing that the one-year rule for negative adjustments contained in **Rev. Proc. 96-31** had been changed by **Rev. Proc. 97-37** to a *4-year* spread for negative adjustments over $25,000). Would it make any difference that the ACRS recovery period had *fully expired* as of the time that the "catch-up" depreciation deduction was being claimed? Or, upon learning that the 4-year spread rules of **Code §481(a)** should have been applied, should an amended tax return be filed for 1999 (i.e., with possible penalties and interest being due)? Or, once again, was this just a "clerical/mathematical error" made by the former accountant that was now being corrected (at least, for the tax years that were still opened)? Here, the accountant took the conservative route and went along with the Service's position (i.e., the $170,000 was spread over a 4-year period starting with the 1999 tax return, even though it effectively meant that the cost of the 15-years ACRS real estate was eventually recovered over a 19-year period).

☞IRS Revises Simplified Procedure for Correcting Some Depreciation Mistakes With Regard to Assets Previously Sold (Rev. Proc. 2007-16)

The IRS has revised a revenue procedure that makes it easier to fix some depreciation-deduction mistakes by waiving the "two-year" adoption-of-method-of-accounting rule in specific instances and by allowing an "automatic consent" change in method of accounting for the tax year in which an asset is disposed. It also updates the revenue procedure used to obtain automatic consent to certain accounting method changes. The new procedure was issued concurrently with final regs dealing with depreciation changes as accounting method changes.

> **Comment:** In most instances, taxpayers will continue to cite **Rev. Proc. 2002-9** (or, **Rev. Proc. 2008-52**) at the top of a Form 3115 for automatic consent in claiming missed depreciation (e.g., due to a misclassification of an asset on Form 4562, or as a result of a cost segregation study) on assets that they continue to own. However, where the asset has already been disposed of in a *prior* taxable year, and the taxpayer is now seeking to go back and amend that year's return to claim any missed depreciation, they will now list **"Automatic Consent Pursuant to Rev. Proc. 2007-16"** (preferably, in red) at the top of the form (i.e., instead of being pursuant to **Rev. Proc. 2004-11**). And, if the asset was disposed of in an earlier year and now the return is under audit with the IRS claiming that the asset's basis should be adjusted downward for the depreciation which should have been claimed (i.e., under the "allowed or allowable" principle), the taxpayer can go back and amend the return for the year in which the asset was disposed of thereby claiming any "catch-up" depreciation.

> **Comment:** Automatic consent status is important for two reasons. First, the approval of the request is *not* dependent upon the discretion of the IRS. Second, since it is an "automatic consent," the normal fee which can now be up to $2,500 for filing Form 3115 is waived.

CHAPTER #9. PRACTITIONERS OVERLOOK ADVANTAGES OF ADR GUIDELINE CLASS 57.0 "DISTRIBUTIVE TRADES AND SERVICES"

A. INTRODUCTION

1. **ADR GUIDELINE CLASS 57.0 "DISTRIBUTIVE TRADES AND SERVICES:"** includes ***any*** asset (other than real property) used in a wholesale or retail business, or in rendering personal and professional services. Inclusion of an asset in this particular MACRS classification means a 5-year write-off using the 200% declining balance method. Therefore, outside of the actual "bricks and mortar" of a retail store, any and all other assets which constituted tangible personal property with regard to that retail outlet could be written off over this shorter period. Examples would include shelving, floor displays, movable fixtures (e.g., track lighting), carpeting, display cases (e.g., such as refrigeration units for a market or convenience store, including the special 220 amp wiring required for its operation).

B. ADR 57.0 "DISTRIBUTIVE TRADES OR SERVICES"

1. **PROFESSIONAL OFFICES:** In a professional setting, this classification would affect a dentist, for instance, who had just spent $200-300,000 for equipment to be used in the treatment of his or her patients, including that to be used by the dental hygienist and the necessary x-ray equipment. However, any other furniture or fixtures to be used in "an office setting" for the dentist,(i.e., an administrative area as opposed to where the dentist consults with, or otherwise examines and treats the patient) or other professionals (e.g., doctors, attorneys, accountants, engineers, etc.) would be under the **general ADR Guideline Classification of .11 (Office Furniture & Fixtures)**. This was the result from a case decided several years ago involving ***Norwest Bank***.[118]

2. **RESTAURANTS:** Other examples of this classification might be seen in a restaurant which would have numerous fixtures, such as tables, chairs (including built-in permanent booths), utensils, wall decorations, along with a professional (e.g. stainless steel) kitchen. All of these items would be 5-year property. Only the furniture and fixtures in the back offices (i.e., where the day's credit card and cash receipts were processed) would be in the 7-year class.

3. **RENT-TO-OWN ASSETS:** The business activity of "leasing consumer durable property" is described in **ADR Guideline Class 57.0 "Distributive Trades and Services"** of **Rev. Proc. 87-56**. As a result, this property has a class life of 9 years and is treated as 5-year property pursuant to **Code §168(e)(1)**. Thus, for consumer durable property subject to rent-to-own contracts as described under **Rev. Proc. 95-38**, the recovery period is 5 years for purposes of **Code §168(c)(1)** and 9 years for purposes of **Code §168(g)**.[119]

4. **CLASSROOM ASSETS:** Furniture and fixtures used in a classroom setting would fall into this 5-year classification as well, since it is *not* technically an "office setting" (i.e., where the actual instruction is taking place). However, as to any furniture and fixtures in the administrative areas of the building, **ADR Class .11 "Office Furniture & Fixtures"** would control and the assets would fall into the 7-year MACRS class.[120]

5. **BANK ASSETS:** A bank or financial institution has various items of tangible personal property, such as ATMs, air purifiers for cleansing the circulating air in the lobbies or office space, and F&F assets. As to the ATMs, the argument would be that they are effectively controlled by the banks computer system (i.e., in

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[118] *Norwest Corporation and Subsidiaries v. Commr.*, 111 T.C. No. 5 (8/10/1998) held that the ADR Classification 0.11 for "Office Furniture and Fixtures" takes precedence over ADR Classification 57.0 "Distributive Trades and Services (Cf. **Issue IV.** in the Tax Court's opinion starting on page 76).

[119] Cf. PLR 199101003 for additional assets properly included in ADR Asset class 57.0.

[120] Unfortunately, even though our conference rooms in the law or accounting firms are used, in a sense, to instruct and inform our clients when we meet with them personally, these furniture and fixture items would still be 7-year property in the opinion of the IRS.

dispensing cash and recording other transactions that the customer might make on-site). Therefore, they should be 5-year property. The IRS could, however, contend that, given the permanency of their location, that under the ***Whiteco*** factors, they have become part of the surrounding real estate and should accordingly be treated as 39-year commercial property. With regard to the air purifiers, these probably are permanently fixed as part of the HVAC system and should be classified as 39-year commercial property, unless it could be shown that they were stand-alone units in which case they would probably be 7-year "Office Furniture and Fixtures."

6. **KENNELS FOR DOG OR PET BOARDING:** The key to the correct classification here would be whether the assets consisted of realty or tangible personal property. If the former, there is no special class for such real estate and, as commercial property, the structure would be 39-year property. However, as to the fencing surrounding the outside runs for the dogs, some cost segregation specialists have argued that 5-year treatment is appropriate (similar to tennis court fences at a country club or apartment complex, as well as security fences surrounding a parking lot). The IRS comeback, under the ***Whiteco*** case, is that these fences are of such a permanent nature that, at best, they should be treated as 15-year "land improvements."

C. PLANNING FOR CLIENTS

1. **RECLASSIFICATIONS:** From the above discussion, one can see how potentially broad this MACRS classification can be. About the only assets left out of the mix, so to speak, would be those tangible personal property items used in farming or manufacturing activities. Even large outdoor signs advertising the business, or decorative canvases displaying the store or firm's name, would be taken over five years. This is what the court determined in a case involving Walgreen's.[121] Thus, if an accounting firm spent $10,000 to have a lighted sign anchored to a cement base outside of the office as a means of attracting passing traffic and displaying their firm's name to the general public, 5-year MACRS depreciation could be used. It would *not* go into the 39-year S/L class as realty, or 15-year "land improvements." Nor, would it go into the 7-year MACRS class since the fixture is *not* in an "office" setting.

a. As discussed the article below, the court in ***Walgreen's*** stated that the MACRS classification **ADR Asset Class 57.0** was found to include restaurant decor items such as a decorative canopy system along with its related concrete foundation, concrete piers, lumber, and attached signs.

☞**Service Rules "Signs" to Be 15-year "Land Improvements" (CCA 200203009)**

In ***Walgreen Co. and Subsidiaries,* T.C. Memo 1996-374 (8/13/1996)**, the Tax Court determined that **ADR Asset Class 57.0** (i.e., 5-year property) was found to include restaurant decor items such as a decorative canopy system along with its related concrete foundation, concrete piers, lumber, and attached signs. However, in this Field Service Advice, the Service ruled that outdoor signs must be written off as 15-year "land improvements." Here, a casino constructed a large pylon sign on its property to draw attention to its gambling and hotel complex. The sign was not attached to the building. The casino had argued that the entire cost of the sign should be written off over five years (i.e., **ADR Asset Class 57.0 "Distributive Trades & Services"**). But, according to the Service's ruling, that treatment applies only to the sign's electronic circuitry. (**Code §168; Signs**)

Comment: CCA 200203009 is discussed in full above in **CHAPTER #7**.

☞**Safe Harbor Write-off Provision Could Be Used for "Smallwares" (PLR 200351009)**

The Service has ruled that a business which specialized in providing coffee and related food and refreshment products and small appliances through several related lines of business would be able to use the safe harbor method of accounting for smallwares (i.e., as defined in **Rev. Proc. 2002-12**); but, only for those contracts in which the taxpayer's employees were directly involved in making beverages at the customer's location. **(Code §162; Smallwares)**

Comment: The Service has also issued a "Field Directive on the Planning and Examination of Cost Segregation Issues in the Restaurant Industry" which contains a special list of depreciation periods for various restaurant assets that examiners can now use to settle disputes with taxpayers. It contains guidelines for

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[121] *Walgreen Co. and Subsidiaries*, TC Memo 1996-374 (1996).

various assets such as outdoor business signs which are depreciated over five years, even if they are attached to a building. The same would also hold true for purely decorative lighting. On the other hand, foundations for light poles and signs would be placed into a 15-year recovery period for depreciation purposes. The Service, however, makes a distinction for lighting “that is necessary for operating a building” and which is *mounted to the side of the building*. This would include lighting for walkways, parking lots and exits, which would be given a 39-year MACRS classification. But, free-standing lighting such as that supported by poles in the parking lot would be 15-year land improvements.