Chapter 1: Depreciation

Corrections were made to this material through January of 2012. No subsequent modifications were made.

In recent years, several pieces of legislation have expanded depreciation options for businesses. Congressional intent is to give businesses an incentive for investing in capital assets in the hopes that such investments will boost the economic climate.

One of the most popular incentives is the IRC §179 deduction, which has undergone a number of changes in recent years. Another is bonus depreciation (also called **special depreciation allowance** in IRS publications) which is discussed later in this chapter.

IRC §179 DEDUCTION

For taxable years beginning in 2010 and 2011, the maximum amount a taxpayer may elect to expense under IRC §179 is $500,000 of the cost of qualifying property placed in service during the year. The maximum amount is reduced on a dollar-for-dollar basis when the amount of qualifying property placed in service during the year exceeds $2 million.

Note. The maximum §179 deduction on SUVs remains unchanged at $25,000. However, new SUVs with a gross vehicle weight (GVW) over 6,000 pounds are eligible for 100% bonus depreciation if they are purchased and placed in service after September 8, 2010, and before January 1, 2012. If a new heavy SUV is purchased and placed in service during the period when bonus depreciation applies, the first $25,000 of the vehicle's purchase price can be expensed under §179. Bonus depreciation can then be applied to the remaining cost basis.

For taxable years beginning in 2012, the maximum amount a taxpayer may expense under §179 is $125,000 (indexed for inflation). The maximum amount is reduced on a dollar-for-dollar basis when the amount of qualifying property placed in service during the year exceeds $500,000 (indexed for inflation).

For taxable years beginning after 2012, the maximum amount a taxpayer can expense under §179 is $25,000. The maximum amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

ELECTION

A taxpayer makes the election to take the §179 deduction by completing Part I of Form 4562, *Depreciation and Amortization.* The election can be made on either an original return or an amended return.[1]

The §179 election can be revoked without obtaining IRS approval by filing an amended return. Once made, the election revocation cannot be changed.[2]

BUSINESS INCOME LIMIT

After applying the annual dollar limits specified above, the total amount of the §179 deduction is further limited to the taxable income from the active conduct of any trade or business during the year.[3] Taxable business income is calculated differently depending on the form of the business.

For individuals, the business income limit includes the taxable income from the active conduct of all trades and businesses during the year. Net income from a trade or business also includes:

- §1231 gains or losses,
- Interest from working capital of trades/businesses, and
- Wages, salaries, tips, or other pay earned as an employee.

At the individual level, business income **does not include:**

- §179 deductions,
- The self-employment tax deduction,
- Any net operating loss deduction, or
- Any unreimbursed employee business expenses.

Any elected §179 deduction not allowed because of the business income limit can be carried to the next year. Special rules apply to real property.

PARTIAL BUSINESS USE

When property is used for both business and personal purposes, the taxpayer can elect the §179 deduction only if the property is used more than 50% for business in the year it is placed in service. If the property is used more than 50% for business, the cost of the property is multiplied by the percentage of business use to calculate the §179 deduction.

> **Example 1.** Joshua buys a riding lawn mower for $3,000 in May 2011. Ninety percent of the mower's use will be in Joshua's landscaping business and 10% of the mower's use will be for personal purposes. The cost of the mower adjusted to reflect the business use of the property is $2,700 ($3,000 × 90%). Joshua's taxable business income before taking into account any §179 deduction is $10,000. Thus, Joshua may elect to expense up to $2,700 of the cost of the mower under §179.

1. Instructions for Form 4562.
2. Ibid.
3. IRC §179(b)(3)(A).

QUALIFYING §179 PROPERTY

To be eligible for the deduction, the property must be acquired by purchase from an unrelated party for use in a trade or business.[4] Additionally, the property must be one of the following types of depreciable property.[5]

1. Tangible personal property
2. Other tangible property (except buildings and their structural components) used as one of the following.
   a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services
   b. A research facility used in connection with any of the activities in (a) above
   c. A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities
3. Single-purpose agricultural or horticultural structures
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or petroleum products
5. Off-the-shelf computer software that is placed in service in a taxable year beginning after 2002 and before 2013[6]
6. Qualified real property

QUALIFIED REAL PROPERTY

For taxable years beginning in 2010 and 2011, the definition of qualifying §179 property is temporarily expanded to include the following types of real property.

- Qualified leasehold improvement property (as defined in IRC §168(e)(6))
- Qualified restaurant property (as defined in IRC §168(e)(7))
- Qualified retail improvement property (as defined in IRC §168(e)(8))

> **Note.** Qualified restaurant property and qualified retail improvement property are **not** subject to related party restrictions. However, leasehold improvement property is subject to related party rules.

The maximum amount of real property that may be expensed for purposes of §179 is $250,000. IRC §179 deductions attributable to qualified real property that are disallowed because of the trade or business taxable income limitation can only be carried forward to taxable years in which the definition of eligible §179 property includes qualified real property. Thus, if a taxpayer's §179 deduction for 2010 for qualified real property is limited by the taxpayer's trade or business income, the disallowed amount may be carried over to 2011. Any §179 amounts that are not used in 2011, plus any 2011 disallowed §179 deductions attributable to qualified real property, are treated as property placed in service in 2011 for purposes of computing depreciation. The §179 carryover amount from 2010 is considered property placed in service on the first day of the 2011 taxable year.

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4. IRC §179(d).
5. IRS Pub. 946, *How to Depreciate Property*.
6. IRC §179(d)(1)(A)(ii).

Example 2. During 2010, Archon Company's only asset purchases eligible for §179 expensing are equipment costing $100,000 and qualified leasehold improvements costing $390,000. Archon is not subject to the taxable income limitation. The maximum §179 deduction the company can claim for 2010 is $350,000 ($100,000 for the equipment + $250,000 for the qualifying leasehold improvements).

Example 3. During 2010, Maxie Corporation's only asset purchases eligible for §179 expensing are equipment costing $300,000 and qualified leasehold improvements costing $300,000. Maxie is not subject to the taxable income limitation. Maxie can choose to expense $250,000 of qualified leasehold improvements and $250,000 of equipment. Alternatively, Maxie can choose to expense $300,000 of equipment and $200,000 of qualified leasehold improvements, or some other combination as long as the total §179 expense does not exceed $500,000 and the portion attributable to qualified leasehold improvements does not exceed $250,000.

Example 4. During 2010, Bargin Company's only asset purchases are §179-eligible equipment costing $100,000 and qualified leasehold improvements costing $200,000. Bargin has a taxable income limitation of $150,000. The maximum §179 deduction the company can claim for 2010 is $150,000, which the company allocates pro rata between the properties, such that the carryover to 2011 is allocated $50,000 to the equipment ($150,000 taxable income limitation ÷ $300,000 total §179-eligible purchases × $100,000 equipment purchases) and $100,000 ($150,000 – $50,000) to the qualified leasehold improvements.

In 2011, Bargin had no asset purchases and had taxable income of $0. The $100,000 carryover from 2010 attributable to qualified leasehold improvements is treated as property placed in service as of the first day of the company's 2011 taxable year. The $50,000 carryover allocated to equipment is carried over to 2012.

A taxpayer may elect to exclude real property from the definition of §179 property. Taxpayers that are close to reaching the $2 million phaseout threshold may find this election useful.

PASS-THROUGH §179 DEDUCTIONS

Taxpayers that are partners in a partnership or shareholders in an S corporation receive a Schedule K-1 from the entity. These entities are also entitled to claim a §179 deduction. However, the entity must pass a pro rata amount through to each partner/shareholder. The §179 deduction is limited at both the entity and the partner/shareholder level. Consequently, it is possible that a taxpayer will not be able to utilize all of the pass-through §179 deduction.

The §179 amount allocated from partnerships/S corporations is added to the partner's/shareholder's other §179 expenses before applying the dollar limit to the total amount. The partner/shareholder does not include any of the cost of §179 property placed in service by the pass-through entity in calculating any reduction in the dollar limit for costs exceeding $2 million. After the dollar limit is applied to the partner's/shareholder's total §179 costs, any remaining costs of §179 property is subject to the business income limit.

Example 5. In 2010, Pecan Partnership placed in service §179 property with a total cost of $2,150,000. The partnership must reduce its dollar limit by $150,000 ($2,150,000 − $2 million limit on total amount of qualifying property).

Therefore, Pecan's maximum §179 deduction is $350,000 ($500,000 − $150,000), and it elects to expense that amount. Pecan's taxable income from the active conduct of all its trades or businesses for the year was $300,000. Consequently, it can deduct 300,000. It allocates $75,000 of its §179 deduction and $100,000 of its taxable income to Connor, one of its partners.

In addition to being a partner in Pecan Partnership, Connor is also a partner in the Sage Partnership, which allocated him a $30,000 §179 deduction and $35,000 of its taxable income from the active conduct of its business.

Connor also conducts a business as a sole proprietor. In 2010, he placed in service in his sole proprietor business qualifying §179 property costing $55,000. He had a net loss of $50,000 from that business for the year.

Connor's §179 costs for 2010 are summarized in the following table.

	Total §179 Costs	Taxable Income	§179 Costs Elected	§179 Costs after Business Income Limit	§179 Carryover
Pecan Partnership	$ 75,000	$100,000	$ 75,000	$55,000	$20,000
Sage Partnership	30,000	35,000	30,000	30,000	0
Sole Proprietorship	55,000	(50,000)	55,000	0	55,000
Total	$160,000	$ 85,000	$160,000	$85,000	$75,000

Connor does not have to include §179 partnership costs to figure any reduction in his dollar limit. Therefore, his total §179 costs for the year are not more than $2 million and his dollar limit is not reduced. His maximum §179 deduction is $500,000. He elects to expense all of the $105,000 in §179 deductions allocated from the partnerships ($75,000 from Pecan Partnership, plus $30,000 from Sage Partnership), plus $55,000 of his sole proprietorship's §179 costs, and notes that information in his books and records. However, his deduction is limited to his business taxable income of $85,000 ($100,000 from Pecan Partnership, plus $35,000 from Sage Partnership, minus $50,000 loss from his sole proprietorship). He carries over $75,000 ($105,000 in §179 deductions from partnerships + $55,000 in §179 deductions from sole proprietorship − $85,000 taxable income limit) of the elected §179 costs to 2011. He allocates the carryover amount to the cost of §179 property placed in service in his sole proprietorship, plus $20,000 from the Pecan Partnership and notes that allocation in his books and records.

Adjustment of Partner's Basis in Partnership

A partner's basis in a partnership interest must be reduced by the total amount of §179 expenses allocated from the partnership even if the partner cannot currently deduct the total amount. If the partner disposes of the partnership interest, the partner's basis for determining gain or loss is increased by any outstanding carryover of disallowed §179 expenses allocated from the partnership.

When a partner receives a distributive share of §179 expenses from multiple sources, the partner's total §179 expenses may exceed the maximum dollar amount allowable for the taxable year. In this situation, the partner's adjusted basis in the partnership interest(s) must be reduced by the partner's full distributive share of the §179 expenses, including the §179 expenses that the partner cannot deduct.[7] The excess §179 expenses may **not** be carried over.

Example 6. For the 2011 taxable year, Erin received a Schedule K-1 from DoRight Partnership, which allocated $450,000 of taxable income and $400,000 of §179 expense to her. Erin also received a Schedule K-1 from ReelOne Partnership, which allocated $225,000 of taxable income and $200,000 of §179 expenses to her.

Because Erin's total §179 deduction is $100,000 more than the maximum amount allowable for 2011 ($400,000 from DoRight Partnership + $200,000 from ReelOne Partnership − $500,000 maximum for 2011), she cannot carry over the excess to a subsequent year. **However, Erin's basis in her partnership interests must be reduced by the entire amount of the §179 deductions that were allocated to her.**

Adjustment of Partnership's Basis in §179 Property

The basis of a **partnership's** §179 property must be reduced by the §179 deduction elected by the partnership. This reduction of basis must be made even if a **partner** cannot deduct all or part of the §179 deduction allocated to that partner by the partnership because of the limits.

7. Rev. Rul. 89-7, 1989-1 CB 178.

IRC §179D ENERGY EFFICIENT COMMERCIAL BUILDING DEDUCTION

IRC §179D provides a **deduction** for qualifying energy efficient **commercial** building property placed in service after December 31, 2005, and before January 1, 2014. The full deduction is equal to the cost of qualified property up to an aggregate lifetime limitation of **$1.80 per square foot** of the commercial building where the property is installed. A partial deduction of **$0.60 per square foot** is allowed for certain expenditures.

A building may be a new or existing structure. The deduction limitation is placed on the building. If two or more taxpayers install qualified property on the same building, the overall limitation of $1.80 per square foot still applies.[8] The basis of property must be reduced by the amount of any deduction claimed.

The deduction may be claimed by the taxpayer who is entitled to depreciate the property. This is usually the building owner, but it also may include a tenant who pays for the installed property. If qualified expenditures are paid by a public entity, such as a school, the deduction may be claimed by the person primarily responsible for designing the property.

QUALIFYING ENERGY EFFICIENT COMMERCIAL BUILDING PROPERTY

In order to be eligible for the deduction, the energy efficient commercial building property must meet **all** of the following conditions.

1. Depreciable
2. Installed on a building that is located in the United States
3. Installed on a building that is constructed within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America
4. Installed as part of one the following building components
    a. Interior lighting system
    b. Heating, cooling, ventilation, and hot water systems
    c. Building envelope
5. Certified as being installed as part of a plan designed to reduce the total annual energy and power costs for the above items by 50% or more in comparison to a comparable reference building

The required 50% reduction must be accomplished solely through energy and power cost reductions for the heating, cooling, ventilation, hot water, and interior lighting systems. Reductions in any other energy usage, such as receptacles, process loads, refrigeration, cooking, and elevators, are not taken into account in determining whether the 50% reduction is achieved.[9]

PARTIAL DEDUCTION

A partial deduction of **$0.60 per square foot** is allowed for certain expenditures that do not meet the 50% energy savings requirement. The rules for the partial deduction are complex. IRS Notices 2008-40 and 2006-52 provide detailed instructions on the rules applicable for each component (e.g., lighting, heating, cooling, ventilation, hot water, and building envelope).

8. IRS Notice 2006-52 (Jun. 26, 2006).
9. Ibid.

BONUS DEPRECIATION[10]

Currently, bonus first-year depreciation applies to qualified property placed in service after December 31, 2007, and before January 1, 2013. To calculate bonus depreciation, the percentage shown in the following table is applied to the adjusted basis of the property.

Date Property Placed in Service	Percentage
January 1, 2008–September 8, 2010	50%
September 9, 2010–December 31, 2010	100% or 50% [a]
January 1, 2011–December 31, 2011	100%
January 1, 2012–December 31, 2012	50%

[a] Using the election pursuant to Rev. Proc. 2011-26.

An extension of one year in the placed-in-service dates applies to certain longer-lived and transportation property. A taxpayer may elect out of bonus depreciation for one or more classes of property for any taxable year.

The bonus depreciation allowance applies **only** for the first year the property is placed in service. The allowance is taken **after** any §179 expense deduction and **before** the regular depreciation allowance under the modified accelerated cost recovery system (MACRS).

Example 7. Butterfly Company purchased earthmoving equipment costing $650,000 on July 10, 2010. The equipment is 5-year MACRS property and was the only capital asset purchased by Butterfly during the taxable year. It qualifies for both §179 expensing and 50% bonus depreciation. Butterfly's first-year deduction on the equipment is as follows.

Equipment cost	$650,000	
Less: §179 expense	(500,000)	$500,000
Adjusted basis	$150,000	
Bonus depreciation rate	× 50%	
Bonus depreciation allowed	$ 75,000	75,000
MACRS depreciation [a]		15,000
Total first-year deduction		$590,000

[a] $$\text{MACRS depreciation} = \frac{\$150{,}000 \text{ adjusted basis} - \$75{,}000 \text{ bonus depreciation}}{5 \text{ years}} \times 200\% \times 0.5$$

CALCULATING THE ALLOWANCE

Basis is increased by items paid such as sales tax, freight, and installation. Basis may be decreased by tax credits, rebates, etc. Depreciable basis for purposes of bonus depreciation is calculated after any applicable reduction for IRC §179 expense claimed on the property. The bonus depreciation allowance is then calculated by multiplying the depreciable basis of the property by the applicable percentage (as shown in the preceding table).

Finally, regular depreciation is calculated on the basis remaining after the §179 and bonus depreciation deductions.

There is no alternative minimum tax (AMT) adjustment for the property if the depreciable basis of the property for AMT purposes is the same as for regular tax purposes.

10. IRC §168(k).

QUALIFIED PROPERTY

The following types of property may qualify for bonus depreciation.

- Tangible property with a recovery period of 20 years or less depreciated under MACRS
- Water utility property (as defined in IRC §168(e)(5))
- Computer software (other than software covered by IRC §197)
- Certain leasehold improvements between unrelated parties (as defined in §168(k)(3))
- Self-constructed property acquired after **September 8, 2010** and before **January 1, 2012**

The following tests must also be met.

1. The property is purchased after December 31, 2007, and before January 1, 2013, but only if no written binding contract for the acquisition was in effect **before** January 1, 2008.
2. The property is placed in service after December 31, 2007, and before January 1, 2013. The placed-in-service date is extended one year for certain transportation property and certain property with a recovery period of 10 years or longer.
3. The taxpayer must be the original user of the property.

Property that does **not qualify** for bonus depreciation includes the following.[11]

- Property placed in service and disposed of during the same tax year
- Property converted from business use to personal use in the same tax year it is acquired
- Property **required** to be depreciated under the alternative depreciation system (ADS)
- Property for which a purchase contract was in force prior to January 1, 2008
- Property built by the taxpayer for the taxpayer's own use if construction began prior to January 1, 2008
- Listed property with business use of 50% or less
- Qualified Liberty Zone leasehold improvement property
- Qualified restaurant property (as defined in §168(e)(7))
- Qualified retail improvement property (as defined in §168(e)(8))

> **Note.** Qualified restaurant property and qualified retail improvement property **does** qualify for bonus depreciation if it also meets the definition of qualified leasehold improvement property. See the "Qualified Leasehold Improvements" section that follows.

Vehicles

Business vehicles are normally subject to limited depreciation under the listed property rules. These vehicles are defined as any 4-wheel vehicle made primarily for use on public streets, roads, and highways. Passenger automobiles subject to the listed property rules are those with an **unloaded** gross vehicle weight (GVW) of 6,000 pounds (lbs) or less. Trucks and vans with a GVW of 6,000 lbs or less are also subject to these limits.[12]

11. Instructions for Form 4562.
12. IRC §280F(d)(5).

For vehicles subject to the listed property rules for passenger automobiles that are placed in service in 2008 through 2012, the limits for vehicles qualifying for bonus depreciation are increased by $8,000. The maximum depreciation deduction allowed for a passenger automobile placed in service in 2010 or 2011 is $11,060; the limit is $10,960 if the passenger automobile is placed in service in 2008 or 2009.[13]

The maximum depreciation deduction for trucks and vans subject to the listed property rules is $11,260 if placed in service in 2011, $11,160 if placed in service in 2010 or 2008, and $11,060 if placed in service in 2009.[14]

These limits are reduced if the business use of the vehicle is less than 100%.[15] Bonus depreciation is not allowed when business use is 50% or less.[16]

Sport utility vehicles (SUV) with a GVW of more than 6,000 lbs are not subject to the listed property rules for passenger automobiles. Thus, the amount of bonus depreciation that can be taken on the purchase price of a new heavy SUV is unlimited.

Example 8. Jackson buys a new Cadillac Escalade for $70,000 on April 1, 2011. It has a GVW of 7,100 lbs and is used 100% for business. Because the vehicle is **not** subject to the listed property rules for passenger automobiles, Jackson can use 100% bonus depreciation to expense the entire purchase price of the SUV.

Example 9. Jackie buys a new Cadillac CTS Wagon for $50,000 on April 1, 2011. It has a GVW of 3,900 lbs and is used 100% for business. Because the vehicle is subject to the listed property rules for passenger automobiles, the maximum depreciation that Jackie can take on the car for 2011 is $11,060.

Note. If the Cadillac Escalade was a used vehicle, bonus depreciation would not be available. IRC §179 would be an option, but the SUV limitation of $25,000 would apply.

QUALIFIED LEASEHOLD IMPROVEMENTS

To qualify for bonus depreciation, improvements to nonresidential real property made pursuant to a lease agreement must be between unrelated parties. The leasehold improvements must meet all the following requirements.

- Made to the interior portion of the building
- Placed in service more than three years after the date the building was first placed in service
- Located in the portion of the building occupied exclusively by the lessee (or sub-lessee)

Note. Bonus depreciation for leasehold improvements is available to the taxpayer that pays for the improvements, whether that taxpayer is the lessor, lessee, or sub-lessee.

The following leasehold improvements **do not qualify.**

- Enlargements of the building
- Elevators or escalators
- Common area improvements
- Changes to the structural framework of the building

13. Rev. Procs. 2008-22, 2009-24, 2010-18, and 2011-21.

14. Ibid.

15. Depreciation and Section 179 Expense. [www.irs.gov/formspubs/article/0,,id=177054,00.html] Accessed on Mar. 11, 2011.

16. Instructions for Form 4562.

Qualified Restaurant and Retail Improvement Property

The following types of property are eligible for bonus depreciation if they also meet the above definition of qualified leasehold improvements.[17]

- **Qualified restaurant property.** Any §1250 property that is an improvement to a building is qualified if more than 50% of the building's square footage is devoted to the preparation, and seating for on-premises consumption of prepared meals.[18]
- **Qualified retail improvement property.** Any improvement to the interior portion of a building is qualified if it is open to the general public and used in the retail trade or business of selling tangible personal property.[19]

Example 10. For the past five years, Antoine has leased a building from an unrelated party for his restaurant, Antoine's Fine French Cuisine. Antoine replaces the flooring in the restaurant in November 2011. Because the flooring is both a qualified leasehold improvement and qualified restaurant property, it is eligible for bonus depreciation.

Example 11. Antoine constructs and places in service a new restaurant building in 2011. The building is not qualified leasehold improvement property and is thus not eligible for bonus depreciation.

Note. For IRC §179 purposes, qualified restaurant property and qualified retail improvement property do **not** have to meet the definition of qualified leasehold improvements. For bonus depreciation, however, they must meet that definition.

Related Parties

Leases between related parties disqualify leasehold improvements from bonus depreciation. Related parties include immediate family members, taxpayers having more than 80% ownership in common, and members of an affiliated group as defined in IRC §1504. An extensive list of additional relationships disqualifying leasehold improvements from bonus depreciation can be found in IRC §267(b). However, 80% must be substituted for 50% wherever it appears in that Code section.

EXTENDED PLACED-IN-SERVICE DATE

An extension of one year in the placed-in-service dates applies to certain longer-lived and transportation property. Property meeting the following requirements qualifies for the extension.[20]

- Property with an estimated production period exceeding one year and a cost exceeding $1 million
- Property that has a recovery period of at least 10 years or that is transportation property
- Property that is subject to the uniform capitalization rules of IRC §263A

Property meeting the above requirements must be acquired by the taxpayer after September 8, 2010, and before January 1, 2013, to qualify for the 100% bonus depreciation.[21]

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17. Rev. Proc. 2011-26, 2011-16 IRB 664.
18. IRC §168(e)(7).
19. IRC §168(e)(8).
20. IRC §168(k((2)(B).
21. IRC §168(k)(5).

STEP DOWN TO 50% BONUS DEPRECIATION

Taxpayers may elect to deduct the 50% bonus depreciation instead of 100% bonus depreciation for qualified property placed in service in the tax year that includes September 9, 2010.[22] This election must be made separately for each **class** of property and does not apply if the taxpayer makes an election not to deduct bonus depreciation for that class of property for the taxable year (see specific instructions under Rev. Proc. 2011-26).

> **Example 12.** Myra Badwell bought and placed in service several items of 5-year property for her company, Embee, Inc., during its taxable year ending December 31, 2010. Some of the items were placed in service before September 9, 2010, and others were placed in service after September 8, 2010. Embee, Inc. may elect to claim the 50% bonus depreciation for **all** its 5-year qualified property placed in service during the 2010 taxable year.

ELECTING OUT

Bonus depreciation is not optional, however taxpayers can **elect** to not deduct the bonus depreciation allowance for any class of property. This election then applies to all such property in the class placed in service during the tax year.

The election is made by attaching a statement to the timely filed (including extensions) tax return. The statement must indicate the taxpayer is not claiming the bonus depreciation allowance and the class of property for which the election applies. The election must be made separately for each class and by each person owning qualified property.

Following is a typical election statement.

> LaLa Mattresses, Inc.
> EIN: 36-9999555
> Year Ended December 31, 2011
> Election to Not Claim Special 100% Depreciation Allowance
>
> Under IRC §168(k)(2)(D)(iii), taxpayer hereby elects to not claim the special depreciation allowance for the following asset class placed in service during the taxable year ended December 31, 2011.
>
> 5-year property

If a tax return was timely filed without making an election to not claim bonus depreciation, the taxpayer can still make the election by filing an amended return within six months of the due date of the return (**excluding** extensions). The notation "Filed pursuant to section 301.9100-2" should be written on the amended return.[23]

Once made, the election cannot be revoked without IRS consent.

> **Note.** If the taxpayer elects out of bonus depreciation, the property may be subject to an AMT adjustment for depreciation.[24]

22. Rev. Proc. 2011-26, 2011-16 IRB 664.
23. Instructions for Form 4562.
24. IRC §168(k)(2)(G).

ORIGINAL USE

In order to qualify for bonus depreciation, the taxpayer must be the original user of the property. **Original use** means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer.[25]

Example 13. Marti bought a notebook computer in 2010 for use in her retail sales shop. However, frustrated by the computer's small display size, she only used it as a paperweight. In January 2011, she sold it to one of her customers, Jan, who uses it as a computer. Jan's use is not the "first use" of the property; thus, her purchase does not qualify for bonus depreciation.

Additional capital expenditures incurred by the taxpayer to recondition or rebuild property satisfy the original use requirement. However, the cost of purchasing already reconditioned or rebuilt property does not.[26]

Example 14. On August 1, 2011, Alonzo pays $20,000 to Brandon for a machine that has been previously used by Brandon in Brandon's business. Alonzo makes a $5,000 capital expenditure to recondition the machine. The $20,000 purchase price does not qualify for the additional first-year bonus depreciation deduction because the original use requirement is not met. However, the $5,000 expenditure satisfies the original use requirement and qualifies for the bonus depreciation deduction, if all the other requirements are met. This is true regardless of whether the $5,000 is added to the basis of the machine or is capitalized as a separate asset.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first use of each fractional interest. Each fractional owner is considered the original user of its proportionate share of that property.[27]

Example 15. In the ordinary course of its business, Gravitas Group sells fractional interests in its aircraft. Gravitas holds out for sale eight equal fractional interests in an aircraft. On January 1, 2010, Gravitas sells five of the eight fractional interests in the aircraft to Halo Company, an unrelated party. Halo begins to use its proportionate share of the aircraft immediately upon purchase. On January 1, 2011, Gravitas sells the remaining unsold $^3/_8$ fractional interest in the aircraft to an unrelated business, Irene, Inc.

Halo is considered the original user of its $^5/_8$ fractional interest in the aircraft and Irene is considered the original user of its $^3/_8$ fractional interest in the aircraft. Thus, assuming all other requirements are met, Halo's purchase price for its $^5/_8$ fractional interest in the aircraft qualifies for the 50% bonus depreciation deduction and Irene's purchase price for its $^3/_8$ fractional interest in the aircraft qualifies for the 100% bonus depreciation deduction. (See the table earlier in this section for the applicable bonus depreciation rates based on the date that the property is placed in service.)

If in the normal course of its business, a taxpayer initially acquires new property and holds the property primarily for sale to customers, a taxpayer that subsequently acquires the property from the person for use in the taxpayer's trade or business is considered the original user of the property.[28]

Example 16. Carter Motors, an automobile dealer, uses some of its automobiles as demonstrators in order to show them to prospective customers. The automobiles that are used as demonstrators by Carter are held by Carter primarily for sale to customers in the ordinary course of its business. On September 1, 2010, Deidre buys an automobile from Carter that was previously used as a demonstrator by Carter. Deidre plans to use the automobile solely for business purposes. The use of the automobile by Carter as a demonstrator does not constitute a "use" for purposes of the original use requirement. Accordingly, Deidre is considered the original user of the automobile. If all the other requirements are met, Deidre's purchase price of the automobile qualifies for the 50% bonus depreciation allowance, subject to the maximum depreciation deduction of $11,060 applicable to passenger automobiles placed in service in 2010.

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25. Treas. Reg. §1.168(k)-1(b)(3)(i).

26. Ibid.

27. Treas. Reg. §1.168(k)-1(b)(3)(iv).

28. Treas. Reg. §1.168(k)-1(b)(3)(ii)(B).

If a taxpayer initially acquires new property for personal use and subsequently uses the property in the taxpayer's trade or business, the taxpayer is considered the original user of the property.[29]

Example 17. Sasha buys a new automobile on January 2, 2010, which she uses solely for personal purposes until July 1, 2010. At that time, Sasha begins using the automobile exclusively in her interior decorating sole proprietorship. The original use of the automobile is considered to begin on July 1, 2010, the date Sasha converted the automobile to business use. Accordingly, the automobile is eligible for bonus depreciation.

LIKE-KIND EXCHANGE

If qualified property is acquired in a like-kind exchange, the carryover basis in the old asset plus the excess basis (boot) of the new asset qualify for bonus depreciation.[30]

Example 18. In September 2009, Goodness Grocers, a June 30 yearend corporation, acquired and placed in service convection ovens costing $20,000. The convection ovens qualify for bonus depreciation. In December 2009, Goodness acquired new walk-in coolers by exchanging the convection ovens and $5,000 cash in a like-kind exchange. The walk-in coolers also qualify for bonus depreciation.

Because the convection ovens were placed in service and disposed of during the same taxable year, no bonus depreciation deduction and no regular depreciation deduction is allowable for the ovens for the taxable year ending June 30, 2010.

The 50% bonus first-year depreciation deduction for the walk-in coolers is allowable for the remaining carryover basis at the time of replacement of $20,000 (the convection ovens' unadjusted depreciable basis of $20,000) and for the remaining excess basis at the time of replacement of $5,000 (cash paid for the walk-in coolers). Thus, the 50% bonus depreciation deduction for the remaining carryover basis at the time of replacement equals $10,000 ($20,000 × 50%) and the bonus depreciation for the remaining excess basis at the time of replacement equals $2,500 ($5,000 × 50%), for a total of $12,500 in bonus depreciation.

PERCENTAGE-OF-COMPLETION METHOD

Taxable income from a long-term contract is generally determined under the percentage-of-completion method. Under this method, the percentage of completion is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the total estimated contract costs.[31] Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred because of the taxpayer's long-term contract activities.

The Small Business Jobs Act of 2010 changed the requirements for the allocation of contract costs by allowing contractors using the percentage-of-completion method to exclude the bonus first-year depreciation taken on qualified property from the costs allocated to the contract. Instead, taxpayers calculate the percentage of completion as if MACRS depreciation were taken on the qualified property in lieu of bonus depreciation.

Qualified property for this purpose is property otherwise eligible for bonus depreciation that also meets both of the following conditions.

- It has a MACRS recovery period of seven years or less.
- It is placed in service after December 31, 2009, and before January 1, 2011 (or before January 1, 2012, for property with a longer production period).[32]

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29. Treas. Reg. §1.168(k)-1(b)(3)(ii)(A).
30. Treas. Reg. §1.168(k)-1(f)(5)(iii).
31. Treas. Reg. §1.460-4(b)(1).
32. See IRC §168(k)(2)(B).

Example 19. Cerapi Corporation is a calendar-year taxpayer required to use the percentage-of-completion method to account for a long-term contract during 2010. During 2010, Cerapi purchases and places into service equipment with a cost basis of $500,000 and a MACRS recovery period of five years. Cerapi uses the equipment exclusively in performing its obligation under the contract.

In computing the percentage of completion, the depreciation on the equipment (assuming a half-year convention) taken into account as a cost allocated to the contract for 2010 is $100,000 ($500,000 basis × 20% MACRS rate). The amount of the depreciation deduction that may be claimed by Cerapi in 2010 for the equipment is $300,000, calculated as follows.

Amount of bonus depreciation:	$500,000 basis × 50% bonus rate	$250,000
Regular depreciation:	($500,000 basis − $250,000 bonus depreciation) × 20% MACRS rate	50,000
Total depreciation deduction		$300,000

STATE CONFORMITY

Many states require that bonus depreciation deductions be added back into income for purposes of calculating state income taxes. The following states **do not conform** in whole or in part to the federal 100% bonus depreciation statutes.

Arizona	Hawaii	Maryland	New Jersey	South Carolina
Arkansas	Idaho	Massachusetts	New York	Tennessee
California	Indiana	Michigan	North Carolina	Texas
Connecticut	Iowa	Minnesota	Ohio	Vermont
District of Columbia	Kentucky	Mississippi	Oregon	Virginia
Florida	Maine	New Hampshire	Rhode Island	Wisconsin
Georgia				

As of April 2011, the following states **conform** to the federal 100% bonus depreciation statutes.

Alabama	Illinois	Montana	Oklahoma
Alaska	Kansas	Nebraska	Pennsylvania
Colorado	Louisiana	New Mexico	Utah
Delaware	Missouri	North Dakota	West Virginia

BONUS DEPRECIATION VERSUS §179 DEDUCTION

The 100% bonus depreciation and §179 deduction provide similar tax benefits. However, there are key differences in the rules that apply to bonus depreciation (both 50% and 100%) and the rules that apply to §179 deductions.

- Bonus depreciation is allowable only for new property while both new and used property qualify for the §179 deduction.
- Bonus depreciation is allowable for property with a life of 20 years or less while §179 property is generally available only for property with a life of 15 years or less.

Example 20. Street Legal, Inc., purchases $500,000 of used property and $500,000 of new property in 2011. If Street Legal expenses the new property under §179, no bonus depreciation is allowed because only new property qualifies. However, Street Legal can expense the used property under §179 and claim 100% bonus depreciation on the $500,000 of new property.

- The amount of property qualifying for the §179 deduction is capped by the annual dollar limitations. **There are no dollar limitations on property qualifying for bonus depreciation.**
- The amount of property qualifying for the §179 deduction is capped by the income of the business. **There is no business income limitation on property qualifying for bonus depreciation.**

Example 21. Humdinger Company has net income of $300,000 in 2011 before taking into account any §179 expense or bonus depreciation. Humdinger purchased new assets totaling $500,000 during the taxable year. If Humdinger utilizes the §179 deduction, it is limited to $300,000. However, Humdinger can take 100% bonus depreciation on the full $500,000 of assets purchased, generating a $200,000 loss. The loss can be carried back or elected to be carried forward.

OPTIMIZING THE DEPRECIATION DEDUCTION

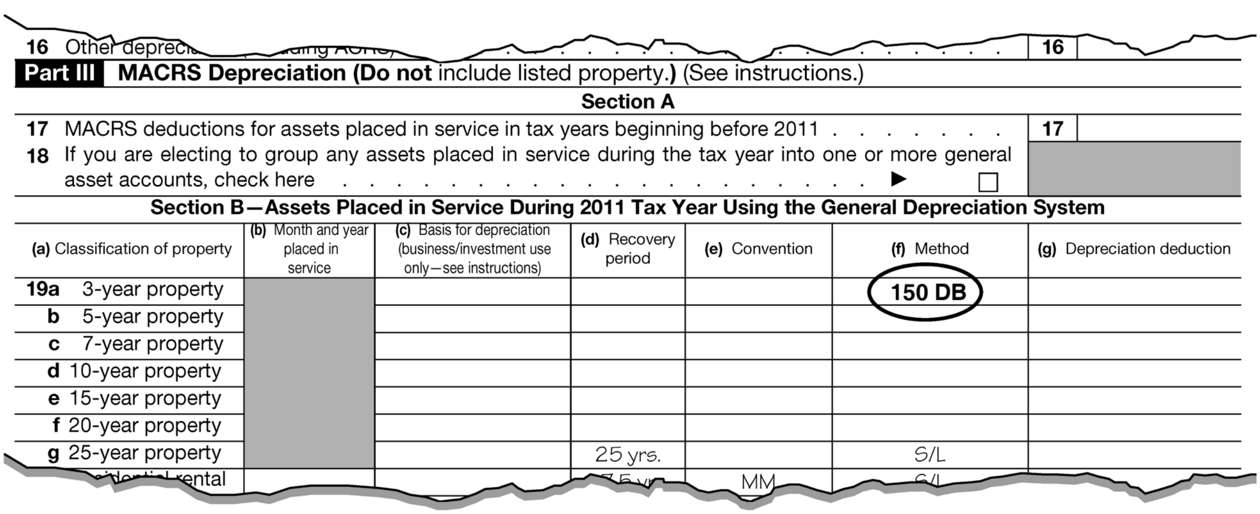
As the previous discussion has illustrated, taxpayers have an opportunity to maximize the write-off of property costs utilizing a mixture of bonus depreciation and §179 deductions. Taxpayers also have options available under MACRS that can defer depreciation into later tax years. When tax professionals advise clients about tax planning opportunities, it is important to include a discussion about the various depreciation options available.

MACRS ELECTIONS

150% Declining Balance Election

A 200% declining balance method is generally used to depreciate 3-, 5-, 7-, or 10-year property under MACRS. However, taxpayers may elect to use the 150% declining balance (DB) method on nonfarm property instead, using the same recovery period that would have been used under the 200% DB method.[33] This election is irrevocable and must be made separately for each property class.

The election is made by entering "150 DB" under column (f) in Part III of Form 4562.



16 Other deprec... | 16

Part III **MACRS Depreciation (Do not** include listed property.**)** (See instructions.)

Section A

17 MACRS deductions for assets placed in service in tax years beginning before 2011 . . . . | 17

18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here . . . . ▶ ☐

Section B—Assets Placed in Service During 2011 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property					150 DB	
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
...rental				MM		

Note. If a tax return was timely filed without making the election, the election can be made by filing an amended return within six months of the due date of the return (excluding extensions). The notation "Filed pursuant to section 301.9100-2" should be written on the election statement.

33. IRC §168(b)(2)(D).

For AMT purposes, the 150% DB method and the recovery period used for regular tax purposes applies to personal property placed in service after December 31, 1998.[34] Consequently, taxpayers who make the 150% DB election for regular income tax purposes do not need to make an AMT depreciation adjustment on the property.

Straight Line Election

Instead of using either the 200% or 150% DB methods over the applicable general depreciation system (GDS) recovery period, the taxpayer can elect to use the straight line (S/L) method over the GDS recovery period. The election is irrevocable and must be made separately for each property class. The election is made by entering "S/L" in column (f) in Part III of Form 4562.

For property placed in service after December 31, 1998, no AMT adjustment is necessary on property for which the S/L election is made.

ADS Election

Taxpayers can elect to use the alternative depreciation system (ADS) for property that qualifies for GDS. ADS uses the S/L method over fixed ADS recovery periods. Except for real estate, the ADS election must be made separately for each property class. For residential rental and nonresidential real estate, the election may be made on a property-by-property basis. The election is made by completing line 20 in Part III of Form 4562.

For property placed in service after 1998, no AMT adjustment is necessary if S/L depreciation is used for regular tax purposes.

PLANNING CONSIDERATIONS

It is sometimes advantageous for taxpayers to recover the cost of their depreciable property as quickly as possible. Therefore, electing out of bonus depreciation or electing the 150% DB method, the S/L method, or the ADS method in lieu of GDS is often not advisable. However, there are some situations in which a greater tax benefit results from minimizing the rate at which depreciation deductions are claimed.

Offset Income in High Tax-Bracket Years

The most common situation that warrants consideration of delaying the rate of depreciation deductions is one in which the taxpayer is in a low tax bracket during the initial period during which the asset is placed in service but expects to be in a higher tax bracket in future years. Thus, deferring depreciation to offset income in the higher tax-bracket years will result in a greater tax savings.

Expiring NOL Carryforward

If a business has a net operating loss (NOL) carryforward that is about to expire, it might be advisable to elect a smaller depreciation deduction in order to increase taxable income to absorb the NOL. The depreciation allowance will then be available in later years whereas there is only a limited period in which to utilize the NOL.

Refunds for Unused Research and AMT Credits

Corporations and certain automotive partnerships can elect to forgo bonus depreciation on eligible property (§168(k)(4) election). Instead, the eligible businesses can increase the limitations relating to the general business credit described in IRC §38(c) and AMT credit described in IRC §53(c). Refunds can be claimed for unused credits from tax years beginning **prior to January 1, 2006,** that are allocable to research expenditures or AMT liabilities.

34. IRC §56(a)(1)(A)(ii).

The §168(k)(4) election was first introduced in the Housing and Economic Recovery Act of 2008. The American Recovery and Reinvestment Tax Act of 2009 extended bonus depreciation and also extended the opportunity for making the §168(k)(4) election. The latest extension of bonus depreciation and the §168(k)(4) election came in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

> **Note.** The calculations involved in making the election are complex and beyond the scope of this chapter. For more information, see Rev. Procs. 2008-65, 2009-16, and 2009-33. Also, see Form 3800, *General Business Credit;* Form 8827, *Credit for Prior Year Minimum Tax — Corporations;* and the related instructions.

Depreciation Recapture

Another factor to consider in deciding whether to delay depreciation is that recaptured depreciation could be taxed at a higher rate in the year of disposition if the asset is sold at a gain. Consequently, the tax paid on the depreciation recapture in higher-bracket years could exceed the tax saved when the depreciation was claimed in the lower-bracket years. Depreciation deductions reduce self-employment (SE) income but recapture from depreciation is not subject to SE tax.

COST SEGREGATION[35]

Cost segregation is the process of separating a single purchase into multiple depreciation classes. This allows the taxpayer to maximize shorter depreciation periods instead of keeping the entire cost of the purchase lumped into one asset with a longer depreciation period.

When a purchase or project involves several types of assets, properly allocating the costs may involve a significant amount of time. The allocation may also involve estimation and will probably require the services of a firm specializing in cost-segregation studies.

BENEFITS

The most common situation that could benefit from cost segregation involves allocating building costs to tangible personal property. Because commercial real estate is generally depreciated over 39 years using the S/L method and personal property is generally depreciated over five to seven years using the double-declining method and may qualify for accelerated deductions, the immediate tax savings can be significant.

Bedford Capital Consulting, a firm specializing in cost-segregation studies, reports on its website that for every $100,000 of costs allocated to personal property instead of real estate, the taxpayer's 10-year net present value savings is approximately $28,000.[36]

35. The primary source document for this section is the *IRS Market Segment Specialization Program's Cost Segregation Audit Techniques Guide,* as revised Mar. 2008. Information from other sources is specifically footnoted.

36. [www.bedfordteam.com/cost_segregation/faqs.asp] Accessed on Mar. 31, 2011.

PROPERTY CLASSIFICATION

Property classification is a facts and circumstances test. Each component must be evaluated based on its particular use and the governing tax law.

Some less obvious examples of tangible personal property that may qualify for faster depreciation include the following.

- Patient corridor handrails
- Partitions
- Plumbing to an X-ray machine
- Billboards
- Exterior decorative lighting
- Parking lots and landscaping

WHEN TO COST SEGREGATE

Cost segregation is ideally done at the time a building is constructed. It may even be beneficial to have a cost-segregation expert involved as early as the design phase. Design choices that affect depreciation include wall partitions, floor coverings, and lighting. However, cost segregation can be done at any time.

Of course, the sooner the costs are segregated, the better the savings results. The results also are more accurate when the studies are done closer to the time of the original construction.

COST SEGREGATION AFTER DEPRECIATION STARTS

The IRS considers a change in depreciation method, recovery period, or convention resulting from a reclassification of property to be a change in method of accounting.[37] As such, the IRS requires a Form 3115, *Application for Change in Accounting Method*, to be filed according to the instructions on the form.

The cumulative depreciation deduction missed during prior years is deducted on the current year's return when a change is made in the method of accounting. Depending on the taxpayer's situation, this may not create the most favorable tax result.

STANDARDS FOR A COST-SEGREGATION STUDY

A plethora of legislative acts, court decisions, and IRS rulings have produced complex and often conflicting guidance with respect to distinguishing personal property from real estate. Related issues, such as the capitalization of interest and production costs and changes in accounting method, add to the complexity.

Unfortunately, there are no standards regarding the preparation of cost-segregation studies. Accordingly, studies vary widely in terms of the methodology, documentation, depth, format, and expertise of the studies' preparers. This lack of consistency, coupled with the complexity of the law, motivated the IRS to prepare the *Cost Segregation Audit Techniques Guide* in order to provide the foundation to better understand these studies.

37. Treas. Reg. §1.446-1(e)(2)(ii)(d).

AUDIT OF A COST-SEGREGATION STUDY

Although there is no specific methodology required for a valid cost-segregation study, taxpayers must substantiate their depreciation deductions and classifications of property. The IRS Market Segment Specialization Program's *Cost Segregation Audit Techniques Guide* (the Audit Guide) provides in-depth guidance on the characteristics of a quality study and the resulting report. A quality study, meeting the standards set forth by the IRS, may reduce the scope and depth of an examination related to cost segregation.

> **Note.** It is important to measure the cost of the study against potential tax benefits. Also, note that a cost segregation study is different from an allocation of assets acquired by purchases reported on Form 8594, *Asset Acquisition Statement* under Section 1060.

A quality study is both accurate and well documented. The resulting report should always:

- Classify assets into property classes (e.g., land, land improvements, building, equipment, furniture, and fixtures),
- Explain the rationale (including legal citations) for classifying assets as either §1245 or §1250 property, and
- Substantiate the cost basis of each asset and reconcile total allocated costs to total actual costs.

The 13 principal elements of a quality study are:

1. Preparation by an individual with expertise and experience,
2. Detailed description of the methodology,
3. Use of appropriate documentation,
4. Interviews conducted with appropriate parties,
5. Use of a common nomenclature,
6. Use of a standard numbering system,
7. Explanation of the legal analysis,
8. Determination of unit costs and engineering "take-offs,"
9. Organization of assets into lists or groups,
10. Reconciliation of total allocated costs to total actual costs,
11. Explanation of the treatment of indirect costs,
12. Identification and listing of §1245 property, and
13. Consideration of related aspects (e.g., IRC §263A, change in accounting method, and sampling techniques).

GUIDANCE FOR SPECIFIC INDUSTRIES

Proper classification of an asset depends on how the asset is used. Different industries may use the same assets in different ways. To help taxpayers and examiners properly classify property, the IRS included asset lists for several industries within the audit guide. It also included chapters on cost segregation within specific industry audit guides.

The following industries are included in the audit guide.

- Casinos
- Restaurants
- Retail industries
- Biotech and pharmaceutical industries
- Auto dealerships

CHANGE IN ACCOUNTING METHOD

AMENDING RETURN VERSUS FILING FORM 3115

Some depreciation changes may be made by filing an amended return under the revenue procedures established by the IRS. However, other depreciation changes require filing Form 3115, *Application for Change in Accounting Method.*

In general, the following are not considered changes in accounting methods and **do not require Form 3115.**[38] These changes should be made on an amended return.

1. Corrections to mathematical or posting errors
2. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is actually based on the useful life, as opposed to being based on assigned life
3. A change in computing depreciation allowances caused by a change in the **taxpayer's use** (not dispositions)
4. A change in salvage value, unless a salvage value of zero is expressly required, as in the case of ACRS, MACRS, and §197 intangibles
5. Any change in the placed-in-service date of a depreciable or amortizable asset unless provided otherwise in the Code, regulations, or other IRS guidance
6. The required change for MACRS assets from a DB method to the S/L method in the year that the S/L method produces a larger deduction

The making of a late depreciation election or the revocation of a timely valid depreciation election **requires a private letter ruling unless otherwise directed.**

A taxpayer adopts a method of accounting for depreciation by using a **permissible** method of determining depreciation on the first tax return filed, or by using the same **impermissible** method of determining depreciation **on two or more consecutively filed tax returns.**[39] Except as listed above, the following are considered changes in accounting methods and filing **Form 3115 is required.**[40]

1. A change in treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa), including assets omitted from the depreciation schedule
2. A change in treatment of property purchases from current expense to depreciable (or vice versa)
3. A change in the depreciation or amortization **method, period of recovery,** or **convention** of a depreciable or amortizable asset
4. A change from **not claiming** to **claiming** bonus depreciation, **except** when the taxpayer made an election not to claim the bonus depreciation for that property's class
5. A change from **claiming** to **not claiming** bonus depreciation for an asset that is **not qualified** for bonus depreciation, including those not qualified because an election out was made for that property's class
6. A change in salvage value to zero for an asset that should have had a zero salvage value under the Code, regulations, or other IRS guidance

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38. Treas. Reg. §1.446-1(e).

39. IRS Pub. 946, *How To Depreciate Property.*

40. Treas. Reg. §1.446-1(e)(2).

7. A change from a single-asset account to a multiple-asset account (or vice versa) or a change from one type of multiple-asset account to another

8. For depreciable or amortizable assets that are **mass assets** accounted for in multiple-asset accounts, a change in the method of identifying assets for which dispositions have occurred

   Mass assets means a group of individual items of assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, are impracticable to separately identify, and are placed in service in the same taxable year. Mass assets are not the same as assets grouped together in a general asset account.[41]

The following situations help clarify when Form 3115 is required.

Situation 1. Rhetta is the owner of Recycled Treasures, a calendar-year taxpayer. In August 2010, she purchased special tilt-proof shelving for use in her store. She accidentally included the cost of the shelving as inventory on her 2010 return. In 2011, she discovered the mistake.

To correct the mistake, she may file an amended return for 2010. Because the improper treatment was only used for one return, she has **not** adopted a method of accounting. However, under Rev. Proc. 2004-11, she may elect to file Form 3115.[42]

Situation 2. Melanie is a calendar-year taxpayer. In 2009, she purchased an electronic whiteboard for use in her sideline business of authoring books. In 2009 and 2010, she accidentally omitted the cost of the board from her returns. In 2011, she discovered the mistake.

To correct the mistake, Melanie must file Form 3115 for her 2011 return. Because she used the improper method of claiming no depreciation on two consecutive returns, she **adopted** the method and must file Form 3115 to change it.

Situation 3. In 2009, Cosmo purchased a sprocket-packing robot. Cosmo incorrectly classified the robot as 7-year property. He used the MACRS 7-year property depreciation rates on his 2009 and 2010 returns. In 2011, he realized the robot was 5-year property.

To correct the mistake, he must file Form 3115. Changing the period of recovery for an asset is a change in accounting method.

Situation 4. W. C. Cogswell is a calendar-year taxpayer. In December 2008, he purchased and placed in service a cog-stamping machine. The invoice for the machine did not arrive until January 2009. As a result, the asset was recorded in his books and records as having been placed in service in 2009. On his 2009 and 2010 returns, he depreciated the asset based on this date. In 2011, he realized that the placed-in-service date was really 2008, and therefore depreciation should have begun in 2008 instead of 2009.

To correct this mistake, Cogswell should file amended returns for 2008, 2009, and 2010. Correcting the placed-in-service date is not a change in accounting method.

REPORTING THE §481(a) ADJUSTMENT

The adjustment calculated when changing methods of accounting is commonly referred to as the "§481(a) adjustment." Rev. Proc. 2008-52 controls how the adjustment for a change in accounting method affects taxable income and on which returns the adjustment is reported.

Permissible to Permissible Method

The change from one permissible method of depreciation to another does not result in a §481(a) adjustment. However, the taxpayer must still use Form 3115 to make the change.

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41. Ibid.

42. Rev. Proc. 2004-11, Appendix Section 1.01(1)(b), IRB 2004-3.

Impermissible to Permissible Method

When changing from an impermissible method to a permissible method, the first step is to calculate the correct amount of depreciation that should have been reported for all assets improperly depreciated. This is done for both open and closed years prior to the year of change.

If the correct depreciation total is greater than the amount actually deducted, there is a negative adjustment to net income. The negative adjustment is deducted on the return for the year that the error is corrected and is reported as "other expenses" on the appropriate schedule of the tax return.[43] However, for property that was disposed of, it is deducted on the return for the year in which the disposition occurred.[44]

If the correct depreciation total is less than the amount actually deducted, there is a positive adjustment to net income. This increase in income is generally taken over four years if the taxpayer voluntarily changes the method of accounting and is reported on the tax returns as "other income."[45] However, if the resulting change is less than $25,000, the taxpayer may elect to take the entire increase into income in the year of change.[46] Also, if the taxpayer ceases the business in which the asset was used, any remaining adjustment is taken in the final year of the business.[47]

Finally, all involuntary changes in accounting method required by an IRS examination must be taken into account in the year of change.

Example 22. Kendall places in service a commercial office building in July 2006. The depreciation is computed on the purchase price of $500,000, including land. Depreciation was computed using 39-year class life as follows:

2006	$ 5,875	5.5 months (mid-month convention)
2007	12,820	
2008	12,820	
2009	12,820	
2010	12,820	
Total	$57,155	

In 2011, Kendall completes a cost-segregation study, and certain building elements are reclassified as 5-year property. An allocation is also made for the land that was purchased in 2006. The building now has a value of $300,000, plus $100,000 for land, and $100,000 for the reclassified 5-year property. Correct depreciation for prior years should have been:

	Building	Land	Equipment
2006	$ 3,525	$0	$20,000
2007	7,692	0	32,000
2008	7,692	0	19,200
2009	7,692	0	11,520
2010	7,692	0	11,520
Total	$34,293	$0	$94,240

Kendall has an IRC §481(a) adjustment for 2011 of $71,378 ($34,293 + $94,240 − $57,155). The net is a negative adjustment; therefore, she is allowed to take the full deduction in one tax year.

Applicable pages of Kendall's Form 3115 follow.

43. IRS Pub. 946, *How To Depreciate Property*.

44. Rev. Proc. 2008-52, 2008-36 IRB 587.

45. IRS Pub. 946, *How To Depreciate Property*.

46. Ibid.

47. Rev. Proc. 2008-52, 2008-36 IRB 587.

For Example 22

Form **3115** (Rev. December 2009) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

OMB No. 1545-0152

Name of filer (name of parent corporation if a consolidated group) (see instructions) **Kendall Miller**	Identification number (see instructions) **123-45-6789** Principal business activity code number (see instructions)
Number, street, and room or suite no. If a P.O. box, see the instructions. **123 Fortune Rd**	Tax year of change begins (MM/DD/YYYY) **01/01/2011** Tax year of change ends (MM/DD/YYYY) **12/31/2011**
City or town, state, and ZIP code **Somewhere, KS 67000**	Name of contact person (see instructions) **Kendall Miller**
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)	Contact person's telephone number

If the applicant is a member of a consolidated group, check this box . . . . ▶ ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box . . . . ▶ ☐

Check the box to indicate the type of applicant.

- ☑ Individual
- ☐ Corporation
- ☐ Controlled foreign corporation (Sec. 957)
- ☐ 10/50 corporation (Sec. 904(d)(2)(E))
- ☐ Qualified personal service corporation (Sec. 448(d)(2))
- ☐ Exempt organization. Enter Code section ▶
- ☐ Cooperative (Sec. 1381)
- ☐ Partnership
- ☐ S corporation
- ☐ Insurance co. (Sec. 816(a))
- ☐ Insurance co. (Sec. 831)
- ☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. (see instructions)

- ☑ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☐ Other (specify) ▶

Caution. *To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes all information requested on this Form 3115 (including its instructions), as well as any other information that is not specifically requested.*

The taxpayer must attach all applicable supplemental statements requested throughout this form.

Part I Information For Automatic Change Request

		Yes	No
1	Enter the applicable designated automatic accounting method change number for the requested automatic change. Enter only one designated automatic accounting method change number, except as provided for in guidance published by the IRS. If the requested change has no designated automatic accounting method change number, check "Other," and provide both a description of the change and citation of the IRS guidance providing the automatic change. See instructions. ▶ (a) Change No. 7 (b) Other ☐ Description ▶		
2	Do any of the scope limitations described in section 4.02 of Rev. Proc. 2008-52 cause automatic consent to be unavailable for the applicant's requested change? If "Yes," attach an explanation.		✓

Note. *Complete Part II below and then Part IV, and also Schedules A through E of this form (if applicable).*

Part II Information For All Requests

		Yes	No
3	Did or will the applicant cease to engage in the trade or business to which the requested change relates, or terminate its existence, in the tax year of change (see instructions)? . . . . If "Yes," the applicant is not eligible to make the change under automatic change request procedures.		✓
4a	Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) under examination (see instructions)? . . . . . . If "No," go to line 5.		✓
b	Is the method of accounting the applicant is requesting to change an issue (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) either (i) under consideration or (ii) placed in suspense (see instructions)?		✓

Signature *(see instructions)*

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Filer	Preparer (other than filer/applicant)
Signature and date	Signature of individual preparing the application and date
Name and title (print or type)	Name of individual preparing the application (print or type)
	Name of firm preparing the application

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Part II **Information For All Requests** (continued)	**Yes**	**No**
4c Is the method of accounting the applicant is requesting to change an issue pending (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) for any tax year under examination (see instructions)?		✓
d Is the request to change the method of accounting being filed under the procedures requiring that the operating division director consent to the filing of the request (see instructions)?		✓
If "Yes," attach the consent statement from the director.		
e Is the request to change the method of accounting being filed under the 90-day or 120-day window period?		✓
If "Yes," check the box for the applicable window period and attach the required statement (see instructions). ☐ 90 day ☐ 120 day: Date examination ended ▶ ______		
f If you answered "Yes" to line 4a, enter the name and telephone number of the examining agent and the tax year(s) under examination. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
g Has a copy of this Form 3115 been provided to the examining agent identified on line 4f?		
5a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) before Appeals and/or a Federal court?		✓
If "Yes," enter the name of the (check the box) ☐ Appeals officer and/or ☐ counsel for the government, telephone number, and the tax year(s) before Appeals and/or a Federal court. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
b Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 5a?		
c Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a Federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member) (see instructions)?		✓
If "Yes," attach an explanation.		
6 If the applicant answered "Yes" to line 4a and/or 5a with respect to any present or former consolidated group, attach a statement that provides each parent corporation's **(a)** name, **(b)** identification number, **(c)** address, and **(d)** tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a Federal court.		
7 If, for federal income tax purposes, the applicant is either an entity (including a limited liability company) treated as a partnership or an S corporation, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a Federal court, with respect to a Federal income tax return of a partner, member, or shareholder of that entity?		
If "Yes," the applicant is **not** eligible to make the change.		
8a Does the applicable revenue procedure (advance consent or automatic consent) state that the applicant does not receive audit protection for the requested change (see instructions)?		✓
b If "Yes," attach an explanation.		
9a Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in method of accounting within the past 5 years (including the year of the requested change)?		✓
b If "Yes," for each trade or business, attach a description of each requested change in method of accounting (including the tax year of change) and state whether the applicant received consent.		
c If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and returned to the IRS, or the change was not made or not made in the requested year of change, attach an explanation.		
10a Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in method of accounting, or technical advice?		✓
b If "Yes," for each request attach a statement providing the name(s) of the taxpayer, identification number(s), the type of request (private letter ruling, change in method of accounting, or technical advice), and the specific issue(s) in the request(s).		
11 Is the applicant requesting to change its **overall** method of accounting?		✓
If "Yes," check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also, complete Schedule A on page 4 of this form.		
Present method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)		
Proposed method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)		

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Part II Information For All Requests (continued)

		Yes	No
12	If the applicant is either (i) **not** changing its overall method of accounting, or (ii) is changing its overall method of accounting and also changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following:		
a	The item(s) being changed.		
b	The applicant's present method for the item(s) being changed.		
c	The applicant's proposed method for the item(s) being changed.		
d	The applicant's present overall method of accounting (cash, accrual, or hybrid).		
13	Attach a detailed and complete description of the applicant's trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application.		
14	Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions . . . . If "No," attach an explanation.	✓	
15a	Has the applicant engaged, or will it engage, in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed tax year of change determined without regard to any potential closing of the year under section 381(b)(1)?		✓
b	If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application.		
16	Does the applicant request a conference with the IRS National Office if the IRS proposes an adverse response?		✓
17	If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460, or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change.		

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.
$	$	$

Part III Information For Advance Consent Request

		Yes	No
18	Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request? . . . . If "Yes," attach an explanation describing why the applicant is submitting its request under advance consent request procedures.		
19	Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. Also, include either a discussion of the contrary authorities or a statement that no contrary authority exists.		
20	Attach a copy of all documents related to the proposed change (see instructions).		
21	Attach a statement of the applicant's reasons for the proposed change.		
22	If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? . . . . If "No," attach an explanation.		
23a	Enter the amount of **user fee** attached to this application (see instructions). ▶ $		
b	If the applicant qualifies for a reduced user fee, attach the required information or certification (see instructions).		

Part IV Section 481(a) Adjustment

		Yes	No
24	Does the applicable revenue procedure, revenue ruling, notice, regulation, or other published guidance require the applicant to implement the requested change in method of accounting on a cut-off basis rather than a section 481(a) adjustment? . . . If "Yes," do not complete lines 25, 26, and 27 below.		✓
25	Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ **-71,378** Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.		

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Part IV	**Section 481(a) Adjustment** (continued)	**Yes**	**No**
26	If the section 481(a) adjustment is an increase to income of less than $25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change?		
27	Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? If "Yes," attach an explanation.		✓

Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I below must be completed.)

Part I **Change in Overall Method** (see instructions)

1 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also, attach a statement providing a breakdown of the amounts entered on lines 1a through 1g.

		Amount
a	Income accrued but not received (such as accounts receivable)	$
b	Income received or reported before it was earned (such as advanced payments). Attach a description of the income and the legal basis for the proposed method	
c	Expenses accrued but not paid (such as accounts payable)	
d	Prepaid expenses previously deducted	
e	Supplies on hand previously deducted and/or not previously reported	
f	Inventory on hand previously deducted and/or not previously reported. Complete Schedule D, Part II	
g	Other amounts (specify). Attach a description of the item and the legal basis for its inclusion in the calculation of the section 481(a) adjustment. ▶	
h	**Net section 481(a) adjustment** (Combine lines 1a–1g.) Indicate whether the adjustment is an increase (+) or decrease (-) in income. Also enter the net amount of this section 481(a) adjustment amount on Part IV, line 25.	$

2 Is the applicant also requesting the recurring item exception under section 461(h)(3)? ☐ **Yes** ☐ **No**

3 Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. Also attach a statement specifying the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, attach a statement explaining the differences.

Part II **Change to the Cash Method For Advance Consent Request** (see instructions)

Applicants requesting a change to the cash method must attach the following information:

1 A description of inventory items (items whose production, purchase, or sale is an income-producing factor) and materials and supplies used in carrying out the business.

2 An explanation as to whether the applicant is required to use the accrual method under any section of the Code or regulations.

Schedule B—Change to the Deferral Method for Advance Payments (see instructions)

1 If the applicant is requesting to change to the Deferral Method for advance payments described in section 5.02 of Rev. Proc. 2004-34, 2004-1 C.B. 991, attach the following information:

a A statement explaining how the advance payments meet the definition in section 4.01 of Rev. Proc. 2004-34.

b If the applicant is filing under the automatic change procedures of Rev. Proc. 2008-52, the information required by section 8.02(3)(a)-(c) of Rev. Proc. 2004-34.

c If the applicant is filing under the advance consent provisions of Rev. Proc. 97-27, the information required by section 8.03(2)(a)-(f) of Rev. Proc. 2004-34.

2 If the applicant is requesting to change to the deferral method for advance payments described in Regulations section 1.451-5(b)(1)(ii), attach the following.

a A statement explaining how the advance payments meet the definition in Regulations section 1.451-5(a)(1).

b A statement explaining what portions of the advance payments, if any, are attributable to services, whether such services are integral to the provisions of goods or items, and whether any portions of the advance payments that are attributable to non-integral services are less than five percent of the total contract prices. See Regulations sections 1.451-5(a)(2)(i) and (3).

c A statement explaining that the advance payments will be included in income no later than when included in gross receipts for purposes of the applicant's financial reports. See Regulations section 1.451-5(b)(1)(ii).

d A statement explaining whether the inventoriable goods exception of Regulations section 1.451-5(c) applies and if so, when substantial advance payments will be received under the contracts, and how the exception will limit the deferral of income.

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For Example 22

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Part III **Method of Cost Allocation** (see instructions) (continued)

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

		Present method	Proposed method
1	Marketing, selling, advertising, and distribution expenses		
2	Research and experimental expenses not included in Section B, line 26		
3	Bidding expenses not included in Section B, line 22		
4	General and administrative costs not included in Section B		
5	Income taxes		
6	Cost of strikes		
7	Warranty and product liability costs		
8	Section 179 costs		
9	On-site storage		
10	Depreciation, amortization, and cost recovery allowance not included in Section B, line 11		
11	Other costs (Attach a list of these costs.)		

Schedule E—Change in Depreciation or Amortization (see instructions)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants ***must*** provide this information for each item or class of property for which a change is requested.

Note. *See the* ***List of Automatic Accounting Method Changes*** *in the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400I, 1400L, or former section 168.* ***Do not*** *file Form 3115 with respect to certain late elections and election revocations (see instructions).*

1 Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? ☐ **Yes** ☑ **No**
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? ☐ **Yes** ☑ **No**
If "Yes," enter the applicable section ▶ ____________

3 Has a depreciation, amortization, or expense election been made for the property (e.g., the election under sections 168(f)(1), 179, or 179C)? ☐ **Yes** ☑ **No**
If "Yes," state the election made ▶ ____________

4a To the extent not already provided, attach a statement describing the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? ☐ **Yes** ☐ **No**

c Is the property public utility property? ☐ **Yes** ☑ **No**

5 To the extent not already provided in the applicant's description of its present method, attach a statement explaining how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, attach a statement of the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information for both the present (if applicable) and proposed methods:

a The Code section under which the property is or will be depreciated or amortized (e.g., section 168(g)).

b The applicable asset class from Rev. Proc. 87-56, 1987-2 C.B. 674, for each asset depreciated under section 168 (MACRS) or under section 1400L; the applicable asset class from Rev. Proc. 83-35, 1983-1 C.B. 745, for each asset depreciated under former section 168 (ACRS); an explanation why no asset class is identified for each asset for which an asset class has not been identified by the applicant.

c The facts to support the asset class for the proposed method.

d The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)).

e The useful life, recovery period, or amortization period of the property.

f The applicable convention of the property.

g A statement of whether or not the additional first-year special depreciation allowance (for example, as provided by section 168(k), 168(l), 168(m), 168(n), 1400L(b), or 1400N(d)) was or will be claimed for the property. If not, also provide an explanation as to why no special depreciation allowance was or will be claimed.

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For Example 22

Kendall Miller
123-45-6789 Federal Statements

Depreciation

Statement 1 — Form 3115, Page 3, Part II, Line 13 — Description of Trade(s) or Business(es)

Rental of Commercial Building

Depreciation

Statement 2 — Form 3115, Page 3, Part IV, Line 25 — Computation & Explanation for Sec. 481(a) Adjustment

Depreciation on building and land originally — $57,155

Depreciation on reclassified 5-year building equipment originally — $0

Cost-segregation study determined building has a basis of $300,000

Land has a basis of $100,000

Reclassified 5-year building equipment has a basis of $100,000

Depreciation computed using correct basis — $128,533

Therefore, taxpayer has a negative adjustment of $71,378

Building

Statement 3 — Form 3115, Page 8, Part III, Sch. E, Line 4a — Description of Property Being Changed

Type of Property	Year Property Placed in Service	Trade/Business Use
Commercial building	2006	Rental
Reclassified 5-year building equipment	2006	Rental
Land	2006	Rental

Building

Statement 4 — Form 3115, Page 8, Part III, Sch. E, Line 5 — Treatment of Property under Present Method

Property was being depreciated using 39-year straight line method with no allocation to land or reclassified 5-year building equipment. Cost-segregation study provided information necessary to make the allocation.

Building

Statement 5 — Form 3115, Page 8, Part III, Sch. E, Line 7 — Information under Present/Proposed Method

Description	Present Method	Proposed Method
7(a): Code section property is depreciated/amortized	168	168
7(b,c): Asset class under §168	39	5
7(d): Depreciation/amortization method	MACRS	MACRS
7(f): Applicable convention of property	MM	HY
7(g): N/A		

Building

Statement 6 — Form 3115, Page 8, Part III, Sch. E, Line 7c — Facts to Support Asset Class

Cost-segregation study was provided by a licensed appraiser.

DEPRECIATION RULES FOR LIKE-KIND EXCHANGE

GENERAL RULE

IRS Notice 2000-4 provides mandatory depreciation rules for MACRS property acquired on or after January 3, 2000, and on or before February 27, 2004, in a like-kind exchange (or in an involuntary conversion). For property acquired after February 27, 2004, the regulations under IRC §168 control the method and manner of depreciating MACRS property acquired in a like-kind exchange.[48]

Before the IRS issued Notice 2000-4, when property was acquired in a like-kind exchange (or involuntary conversion), the remaining basis in the relinquished property was added to any new basis in the acquired property and the total was depreciated over the life of the acquired property. However, under Notice 2000-4 and the regulations under §168, MACRS property acquired in a like-kind exchange is treated as having two cost components for depreciation purposes — the **old basis** and the **new basis.** The old basis is the remaining basis from the relinquished property. This component of the replacement property's basis continues to be depreciated over the remaining recovery period, and using the same depreciation method and convention as the relinquished property. The new basis is the boot, if any, paid in the exchange. This is required to be separately depreciated as newly purchased MACRS property.

Note. While there are two cost components for depreciation purposes, the asset continues to have a single adjusted cost basis for purposes of calculating any gain or loss on disposition.

Example 23. Taylor Sloe purchased a new copier in July 2010 at a cost of $30,000. Taylor did not purchase any other assets during the tax year. She elected out of bonus depreciation and did not claim a §179 deduction. Thus, her depreciation for the copier for 2010 is $6,000 ($30,000 × 20%). In January 2011, Taylor trades the copier for a new model, paying $5,000 boot. Taylor makes no other acquisitions during the year. She elects out of bonus depreciation and does not claim a §179 deduction. Her **2011** depreciation is calculated as follows.

Old basis: $30,000 × 32%	$ 9,600
New basis: $5,000 × 20%	1,000
Total 2011 depreciation	$10,600

Observation. Tax practitioners must determine how to link the different components of the same asset following a trade. It may be helpful to renumber or reorder the old asset in order to group it with the current location of the new asset on the depreciation schedule. In addition, the asset may need to be relabeled.

ASSETS OTHER THAN PASSENGER VEHICLES

The depreciation rules established by the regulations specify one special set of rules for trades of passenger vehicles. For traded assets other than passenger vehicles, the depreciation rules take the form of the following 4-step process.

Step 1. Calculate the depreciation on the traded (relinquished) asset using the applicable method and convention before determining the eligible basis for depreciation. If the replacement property is qualified property, the remaining basis (carryover basis) in the old asset plus the boot of the new asset qualify for bonus depreciation. Only the boot paid is eligible for an IRC §179 election, including assets omitted from the depreciation schedule.

Step 2. Determine the IRC §179 expense election amount and reduce the basis.

Step 3. Apply the depreciation rules of Treas. Reg. §1.168(i)-6 to the carryover basis of the relinquished asset.

48. TD 9314, 2007-14 IRB 845.

Replacement Property Has:	Applicable Rule
Same MACRS recovery period and **same or faster** depreciation method	(a) Apply the same depreciation method and convention to the carryover basis as used for the relinquished property (b) Elect out of rules under Treas. Reg. §1.168(i)-6(i)
MACRS recovery period of replacement asset **shorter** than traded asset and **same or faster** depreciation method	(a) Apply the same depreciation method and convention to the carryover basis as used for the relinquished property (b) Elect out of rules under Treas. Reg. §1.168(i)-6(i)
MACRS recovery period of replacement asset **longer** than traded asset and **same or slower** depreciation method	(a) Apply the longer recovery period and slower depreciation method to the carryover basis (b) Elect out of rules under Treas. Reg. §1.168(i)-6(i)

Note. As noted in the preceding table, an election out of the procedures of the Treasury regulation can be made. If the election is made, the entire basis of the replacement asset (reflecting both the remaining adjusted basis of the relinquished property and any boot paid) is depreciated using the recovery period for the replacement asset. Depreciation begins on the date the replacement property is placed in service. Electing out is done on an asset-by-asset basis by the due date (including extensions) of the return for the year of replacement. A statement should be attached to the return indicating "Election Made under Section 1.168(i)-6(i)."

Step 4. Depreciate the remaining boot basis as of the date of acquisition using the regular IRC §168 recovery periods, depreciation methods, and conventions.

Observation. For purposes of determining whether the mid-quarter convention applies, boot is taken into account in the quarter in which the replacement property is placed in service and the carryover basis is not taken into account.[49]

Although electing out of the procedures of the Treasury regulation may seem the simplest route to compliance, it produces the smallest depreciation deduction in the first year.

49. Special rules apply if property is acquired (but not through a like-kind exchange) and disposed of in a like-kind exchange in the same taxable year. See Treas. Reg. §1.168(i)-6(f).

Example 24. On August 1, 2006, Noah Surveying Equipment purchases and places in service a metalworking lathe for $10,000. The lathe is 7-year property and the half-year convention applies. On August 1, 2011, Noah acquires a new lathe by trading the old lathe and paying an additional $10,000.

Like-Kind Exchange Rules Apply

Date	Property	Accumulated Depreciation as of Dec. 31, 2010	2011 Depreciation	Remaining Basis
August 1, 2006	Lathe (cost $10,000)	$7,769	$ 892	$1,339
August 1, 2011	Boot paid for lathe ($10,000)		1,429	8,571
			$2,321	$9,910

Election Made under Treas. Reg. §1.168(i)-6(i)

Date	Property	Accumulated Depreciation as of Dec. 31, 2010	2011 Depreciation (½-Year)	Remaining Basis
August 1, 2006	Lathe (cost $10,000)	$7,769	$ 446	$ 1,785
August 1, 2011	Lathe ($10,000 boot + $1,785 carryover basis)		1,684	8,316
			$2,130	$10,101

HANDLING DEPRECIATION FOR TRADED PASSENGER VEHICLES

Under the regulations, the taxpayer's basis in a replacement MACRS passenger automobile is composed of two elements. The first element is the exchanged basis and the second element is the boot, if any. The relinquished automobile is subject to the §280F limits in effect when the relinquished automobile was placed in service by the taxpayer. The replacement automobile is subject to the §280F limits in effect at the time of replacement.[50]

The following ordering rules determine the depreciation deductions for both the relinquished automobile and the replacement automobile.[51]

Step 1. The depreciation deduction for the relinquished automobile for the year of disposition to the extent of the smaller of the relinquished automobile's §280F limit and the replacement automobile's §280F limit, if the year of disposition is the year of replacement (If the year of replacement is a taxable year subsequent to the year of disposition, the allowable depreciation deduction for the relinquished automobile for the year of disposition is limited to the relinquished automobile's §280F limit.)

Step 2. The bonus depreciation on the carryover basis of the replacement automobile to the extent that the replacement automobile's §280F limit exceeds the amount determined in Step 1

Step 3. The depreciation deduction on the carryover basis of the replacement automobile to the extent of the excess, if any, that the smaller of the replacement automobile's §280F limit and the relinquished automobile's §280F limit exceeds the sum of the amounts allowable under Steps 1 and 2

Step 4. Any §179 deduction on the boot of the replacement automobile to the extent the replacement automobile's §280F limit exceeds the sum of the amounts allowable under Steps 1–3

Step 5. The bonus depreciation on the boot of the replacement automobile to the extent the replacement automobile's §280F limit exceeds the sum of the amounts allowable under Steps 1–4

Step 6. The depreciation deduction for the boot of the replacement automobile to the extent the replacement automobile's §280F limit exceeds the sum of the amounts allowable under Steps 1–5

Example 25. Dennis purchased a car in 2007 for $30,000, which he used solely in his business. In 2010, he exchanged the car plus $15,000 cash for a new vehicle which he plans to also use solely for business purposes. No IRC §179 allowance or additional first-year bonus depreciation was claimed on the car purchased in 2007. Dennis depreciated the car using the 200% DB method and the half-year convention.

Dennis wants to utilize bonus depreciation for the replacement vehicle but does not plan to take any §179 deduction. The 2010 depreciation limit for passenger automobiles to which bonus depreciation applies is $11,060.[52]

Dennis's annual depreciation deduction on the relinquished car is shown below.

Year	§280F Annual Limit	Depreciation Deduction	Deduction Limitation
2007	$2,960	$6,000	$2,960
2008	4,800	9,600	4,800
2009	2,850	5,760	2,850
2010	1,775	3,878	1,775

50. Treas. Reg. §1.168(i)-6(d)(3)(i).

51. Treas. Reg. §1.168(i)-6(d)(3)(ii).

52. Rev. Proc. 2010-18, 2010-9 IRB 427.

Each deprecation deduction is computed using 40% as the double declining balance rate for 5-year property. Fifty percent is used to reflect the half-year convention in the acquisition year and trade-in year. The computations are as follows:

- 2007 (year of acquisition): $30,000 × 40% × 50% = $6,000
- 2008: ($30,000 – $6,000) × 40% = $9,600
- 2009: ($30,000 – $6,000 − $9,600) × 40% = $5,760
- 2010 (trade-in year): ($30,000 – $2,960 – $4,800 – $2,850) × 40% × 50% = $3,878

In accordance with Treas. Reg. §1.168(i)-6(e), the deduction in the year of the relinquished vehicle's disposition is determined by multiplying the "unadjusted depreciable basis" by the recovery percentage for the year of disposition. The product is then multiplied by .50 under the half-year convention.

The carryover basis of the replacement vehicle is calculated by reducing the original cost of the acquired vehicle by the depreciation actually allowed on the replacement vehicle before the trade-in. This is computed as follows:

Original purchase price	$30,000
Less: annual limit 2007	(2,960)
Less: annual limit 2008	(4,800)
Less: annual limit 2009	(2,850)
Less: annual limit 2010	(1,775)
Carryover basis	$17,615

Bonus and regular depreciation are computed on the carryover basis without regard to the §280F limits:

Bonus depreciation ($17,615 × 50%)	$8,808
Regular depreciation ($17,615 – $8,808) × 40% × .50	1,761

Note. If Dennis purchased the replacement vehicle in 2011, the applicable bonus depreciation rate would be 100%; thus, there would be no regular depreciation.

Bonus depreciation, the §179 deduction, and regular depreciation are computed on the boot without regard to the §280F limit.

Bonus depreciation on boot ($15,000 × 50%)	$7,500
§179 deduction	N/A
Regular first-year depreciation (($15,000 – $7,500) × 40% × .50)	1,500

The ordering rules are then applied as follows:

Step 1. The depreciation deduction for the relinquished automobile is the smaller of:

Replacement automobile's §280F limit	$11,060
Relinquished automobile's §280F limit	1,775
Result	$ 1,775

Step 2. The bonus depreciation allowed on the carryover basis of the replacement automobile is computed as follows:

Replacement automobile's §280F limit	$11,060
Less: result from Step 1	(1,775)
Bonus depreciation limit	$ 9,285
Bonus depreciation computed on carryover basis without regard to §280F limits	8,808
Bonus depreciation allowed on carryover basis	$ 8,808

Step 3. The regular depreciation deduction on the carryover basis of the replacement automobile ($1,761) is allowed to the extent of the excess, if any, of:

Smaller of the relinquished automobile's §280F limit ($1,775) or replacement automobile's §280F limit ($11,060)	$ 1,775
Less: sum of Steps 1 and 2	(10,583)
Amount of regular depreciation allowed	0

Step 4. Not applicable (no §179 deduction taken)

Step 5. The bonus depreciation allowed on the boot is calculated as follows:

Replacement automobile's §280F limit	$11,060
Less: Step 1 result	(1,775)
Less: Step 2 result	(8,808)
Less: Step 3 result	0
Less: Step 4 result	0
Bonus depreciation allowed on boot	$ 477

Step 6. Since the §280F limit for the replacement automobile is used up in the previous steps, no portion of the regular depreciation deduction for the boot ($1,500) is allowed.

Note. An election out of the above rules can be made when dealing with the like-kind exchange of a passenger vehicle subject to the IRC §280F limitations. The election out is made under Treas. Reg. §1.168(i)-6(i) as described earlier. Electing out simplifies reporting of the transaction and may be important if a taxpayer trades a passenger vehicle (subject to the §280F limits) for a vehicle with a GVW of more than 6,000 pounds. If the election out is not made, the general depreciation rule for passenger vehicles applies. As a result, the depreciation caps continue to apply to the remaining adjusted basis of the traded vehicle. **If the election out is made, the remaining adjusted basis of the traded vehicle is no longer subject to the IRC §280F depreciation limits.**

RECAPTURE

Taxpayers must keep in mind that all or part of the gain on the disposition of depreciable property may be recaptured as ordinary income. To calculate the recapture amount, adequate records must be maintained that show the depreciation allowed or allowable on the property. **Depreciation allowed** is the amount that was actually deducted, including any §179 expense and bonus depreciation, as well as regular depreciation. **Depreciation allowable** is the amount to which the taxpayer was actually entitled.

Recapture of property under IRC §§1245, 1250, 1252, 1254, and 1255 is reported in Part III of Form 4797, *Sales of Business Property*. Recapture of property under §179 is reported in Part IV of Form 4797.

§1245 PROPERTY

When §1245 property is sold, taxpayers are required to report as ordinary income the lesser of the gain realized or the depreciation allowed or allowable on the asset. In general, this rule applies to depreciable personal property and certain types of real property, such as single-purpose agricultural and horticultural structures and property used as an integral part of production.

The depreciation and amortization that must be recaptured includes the following.

1. Ordinary depreciation deductions
2. Bonus depreciation
3. Amortization deductions for the following costs
    a. Lease acquisition
    b. Lessee improvements
    c. Certified pollution control facilities
    d. Certain reforestation expenses
    e. IRC §197 intangibles
4. §179 deductions
5. Deductions for the following costs
    a. Removing barriers to the disabled and elderly
    b. Tertiary injectant expenses
    c. Depreciable clean-fuel vehicles and refueling property
    d. Environmental clean-up costs
    e. Certain reforestation expenses
    f. Qualified disaster expenses
6. Basis reduction for the investment credit
7. Basis reduction for the qualified electric vehicle credit

Example 26. In February 2009, Karla bought and placed in service office furniture that cost $15,000. Her MACRS deductions for the furniture totaled $4,593 for 2009–2010. Karla sells the furniture in May 2011 for $13,000. The MACRS deduction for 2011, the year of sale, is $875. The gain subject to recapture as ordinary income is calculated as follows.

1	Amount realized		$13,000
2	Cost	$15,000	
3	Less: depreciation	(5,468)	
4	Adjusted basis	$ 9,532	(9,532)
5	Gain realized		$ 3,468
6	Gain treated as ordinary income (lesser of line 3 or line 5)		$ 3,468

The transaction is reported on Form 4797, Part III.

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Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Office furniture	02/01/2009	05/10/2011
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	13,000			
21 Cost or other basis plus expense of sale	21	15,000			
22 Depreciation (or depletion) allowed or allowable	22	5,468			
23 Adjusted basis. Subtract line 22 from line 21	23	9,532			
24 Total gain. Subtract line 23 from line 20	24	3,468			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	5,468			
b Enter the **smaller** of line 24 or 25a	25b	3,468			
property: If straight line depreciation was used					

§1250 PROPERTY

Upon the sale or transfer of any asset defined as §1250 property, the lesser of the gain realized or the depreciation claimed in excess of S/L depreciation generally is reported as ordinary income. IRC §1250 property includes all depreciable real property that is not §1245 property.

MACRS Property

IRC §1250 recapture does not apply to dispositions of the following MACRS property placed in service after 1986.

- 27.5-year (or 40-year, if elected) residential real property (except for 27.5-year qualified New York Liberty Zone property acquired after September 10, 2001)
- 22-, 31.5-, or 39-year (or 40-year, if elected) nonresidential real property (except for 39-year qualified New York Liberty Zone property acquired after September 10, 2001, and property for which the taxpayer elected a commercial revitalization deduction)

ACRS Property

Real property depreciable under the pre-1987 ACRS rules generally is subject to recapture under §1245. However, the following types of property are depreciated under the ACRS S/L method and are treated as §1250 property for purposes of recapture.

- 15-, 18-, or 19-year real property and low-income housing that is residential rental property
- 15-, 18-, or 19-year real property and low-income housing that is used mostly outside the United States
- 15-, 18-, or 19-year real property and low-income housing for which a S/L election was made
- Low-income rental housing as described in clause (i)–(iv) of §1250(a)(1)(B)

Additional Corporate Recapture

Under IRC §291, a C corporation that realizes a gain on §1250 property disposed of during the taxable year may be required to recapture part of the depreciation claimed on the property even though recapture is not otherwise required. The amount treated as ordinary income is 20% of the excess, if any, of:[53]

1. The amount which would be treated as ordinary income if the property were §1245 property, **minus**
2. The amount treated as ordinary income under §1250.

If the corporation used the S/L method of depreciation, the ordinary income is 20% of the amount figured under §1245.

Example 27. Amazonia, Inc., a C corporation, placed nonresidential real property in service in 2001. The building cost $1 million and was sold in 2011 for $1.3 million. For the years 2001–2011, $320,000 of depreciation was claimed on the property. Although the building is not subject to recapture under §1250, Amazonia is subject to recapture under §291.

The amount of the gain that would be subject to recapture under §1245 is shown below.

1	Amount realized		$1,300,000
2	Cost	$1,000,000	
3	Less: depreciation	(320,000)	
4	Adjusted basis	$680,000	(680,000)
5	Gain realized		$ 620,000
6	Gain treated as ordinary income (lesser of line 3 or line 5)		$ 320,000

Because the amount that would be treated as ordinary income under §1245 exceeds the amount treated as ordinary income under §1250 by $320,000 ($320,000 − $0), the amount recaptured as ordinary income under §291 is $64,000 ($320,000 × 20%). This is entered on line 26f of Form 4797.

b	Enter the sma[...] 24 or 25a	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a				
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c	Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d	Additional depreciation after 1969 and before 1976	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f	64,000			
g	Add lines 26b, 26e, and 26f	26g				
27	**If section 1252 property:** Skip this section if you did not [...]					

53. IRC §291(a)(1).

Because there is no preferential capital gains rate for corporations, the §291 adjustment is usually not a major consideration. However, the recharacterization of income will have an impact in years in which the C corporation has capital losses in excess of capital gains because the excess capital losses of the corporation cannot be used to offset ordinary income. However, a capital loss may be carried back three years and forward five years.[54]

IRC §291 also applies to an S corporation that was a C corporation in any of the three immediately preceding taxable years.[55]

§1252 PROPERTY

Gains from the disposition of certain farmland held for less than 10 years are subject to recapture as ordinary income under IRC §1252. This includes land in which soil and water conservation or land-clearing expenses have been deducted.

> **Note.** Because land is not depreciable property, details on recapture under §1252 are not covered here. For more information, see Treas. Reg. §1.1252-1 and the instructions for Form 4797.

§1254 PROPERTY

Under IRC §1254, part or all of the gain on the disposition of oil, gas, or geothermal property is treated as ordinary income. The gain treated as ordinary income is the **lesser** of the following two amounts.[56]

1. The total of the following §1254 costs
   - **a.** For property placed in service after December 31, 1986
     - **i.** The aggregate amount of expenditures deducted under IRC §§263, 616, or 617 with respect to the property that were not included in the adjusted basis of the property
     - **ii.** The deductions for depletion under §611 that reduced the adjusted basis of the property
   - **b.** For property placed in service before January 1, 1987
     - **i.** The aggregate amount of costs paid or incurred after December 31, 1975, with respect to the property that were deducted as intangible drilling and development costs under IRC §263(c) and that were not reflected in the adjusted basis of the property
     - **ii.** The amount by which the deduction for depletion under §611 would have been increased if the costs had been charged to a capital account rather than deducted
2. The gain on the disposition of the property

§1255 PROPERTY

Payments that farmers receive under certain cost-sharing conservation programs are excluded from gross income under IRC §126. Under IRC §1255, a portion of the payments may be recaptured as ordinary income upon the disposition of the property to which the §126 payments relate.

> **Note.** Because IRC §1255 does not pertain to recapture of depreciation, the details are not covered here. For more information, see Treas. Reg. §16A.1255-1.

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54. IRC §1212(a)(1).

55. IRC §1363(b)(4).

56. Treas. Reg. §1.1254-1.

§179 PROPERTY

If the business usage of §179 property drops below 50% at any time before the end of the property's recovery period, the taxpayer must recapture any benefit derived from the §179 deduction. The recapture is calculated on Form 4797, Part IV, in the taxable year in which the usage of the property drops below 50%.[57] The recapture amount is then reported as "other income" on the same form or schedule on which the taxpayer took the depreciation deduction. The basis of the asset is increased by the recapture amount.

If the property is not listed property, the recapture amount is calculated as follows.[58]

1. Calculate the depreciation that would have been allowable on the §179 deduction that was claimed. Begin with the year the property was placed in service and include the year of recapture.
2. Subtract the depreciation figured in (1) from the §179 deduction claimed. The result is the recapture amount.

Example 28. In January 2009, Jordan bought and placed in service a copier costing $10,000. The copier is 5-year property and is used in Jordan's accounting practice. Jordan elected to expense $5,000 of the purchase under §179. He used the copier solely for business in 2009 and 2010. In 2011, Jordan's wife used the copier in her volunteer activities, which reduced Jordan's business use of the copier to 40%. He figures his recapture amount as follows.

§179 deduction claimed in 2009		$5,000
Allowable depreciation 2009	$1,000	
Allowable depreciation 2010	1,600	
Allowable depreciation 2011 ($960 × 40%)	384	
Total allowable depreciation	$2,984	(2,984)
2011 recapture amount		$2,016

Jordan must recapture $2,016 as ordinary income in 2011. This is reported on Part IV of Form 4797, as shown here.

other than casu... orm 4797 ... 32

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33	5,000	
34	Recomputed depreciation (see instructions)	34	2,984	
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	2,016	

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The recapture amount on listed property is calculated as the excess, if any, of:[59]

1. The depreciation allowable for the property, including any §179 deduction and bonus depreciation claimed, for the years prior to the year the business usage of the property fell to less than 50%, **minus**
2. The depreciation that would have been allowable for those years if the property had not been used predominantly for qualified business purposes in the year it was placed in service. This amount is determined by calculating the depreciation using the S/L method and the ADS recovery period.

57. Treas. Reg. §1.179-1(e).

58. IRS Pub. 946, *How to Depreciate Property.*

59. Ibid.

DEPRECIATION ON FOREIGN PROPERTY

Depreciation on property located outside the United States is determined under ADS.[60] Property is considered used predominantly outside the United States if it is physically located outside the United States during more than 50% of the taxable year. If the property is placed in service after the first day of the taxable year, the relevant period begins on the date on which the property is placed in service and ends on the last day of the taxable year.

The depreciation deduction under ADS is determined using the S/L method, the applicable convention, and the recovery period as shown below.[61]

Description of Property	Recovery Period
Personal property with no class life	12 years
Nonresidential real and residential rental property	40 years
Railroad grading or tunnel bore or water utility property	50 years
All other property	The class life

Certain property is exempt from the requirement to use ADS, even if the property is used predominantly outside the United States. This property includes, but is not limited to, the following.[62]

- Aircraft registered with the Federal Aviation Agency and operated to and from the United States
- Certain rolling stock used inside and outside the United States
- Any vessel documented under the laws of the United States and operated in U.S. foreign or domestic commerce
- Any motor vehicle of a U.S. person operated to and from the United States
- Any container of a U.S. person used in the transportation of property to and from the United States

ELECTION TO NOT APPLY IRC §263A

Under the uniform capitalization rules, taxpayers must include certain direct and indirect costs in the basis of property produced or in inventory costs in lieu of claiming such costs as a current deduction. In a farming business, the uniform capitalization rules generally apply to the direct and indirect costs of producing plants or animals.

Farmers can elect to not apply the uniform capitalization rules for plants with a preproductive period of more than two years. The election cannot be made by corporations, partnerships, or tax shelters that are required to use an accrual method of accounting. The election also does not apply to costs incurred for the planting, cultivation, maintenance, or development of any citrus or almond grove within the first four years of planting.

Farmers who qualify to use the uniform capitalization rules of §263A, but elect not to, must use ADS for all property used in any of their farming businesses and placed in service in any tax year during which the election is in effect.[63]

60. IRC §168(g)(1).
61. IRC §168(g)(2).
62. IRC §168(g)(4).
63. Treas. Reg. §1.263A-4(d).