Chapter 2: Depreciation

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Please note. Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

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Other chapter contributors and reviewers are listed at the front of this volume.

Throughout the 2020 *University of Illinois Federal Tax Workbook,* there are topics affected by recent major legislation, notably the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020, and the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. For the reader's convenience in locating these issues, there are icons in the left margin highlighting areas of impact and their source.


CARES Act


SECURE Act

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

One of the most popular incentives is the IRC §179 deduction, which has undergone several changes. Another is bonus depreciation, which is also discussed in this chapter.

Additionally, this chapter includes information about other changes enacted by the Tax Cuts and Jobs Act (TCJA) and the CARES Act that affect depreciation. The chapter concludes with tips for optimizing the depreciation deduction.

CAPITALIZATION VERSUS REPAIR

To determine whether to write off certain business expenses or depreciate them often requires a critical analysis of facts and circumstances. IRC §162(a) allows taxpayers engaged in a trade or business to deduct "ordinary and necessary" business expenses. However, IRC §263(a) disallows deductions for buildings and most tangible property improvements. **Improvement** for this purpose is defined as an addition to or partial replacement of property that is a **betterment** to the property, an **adaptation** to a new or different use, or a **restoration** of the property.[1] Instead of deducting these costs, taxpayers **must capitalize** §263(a) enhancements and recover these investments through depreciation.

Example 1. Jane owns a rental house. In 2020, she pays for repairs to a small section of the rental house roof. She deducts the cost of the repair on her 2020 tax return.

If Jane completely replaced the rental house roof, the replacement would be classified as an improvement because it is a restoration of the building. If Jane did this, she would have to depreciate the cost of the new roof.

Note. For detailed information about how to distinguish between capitalizations and repairs, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive]. For further guidance, see Treas. Reg. §1.263(a)-3.

1. IRS Pub. 946, *How to Depreciate Property;* Treas. Reg. §1.263(a)-3.

IRC §179 DEDUCTION

For tax years beginning in 2020, the maximum amount a taxpayer may elect to expense under IRC §179 is $1.04 million 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 the taxpayer places in service during the year exceeds $2.59 million. These amounts are adjusted annually for inflation.[2]

Example 2. In 2020, Brenda purchased, installed, and placed in service 10 new industrial ovens in her bakery business. The ovens were the only items of qualifying property she placed in service during the year. The total cost of the ovens was $2.7 million.

Brenda elects to expense these ovens under §179. The maximum amount of Brenda's §179 deduction is $930,000, because the total cost of the ovens is $110,000 over the $2.59 million limit. Therefore, her maximum §179 deduction is reduced to $930,000 ($1.04 million limit – $110,000 over-threshold amount).

ELECTION[3]

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 or an amended return.

The taxpayer can revoke the §179 election without obtaining IRS approval by filing an amended return. Once made, the election revocation cannot be changed.[4]

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.**[5] The determination of whether a taxpayer actively conducts a trade or business is made based on all the facts and circumstances. The purpose of the active conduct requirement is to prevent a passive investor from deducting §179 expenses against that trade or business's taxable income. A taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the trade or business's management or operations.[6]

For individuals, partnerships, and S corporations, 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 includes:

- IRC §1231 gains or losses,
- Interest from working capital of trades/businesses, and
- Wages, salaries, tips, or other pay earned as an employee.[7]

Business income **does not include:**

- §179 deductions,
- The self-employment (SE) tax deduction,
- Any net operating loss (NOL) carryback or carryforward, or
- Any unreimbursed employee business expenses.[8]

2. IRC §179(b)(6).
3. Instructions for Form 4562.
4. IRC §179(c).
5. IRC §179(b)(3)(A).
6. Treas. Reg. §1.179-2(c)(6)(ii).
7. IRS Pub. 946, *How To Depreciate Property;* Treas. Reg. §1.179-2(c).
8. Ibid.

Any elected §179 deduction not allowed because of the business income limit can be carried forward to the next year and added to the otherwise deductible amount for that year.[9] The amount carried forward to the next year is shown on line 13 of Form 4562.[10]

When a property is sold or otherwise disposed of before the taxpayer uses the full amount of any outstanding carryover of a disallowed §179 deduction, the taxpayer cannot deduct any of the unused amount. Instead, the taxpayer must add the amount back to the property's basis.[11]

Example 3. In 2019, Boyce purchased and placed in service office equipment costing $25,000 that he uses in connection with his sole proprietorship business. He elected to expense the entire amount of the equipment under §179. However, his 2019 taxable income before taking into account the §179 deduction was only $20,000. Therefore, his §179 deduction was limited to $20,000, and he carried forward $5,000 of §179 expense.

In 2020, Boyce sells the office equipment for $22,000. He claims no depreciation in 2020 because the depreciable basis of the equipment at the beginning of 2020 was $0 ($25,000 cost – $25,000 elected §179 expense). However, to compute his gain or loss on the equipment, Boyce adds back the $5,000 of disallowed §179 expense. Therefore, his gain on the sale is $17,000 ($22,000 sales price – $5,000 basis from addback of disallowed §179 expense).

QUALIFYING PROPERTY

To be eligible for the §179 deduction, property must be acquired by purchase from an **unrelated party** for use in a **trade or business.**[12] Additionally, the property must be one of the following types of depreciable property.[13]

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)
   - **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
6. Qualified real property (described later)

9. IRC §179(b)(3)(B).
10. IRS Pub. 946, *How To Depreciate Property.*
11. Ibid; Treas. Reg. §1.179-3(f)(1).
12. IRC §179(d).
13. IRS Pub. 946, *How To Depreciate Property.*

A taxpayer can claim the §179 deduction for listed property if the property meets the business-use requirement. To meet this requirement, listed property must be used predominantly (more than 50%) for qualified business use. Property **not** used predominantly for qualified business use during the year it is placed in service does not qualify for the §179 deduction. **Qualified business use** is any use of the property in the taxpayer's trade or business, with certain exceptions that apply to 5% owners or related persons.[14] These exceptions are explained later in the section titled "Listed Property Restrictions."

Residential Tangible Personal Property[15]

Under a provision included in the TCJA, property that is used predominantly to furnish lodging or in connection with the furnishing of lodging now qualifies for §179 expensing. The furnishing of lodging includes beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let.[16]

> **Example 4.** In 2020, Melba paid $15,000 for five new refrigerators placed in residential rental properties she operates as a trade or business. She can elect to deduct this cost under §179.

Qualified Real Property[17]

A taxpayer can elect to treat certain real property placed in service during the tax year as §179 property. If the election is made, §179 property includes any qualified real property that is one of the following.

- Qualified improvement property (as defined in IRC §168(e)(6))
- Any of the following improvements to **nonresidential real property** placed in service after the date the nonresidential real property was first placed in service
  - Roofs
  - Heating, ventilation, and air-conditioning property
  - Fire protection and alarm systems
  - Security systems

Qualified Improvement Property.[18] Qualified improvement property (QIP) is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service.

QIP does **not** include any improvement attributable to the following.

- The enlargement of the building
- An elevator or escalator
- The internal structural framework of the building

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14. Ibid.
15. IRC §179(d)(1)(B); Rev. Proc. 2019-8, 2019-3 IRB 347.
16. Treas. Reg. §1.48-1(h)(1).
17. IRC §179(d)(1)(B); Rev. Proc. 2019-8, 2019-3 IRB 347.
18. IRC §168(e)(6).

Trade or Business Use[19]

To qualify for the §179 deduction, the property must have been acquired for use in the taxpayer's trade or business. Property acquired only for the production of income does **not** qualify. This includes the following.

- Investment property
- Rental property (if renting property is not the taxpayer's trade or business)
- Property that produces royalties

Example 5. In 2020, Michelle paid $15,000 for fencing to be placed on land she is holding for investment. She cannot deduct any of the cost under §179. Even though the fencing is tangible property, investment property does not qualify for the §179 deduction.

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.[20]

Example 6. Joshua buys a riding lawn mower for $3,000 in May 2020. He uses the mower 90% in his landscaping business and 10% 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. Therefore, Joshua may elect to expense up to $2,700 of the cost of the mower under §179 for the 2020 tax year.

PASS-THROUGH §179 DEDUCTIONS[21]

Taxpayers that are partners in a partnership or shareholders in an S corporation receive a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* 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 the entire 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 $2.59 million (for 2020). After the dollar limit is applied to the partner's/shareholder's total §179 costs, any remaining cost of §179 property is subject to the business income limit.

Example 7. In 2020, WDJ Partnership placed in service §179 property with a total cost of $2.7 million. The partnership must reduce its dollar limit by $110,000 ($2.7 million − $2.59 million limit on total amount of qualifying property).

Therefore, WDJ's maximum §179 deduction is $930,000 ($1.04 million − $110,000), and it elects to expense that amount. WDJ's taxable income from the active conduct of all its trades or businesses for the year was $800,000. Consequently, it can deduct $800,000 of §179 expense. It allocates $465,000 of its §179 deduction and $400,000 of its taxable income to Willard, one of its partners.

In addition to being a partner in WDJ Partnership, Willard is also a partner in the 1924 Partnership, which allocated a $30,000 §179 deduction and $35,000 of its taxable income to him from the active conduct of its business in 2020.

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19. IRS Pub. 946, *How To Depreciate Property.*
20. Ibid.
21. Ibid.

Willard also conducts a business as a sole proprietor. In 2020, he placed in service qualifying §179 property costing $55,000 in his sole proprietor business. He had a net loss of $50,000 from that business for the year.

Willard's §179 costs for 2020 are summarized in the following table.

	Total §179 Costs	Taxable Income	§179 Costs Elected	§179 Costs After Business Income Limit	§179 Carryover
WDJ Partnership	$465,000	$400,000	$465,000	$355,000	$110,000
1924 Partnership	30,000	35,000	30,000	30,000	0
Sole Proprietorship	55,000	(50,000)	55,000	0	55,000
	$550,000	$385,000	$550,000	$385,000	$165,000

Willard does not have to include §179 partnership costs to calculate any reduction in his dollar limit. Therefore, his total §179 costs for the year are not more than $2.59 million and his dollar limit is not reduced. His maximum §179 deduction is $1.04 million. He elects to expense the entire $495,000 in §179 deductions allocated from the partnerships ($465,000 from WDJ Partnership + $30,000 from 1924 Partnership), plus $55,000 of his sole proprietorship's §179 costs, and documents that information in his books and records.

However, his deduction is limited to his business taxable income of $385,000 ($400,000 from WDJ Partnership + $35,000 from 1924 Partnership – $50,000 loss from his sole proprietorship). He carries over $165,000 ($550,000 total §179 costs − $385,000 taxable income limit) of the elected §179 costs to 2021. He allocates the carryover amount to the cost of §179 property placed in service in his sole proprietorship, plus $110,000 from the WDJ Partnership and documents 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.[22]

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 tax 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.[23] The excess §179 expenses may **not** be carried over.[24]

Example 8. For the 2020 tax year, Doris received a Schedule K-1 from Somerset Partnership, which allocated $600,000 of taxable income and $550,000 of §179 expense to her. Doris also received a Schedule K-1 from Monticello Partnership, which allocated $625,000 of taxable income and $600,000 of §179 expenses to her.

Because Doris's total §179 deduction is $110,000 more than the maximum amount allowable for 2020 ($550,000 from Somerset Partnership + $600,000 from Monticello Partnership − $1.04 million maximum for 2020), she cannot carry over the excess to a subsequent year. **However, Doris's basis in her partnership interests must be reduced by the entire amount of the §179 deductions that were allocated to her.**

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22. Ibid.

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

24. Instructions for Form 4562; *The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects.* Guenther, Gary. May 1, 2018. Congressional Research Service. [fas.org/sgp/crs/misc/RL31852.pdf] Accessed on Sep. 26, 2019.

Adjustment of Partnership's Basis in §179 Property[25]

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.

Special Rules for Trusts and Estates[26]

Because the §179 deduction is not allowable for trusts or estates, a trust or estate that is a partner or S corporation shareholder cannot deduct its allocable share of the §179 expense elected by the partnership or S corporation. The partnership or S corporation's basis in §179 property is not reduced to reflect any portion of the §179 expense allocable to the trust or estate. Accordingly, the partnership or S corporation can claim a depreciation deduction for any depreciable basis that results from the disallowance of the trust or estate's allocable portion of the §179 expense.

Example 9. Alley Partnership has a trust that is a 10% partner. Alley elects to expense property that it acquired for $100,000 under §179; therefore, $10,000 ($100,000 × 10%) of the §179 expense is allocable to the trust.

Because the §179 deduction is not allowable to the trust, Alley's basis in the property is not reduced by the $10,000 allocable to the trust. Alley can claim a depreciation deduction on the $10,000 remaining basis.

BONUS DEPRECIATION[27]

IRC §168(k) was added to the Code by the Job Creation and Worker Assistance Act of 2002.[28] IRC §168(k) allows an additional first-year depreciation deduction (bonus depreciation) in the year the qualified property is placed in service. Over the years, amendments to §168(k) have changed the bonus depreciation rate several times, extended the placed-in-service date, and made other changes.[29]

The TCJA made several changes to bonus depreciation. This section describes the most noteworthy of these changes.

Under the TCJA, first-year bonus depreciation applies at a rate of 100% to qualified property placed in service after September 27, 2017, and before January 1, 2023.[30] The 100% rate is phased down for years beginning after 2022. The applicable bonus depreciation rates are shown in the following table.[31]

Year Acquired and Placed in Service		
Property with Longer Production Periods and Certain Aircraft	**All Other Property**	**Bonus Depreciation Rate**
After September 27, 2017 and before 2024	After September 27, 2017 and before 2023	100%
2024	2023	80%
2025	2024	60%
2026	2025	40%
2027	2026	20%
2028 and thereafter	2027 and thereafter	0%

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

26. Treas. Reg. §1.179-1(f)(3).

27. IRC §168(k).

28. PL 107-147.

29. TD 9874, 2019-41 IRB 809.

30. IRC §§168(k)(1)(A) and (6)(A).

31. IRC §168(k)(6).

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).[32]

A transition rule under the TCJA applies to property **acquired before September 28, 2017,** and placed in service **after September 27, 2017.** Under the provision, the applicable bonus depreciation rates for qualified property acquired before September 28, 2017, are shown in the following table.

Year Placed in Service	Property with Longer Production Periods and Certain Aircraft	All Other Property
2017	50%	50%
2018	50%	40%
2019	40%	30%
2020	30%	None

Note. For more information about the rules that apply to property acquired before September 28, 2017, and placed in service after September 27, 2017, see IRS Pub. 946, *How To Depreciate Property.*

CALCULATING THE ALLOWANCE[33]

The depreciable basis of property is the property's cost or other basis multiplied by the percentage of business/investment use, reduced by the amount of any credits and deductions (including any §179 deduction) allocable to the property. The bonus depreciation allowance is then calculated by multiplying the depreciable basis of the property by the applicable bonus depreciation rate (as shown in the preceding tables).

Regular depreciation is calculated on any 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.

QUALIFIED PROPERTY

The following types of property may qualify for bonus depreciation.[34]

- Tangible property with a MACRS recovery period of 20 years or less
- Computer software defined in and depreciated under IRC §167(f)(1)(B)
- Water utility property
- Qualified film, television, and live theatrical productions, as defined in IRC §§181(d) and (e)
- Specified plants for which the taxpayer made the election to apply §168(k)(5) for the tax year in which the plant is planted or grafted

Note. For more information about the treatment of plants, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Agricultural Issues and Rural Investments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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

33. Ibid.

34. Ibid; IRC §168(k)(2)(A)(i).

In addition, the property must meet the following requirements.

- It must be purchased before January 1, 2027 (or before January 1, 2028, for certain property with a long production period and certain aircraft).[35]
- The property can be either **new property** (**original use** begins with the taxpayer) **or certain used property** (defined next).

A taxpayer can claim bonus depreciation for listed property if the property meets the business-use requirement. As stated earlier, listed property must be used predominantly (more than 50%) for qualified business use to meet this requirement. Property **not** used predominantly for qualified business use during the year it is placed in service does not qualify for bonus depreciation.[36]

Qualifying Used Property

Used property may qualify for bonus depreciation if it meets the following acquisition requirements.[37]

- The property was not used by the taxpayer or a **predecessor** at any time before acquiring it.
- The taxpayer acquired the property by **purchase** within the meaning of §179(d)(2).

The property is treated as used by the taxpayer or a predecessor at any time prior to acquisition if the taxpayer or the predecessor had a depreciable interest in the property at any time prior to the acquisition. To make this determination, only the **five calendar years** immediately prior to the taxpayer's current placed-in-service year of the property is taken into account.[38]

A **predecessor** for this purpose includes the following.[39]

- A transferor of an asset to a transferee in a transaction to which IRC §381(a) applies (i.e., carryovers in certain corporate acquisitions)
- A transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor
- A partnership that is considered as continuing under IRC §708(b)(2) and Treas. Reg. §1.708-1
- The decedent in the case of an asset acquired by the estate
- A transferor of an asset to a trust

35. IRC §168(k)(6).
36. IRS Pub. 946, *How To Depreciate Property.*
37. IRC §168(k)(2)(E)(ii); Treas. Reg. §1.168(k)-2(b)(3)(iii).
38. Treas. Reg. §1.168(k)-2(b)(3)(iii).
39. Treas. Reg. §1.168(k)-2(a)(2)(iv).

An acquisition is considered a **purchase** (under §179(d)(2)) unless the property:

1. Is acquired from a close family member,[40]

> **Note.** Family relationships that restrict the use of §179 expensing and bonus depreciation are discussed in the section "Depreciation Transactions Involving Related Parties."

2. Is acquired by one member of a controlled group of corporations from another member (substituting 50% for the 80% stock ownership requirement otherwise applicable),
3. Has a basis in the hands of the acquirer determined wholly or partly by reference to the adjusted basis of the disposing party (e.g., a gift or IRC §1022 basis property), or
4. Has its basis determined under IRC §1014(a) (relating to inherited or bequeathed property).

Example 10. On August 1, 2018, Anna bought a new machine for $35,000 from an **unrelated party** for use in her trade or business. On July 1, 2020, Bill bought that machine from Anna for $20,000 for use in his trade or business, which is unrelated to Anna's trade or business. On October 1, 2020, Bill made a $5,000 capital expenditure to recondition the machine. Bill did not have any depreciable interest in the machine before he acquired it on July 1, 2020.

Anna purchased the machine when it was new; therefore, her purchase satisfies the original-use requirement. If the purchase satisfies all other applicable requirements, it qualifies for bonus depreciation.

Bill purchased the used machine from Anna; therefore, it did not satisfy the original-use requirement. However, it did satisfy the used property acquisition requirements. If all the other requirements are met, the $20,000 purchase price qualifies for the bonus depreciation deduction. In addition, Bill's $5,000 expenditure for reconditioning satisfies the original-use requirement and, assuming all other requirements are met, qualifies for the bonus depreciation deduction.[41]

Practitioner Planning Tip

IRC §743(b) provides that transfers of partnership interests for a partnership with an IRC §754 election in effect increase the adjusted basis of partnership property. The §743(b) basis adjustment is allocated among partnership properties. Prior to the TCJA, §743(b) adjustments failed the original-use requirement for purposes of bonus depreciation because partnership property to which a §743(b) basis adjustment relates would have been previously used by the partnership and its partners prior to the transfer that gave rise to the §743(b) adjustment. After the enactment of the TCJA, a transaction giving rise to a §743(b) basis adjustment may satisfy the used property acquisition requirements for bonus depreciation, depending on the facts and circumstances.[42]

40. As defined under IRC §§267 or 707(b) except as modified by IRC §179(d)(2)(A).
41. Adapted from example in Treas. Reg. §1.168(k)-2(b)(3)(vii).
42. Preamble to REG-104397-18 (Aug. 8, 2018); Treas. Reg. §1.168(k)-2(g)(1)(iii).

Excluded Property

Property acquired after September 27, 2017, that does **not qualify** for bonus depreciation includes the following.[43]

- Property placed in service, or planted or grafted, 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 the taxpayer elected not to claim any bonus depreciation
- Property primarily used in a trade or business described in IRC §163(j)(7)(A)(iv) (involving the furnishing or sale of certain energy, water, sewage disposal services, or gas or steam distribution or transportation), and placed in service in any tax year beginning after December 31, 2017[44]
- Property described in §168(k)(9)(B) (certain property with floor plan financing indebtedness) and placed in service in any tax year beginning after December 31, 2017

Exclusion for Floor Plan Financing Indebtedness. Certain property used in a trade or business that had floor plan financing indebtedness does not qualify for bonus depreciation. Floor plan financing indebtedness is defined as indebtedness:

- Used to finance the acquisition of **motor vehicles** held for sale or lease, and
- That is secured by the inventory acquired.[45]

This exclusion applies when the floor plan financing interest on the indebtedness was taken into account under the new rules that limit the business interest deduction to the following percentages of adjusted taxable income plus floor plan financing interest and interest income.[46]

- 30% for 2018
- 50% for 2019 and 2020
- 30% for years beginning after 2020

The exclusion applies to property placed in service by the taxpayer after December 31, 2017.[47]

If the sum of the taxpayer's business interest income plus 50% of adjusted taxable income (for 2019 and 2020) equals or exceeds the business interest (as defined in §163(j)(5)) for the tax year, floor plan financing interest is **not** taken into account for the tax year.[48]

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43. IRS Pub. 946, *How To Depreciate Property.*
44. Also see IRC §168(k)(9)(A).
45. IRC §163(j)(9).
46. IRC §§168(k)(9), 163(j)(1), and 163(j)(9); Rev. Proc. 2019-08, 2019-03 IRB 347.
47. Treas. Reg. §1.168(k)-2(b)(2)(ii)(F).
48. Prop. Treas. Reg. §1.168(k)-2.

Example 11. In 2019, Franklin Motors, an automobile dealer, buys new computers for $50,000 for use in its trade or business of selling automobiles. Franklin has the following for 2019.

- $100,000 of adjusted taxable income
- $4,000 of business interest income
- $60,000 of business interest (including $10,000 of floor plan financing interest)

The sum of Franklin's business interest income plus 50% of adjusted taxable income is $54,000 ($4,000 + ($100,000 × 50%)), which is less than his business interest of $60,000. Therefore, Franklin must take into account his floor plan financing interest for 2019. Accordingly, Franklin's purchase of computers for $50,000 does not qualify for bonus depreciation.[49]

Note. For more information on changes to business indebtedness, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

Qualified Improvement Property[50]

MACRS property with a recovery period of 20 years or less includes the following property acquired by the taxpayer after September 27, 2017, and **placed in service by the taxpayer after September 27, 2017.**

- Qualified leasehold improvement property
- Qualified restaurant property that is QIP
- Qualified retail improvement property

For property placed in service **after December 31, 2017,** the TCJA amended §168(e) to eliminate the 15-year MACRS property classifications for these types of property. However, the CARES Act made a technical correction that restores the 15-year MACRS classification for QIP. Moreover, the CARES Act amendment is retroactive to January 1, 2018.[51] **As a result of this amendment, QIP is eligible for bonus depreciation.**

Practitioner Planning Tip

Prior to the amendment to the CARES Act, QIP was depreciated over 39 years effective January 1, 2018, due to a TCJA drafting error. As a result, QIP did not qualify for bonus depreciation. Now that the CARES Act corrected this error, practitioners can file amended returns or a change in accounting method for their clients to take advantage of the shorter depreciation period or to claim bonus depreciation, if desired.

49. Adapted from example in REG-106808-19 (Sep. 13, 2019), p. 53.

50. TD 9874, 2019-41 IRB 809.

51. PL 116-136 §2307, amending IRC §168.

Technical Correction on QIP[52]

As mentioned earlier, the TCJA amended §168(e) to eliminate the 15-year recovery period for QIP placed in service after December 31, 2017. Under the TCJA, QIP had a 39-year life under the general depreciation system (GDS) and a 40-year life under the ADS. However, the CARES Act restored the 15-year GDS recovery period and the 20-year ADS recovery period for QIP retroactive to January 1, 2018. In addition, the CARES Act amended the definition of QIP by specifying that the improvement **"must be made by the taxpayer."**

The IRS issued Rev. Proc. 2020-25, which provides guidance allowing a taxpayer to change its depreciation under §168 for QIP placed in service after December 31, 2017, in its tax year ending in 2018, 2019, or 2020. In addition, the revenue procedure allows a taxpayer to make a late election, or to revoke or withdraw an election, under the following Code sections for the 2018, 2019, or 2020 tax years.

- IRC §168(g)(7) — Election to use ADS
- IRC §168(k)(5) — Bonus depreciation for certain plants
- IRC §168(k)(7) — Election out of bonus depreciation
- IRC §168(k)(10) — Election to apply 50% bonus depreciation (instead of 100% bonus depreciation) for property placed in service by the taxpayer during the first tax year ending after September 27, 2017

Because QIP now has a MACRS recovery period less than 20 years, it is eligible for bonus depreciation, provided it meets all the other requirements for bonus depreciation (discussed earlier in the chapter).

The guidance contained in Rev. Proc. 2020-25 does not apply to QIP placed in service after December 31, 2017, by an electing real property trade or business or an electing farming business under §163(j)(7).

> **Note.** Electing real property trades or businesses and electing farming businesses are discussed later in this chapter. For further information, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments and Rev. Proc. 2020-22.

In accordance with Rev. Proc. 2020-25, a taxpayer can apply the changes to depreciation for QIP using one of the following methods.

- File an amended return
- File a Form 3115
- Make an administrative adjustment request (AAR) under IRC §6227

> **Note.** Rev. Proc. **2020-23** provides guidance relating to partnerships subject to the centralized audit regime enacted under the Bipartisan Budget Act of 2015 (BBA).[53] Rev. Proc. 2020-23 allowed BBA partnerships meeting certain conditions to file amended returns for the 2018 and 2019 tax years by September 30, 2020. A BBA partnership that did not file an amended Form 1065, *U.S. Return of Partnership Income,* as permitted under Rev. Proc. 2020-23, can file an AAR for the placed-in-service year of the QIP on or before October 15, 2021, under the guidance provided in Rev. Proc. **2020-25.** For more information on filing an AAR for QIP, see Rev. Proc. 2020-25.

52. Rev. Proc. 2020-25, 2020-19 IRB 785.

53. PL 114-74.

Filing an Amended Return. A taxpayer that chooses to file an amended return for the placed-in-service year of the QIP must generally do so by October 15, 2021, but no later than the applicable period of limitations for the tax year for which the amended return is being filed. When a refund is expected on an amended return, taxpayers must generally file the return within three years after the due date of the original return.[54]

The amended return must include the adjustment to taxable income for the change in depreciation of the QIP, as well as any collateral adjustments to taxable income or tax liability. Moreover, such collateral adjustments must also be made on original or amended federal returns for any affected succeeding years.

Filing Form 3115. A taxpayer can choose to file a Form 3115, *Application For Change In Accounting Method*, with their timely filed federal tax return under the automatic change procedures contained in Rev. Proc. 2015-13. A taxpayer can change from an impermissible to a permissible method of accounting for depreciation for any item of QIP that meets the following conditions.

1. The taxpayer placed the property in service after December 31, 2017.
2. The taxpayer used the impermissible method of accounting in at least two tax years preceding the year of change.
3. The taxpayer owned the property at the beginning of the year of change.

If the taxpayer does not satisfy the above requirements for an item of QIP because the taxpayer placed the item of QIP in service in the tax year immediately preceding the year of change (1-year QIP), the taxpayer can nonetheless change from the impermissible method of determining depreciation to the permissible method of determining depreciation by filing a Form 3115. To qualify, the IRC §481(a) adjustment reported on the Form 3115 should include the amount attributable to all property (including the 1-year QIP) subject to the Form 3115. Alternatively, the taxpayer can change from the impermissible method to the permissible method of determining depreciation for the 1-year QIP by filing an amended federal income tax return for the property's placed-in-service year prior to the date the taxpayer files its federal income tax return for the tax year succeeding the placed-in-service year.

A taxpayer making a change in accounting method for QIP placed in service after December 31, 2017, is required to complete only the following information on Form 3115.

1. The identification section of page 1 (above part I)
2. The signature section at the bottom of page 1
3. Part I
4. Part II, all lines except 11, 12, 13, 15, 16, 17, and 19
5. Part IV, all lines
6. Schedule E, all lines except lines 1, 4b, 5, and 6

A taxpayer that makes this change for multiple assets for the same year should file a single Form 3115 for all such assets. The taxpayer should provide a single net §481(a) adjustment for all the changes included in the Form 3115. The designated accounting method change number (DCN) that should be entered on the form is 244.

> **Note.** For more information about making a change in accounting method using Form 3115, including §481(a) adjustments and DCNs, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

54. IRM 25.6.1.5 (Oct. 1, 2019).

Example 12. In 2017, Pollie purchased an office building, which she owns as a sole proprietor. On July 1, 2018, renovations to the building were completed and placed into service. These renovations cost $100,000 and are QIP. Under the TCJA, Pollie was required to depreciate the renovations as 39-year property.

Pollie's accountant, Elmer, filed her 2019 federal tax return on March 15, 2020. After the CARES Act was passed on March 27, Elmer discussed the impact on QIP with Pollie. They decided it would be most beneficial for her to claim bonus depreciation on the QIP. Accordingly, Elmer prepared the following Form 3115 to claim the additional depreciation on Pollie's 2019 return.

Note. The change in accounting method results in a negative §481(a) adjustment, which Pollie may fully claim in the year of change. The adjustment is reported on the same form on which regular depreciation of the assets is claimed.

For Example 12

Form **3115** (Rev. December 2018)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

► Go to *www.irs.gov/Form3115* for instructions and the latest information.

OMB No. 1545-2070

Name of filer (name of parent corporation if a consolidated group) (see instructions) **Pollie Gee**	**Identification number** (see instructions) **555-44-3333**
	Principal business activity code number (see instructions)
Number, street, and room or suite no. If a P.O. box, see the instructions. **123 Fourth Street**	Tax year of change begins (MM/DD/YYYY) **01/01/2019** Tax year of change ends (MM/DD/YYYY) **12/31/2019**
City or town, state, and ZIP code **Berea, KY 40403**	Name of contact person (see instructions)
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 **(1)** all relevant information requested on this Form 3115 (including its instructions), and **(2)** any other relevant information, even if not specifically requested on Form 3115.
The taxpayer must attach all applicable statements requested throughout this form.

Part I Information for Automatic Change Request

		Yes	No
1	Enter the applicable designated automatic accounting method change number ("DCN") for the requested automatic change. Enter only one DCN, except as provided for in guidance published by the IRS. If the requested change has no DCN, check "Other," and provide both a description of the change and a citation of the IRS guidance providing the automatic change. See instructions.		
a	(1) DCN: **244** (2) DCN: ____ (3) DCN: ____ (4) DCN: ____ (5) DCN: ____ (6) DCN: ____ (7) DCN: ____ (8) DCN: ____ (9) DCN: ____ (10) DCN: ____ (11) DCN: ____ (12) DCN: ____		
b	Other ☐ Description ► ____		
2	Do any of the eligibility rules restrict the applicant from filing the requested change using the automatic change procedures (see instructions)? If "Yes," attach an explanation.		×
3	Has the filer provided all the information and statements required **(a)** on this form and **(b)** by the List of Automatic Changes under which the applicant is requesting a change? See instructions.	×	
	Note: Complete Part II and Part IV of this form, and, Schedules A through E, if applicable.		

Part II Information for All Requests

		Yes	No
4	During the tax year of change, did or will the applicant **(a)** cease to engage in the trade or business to which the requested change relates, or **(b)** terminate its existence? See instructions.		×
5	Is the applicant requesting to change to the principal method in the tax year of change under Regulations section 1.381(c)(4)-1(d)(1) or 1.381(c)(5)-1(d)(1)?		×
	If "No," go to line 6a. If "Yes," the applicant cannot file a Form 3115 for this change. See instructions.		

Sign Here

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.

Signature of filer (and spouse, if joint return)	Date	Name and title (print or type)

Preparer (other than filer/applicant)

Print/Type preparer's name	Preparer's signature	Date
Elmer Glu		
Firm's name ►		

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 19280E Form **3115** (Rev. 12-2018)

For Example 12

Form 3115 (Rev. 12-2018) Page 2

Part II Information for All Requests *(continued)*	Yes	No
6a 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 7a.		
b Is the method of accounting the applicant is requesting to change an issue under consideration (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))? See instructions.		
c Enter the name and telephone number of the examining agent and the tax year(s) under examination. Name ▶ _____ Telephone number ▶ _____ Tax year(s) ▶ _____		
d Has a copy of this Form 3115 been provided to the examining agent identified on line 6c?		
7a Does audit protection apply to the applicant's requested change in method of accounting? See instructions. . .	×	
If "No," attach an explanation.		
b If "Yes," check the applicable box and attach the required statement. ☒ Not under exam ☐ 3-month window ☐ 120 day: Date examination ended ▶ ☐ Method not before director ☐ Negative adjustment ☐ CAP: Date member joined group ▶ ☐ Audit protection at end of exam ☐ Other		
8a 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 "No," go to line 9.		
b 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.		
c 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) ▶ _____		
d Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 8c?		
9 If the applicant answered "Yes" to line 6a and/or 8a 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.		
10 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?		
11a Has the applicant, its predecessor, or a related party requested or made (under either an automatic or non-automatic change procedure) a change in method of accounting within any of the five tax years ending with the tax year of change?		
If "No," go to line 12.		
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.		
12 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? . . .		
If "Yes," for each request attach a statement providing **(a)** the name(s) of the taxpayer, **(b)** identification number(s), **(c)** the type of request (private letter ruling, change in method of accounting, or technical advice), and **(d)** the specific issue(s) in the request(s).		
13 Is the applicant requesting to change its **overall** method of accounting?		
If "Yes," complete Schedule A on page 4 of the form.		

Form **3115** (Rev. 12-2018)

For Example 12

Part II Information for All Requests *(continued)*

		Yes	No
14	If the applicant is either **(i) not** changing its overall method of accounting, or **(ii)** changing its overall method of accounting **and** changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following (see instructions):		
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).		
15a	Attach a detailed and complete description of the applicant's trade(s) or business(es). See section 446(d).		
b	If the applicant has more than one trade or business, as defined in Regulations section 1.446-1(d), describe **(i)** whether each trade or business is accounted for separately; **(ii)** the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; **(iii)** the overall method of accounting for each trade or business; and **(iv)** which trade or business is requesting to change its accounting method as part of this application or a separate application. **Note:** If you are requesting an automatic method change, see the instructions to see if you are required to complete lines 16a–16c.		
16a	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.		
b	Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method.		
c	Include either a discussion of the contrary authorities or a statement that no contrary authority exists.		
17	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.		
18	Does the applicant request a conference with the IRS National Office if the IRS National Office proposes an adverse response?	×	
19a	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 (see 19b), 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.
$	$	$

b	If the applicant is changing its method of accounting for any long-term contract subject to section 460, in addition to completing 19a, enter the applicant's gross receipts for the 4th tax year preceding the tax year of change:		
	4th preceding year ended: mo. _____ yr. _____ $ _____		

Part III Information for Non-Automatic Change Request

		Yes	No
20	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 the non-automatic change procedures.		
21	Attach a copy of all documents related to the proposed change (see instructions).		
22	Attach a statement of the applicant's reasons for the proposed change.		
23	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.		
24a	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).		

For Example 12

Form 3115 (Rev. 12-2018) Page 4

Part IV Section 481(a) Adjustment	Yes	No
25 Does published guidance require the applicant (or permit the applicant and the applicant is electing) to implement the requested change in method of accounting on a cut-off basis? . . . . . If "Yes," attach an explanation and do not complete lines 26, 27, and 28 below.		×
26 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ► $ -96,259 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 application, attach a list of the **(a)** name, **(b)** identification number, and **(c)** the amount of the section 481(a) adjustment attributable to each applicant.		
27 Is the applicant making an election to take the entire amount of the adjustment into account in the tax year of change? If "Yes," check the box for the applicable elective provision used to make the election (see instructions). ☐ $50,000 de minimis election ☐ Eligible acquisition transaction election		×
28 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 Check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting.
Present method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)
Proposed method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)

2 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 2a through 2g.

		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 2a–2g.) 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 26.	$

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

4 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 (such as, tax-exempt organization returns) for that period. If the amounts in Part I, lines 2a through 2g, do not agree with the amounts shown on both the profit and loss statement and the balance sheet, attach a statement explaining the differences.

5 Is the applicant making a change to the overall cash method as a small business taxpayer (see instructions)? ☐ **Yes** ☐ **No**

Part II Change to the Cash Method for Non-Automatic Change 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.

Form **3115** (Rev. 12-2018)

For Example 12

Form 3115 (Rev. 12-2018) Page 8

Part III **Method of Cost Allocation** *(continued)* See instructions.

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 ***Summary of 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, such as section 263A? ☐ **Yes** ☒ **No**
If "Yes," enter the applicable section ▶ _____

3 Has a depreciation, amortization, expense, or disposition election been made for the property, such as the election under sections 168(f)(1), 168(i)(4), 179, 179C, or Regulations section 1.168(i)-8(d)? ☐ **Yes** ☒ **No**
If "Yes," state the election made ▶ _____

4a To the extent not already provided, attach a statement describing the property subject to the change. 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 (for example, 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 (for example, 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 (for example, 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 Whether 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.

h Whether the property was or will be in a single asset account, a multiple asset account, or a general asset account.

Form **3115** (Rev. 12-2018)

For Example 12

Attachment:

PG Properties
Section 481(a) Adjustment
For the Period January 1, 2019 to December 31, 2019

Business Description

PG Properties rents office space to commercial enterprises, in a building owned by the proprietor, which is located at 123 Fourth Street, Berea, KY 40403.

Description of Change in Accounting Method

PG Properties completed renovations on its office building referred to above on July 1, 2018. These renovations (which include drywall, lighting, and plumbing) are qualified improvement property. The renovations had a 39-year recovery period and were ineligible for bonus depreciation under the Tax Cuts and Jobs Act. Under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), these renovations are 15-year property and are eligible for bonus depreciation under IRC §168(k). The CARES Act provision is retroactive to January 1, 2018. The taxpayer is filing a change in accounting method to claim bonus depreciation and reverse the previous MACRS depreciation.

Part IV, Line 26:

Prior Method

Description: Renovations to building

Placed in Service: July 2018

Depreciation Method: 39-year MACRS, straight-line, mid-month convention

Book Cost: $100,000

Depreciation Taken:

2018	$1,177
2019	2,564
Total	$3,741

Proposed Method

Description: Renovations to building

Placed in Service: July 2018

Depreciation Method: 100% bonus depreciation

Section 481(a) adjustment:

Proposed bonus depreciation	$100,000
Prior depreciation taken	(3,741)
§481(a) adjustment	$ 96,259

Late Elections or Revocation of Elections. A taxpayer that wants to make a late election under §§168(g)(7), (k)(5), (k)(7), or (k)(10) can do so by filing Form 3115. Similarly, a taxpayer that wants to revoke an election under §§168(k)(5), (k)(7), or (k)(10) can also accomplish this by filing Form 3115.

The IRS treats a late election under §§168(g)(7), (k)(5), (k)(7), or (k)(10), or the revocation of an election under §§168(k)(5), (k)(7), or (k)(10), as a change in accounting method with a §481(a) adjustment only for:

- The taxpayer's first or second tax year succeeding the tax year in which the taxpayer placed in service the property affected by the late election or revocation of the election; or
- If later, any tax year for which the taxpayer timely files an original federal income tax return on or after April 17, 2020, and on or before October 15, 2021.

A taxpayer filing Form 3115 to make a late election or revoke an election is required to complete only the following information on Form 3115.

- The identification section of page 1 (above part I)
- The signature section at the bottom of page 1
- Part I
- Part II, all lines except lines 11, 12, 13, 15, 16, 17, and 19
- Part IV, all lines
- Schedule E, all lines except lines 1, 4b, 5, and 6

A taxpayer that is making one or more late elections and/or revoking one or more elections for the same year of change should file a single Form 3115 for all the changes. The Form 3115 must include a single net §481(a) adjustment for all the changes. The DCN that should be entered on the form is 245.

Vehicles

The TCJA allows 100% bonus depreciation for certain business assets, including business automobiles.[55] However, for passenger automobiles qualifying for bonus depreciation that are acquired **after September 27, 2017, and placed in service in 2019,** the allowed first-year depreciation (which includes §179 expense as well as bonus depreciation)[56] is limited to $18,100. The following table shows the depreciation limitations for passenger automobiles for which the bonus depreciation deduction applies.[57]

Tax Year	Amount
1st tax year	$18,100 [a]
2nd tax year	16,100
3rd tax year	9,700
Each succeeding year	5,760

[a] The first-year depreciation is limited to $10,100 for 2019 if the taxpayer elects out of bonus depreciation or the vehicle does not qualify for bonus depreciation.

55. IRC §168(k); TCJA §13201.

56. IRC §280F(d)(1).

57. Rev. Proc. 2019-26, 2019-24 IRB 1323.

Under IRC §280F(a)(1)(B), the unrecovered basis of a passenger automobile is treated as an expense for the first tax year after the recovery period. The unrecovered basis that can be treated as an expense in any succeeding tax year cannot exceed $5,760. If the unadjusted depreciable basis of a passenger automobile for which the 100% bonus depreciation deduction is allowable exceeds the first-year limitation amount under §280F(a)(1)(A)(i) (i.e., $18,100 for vehicles placed in service in 2019), the excess amount is treated as a deductible expense in the first tax year after the end of the recovery period.[58]

Example 13. On October 1, 2019, Troy purchased a $50,000 passenger automobile for use in his business. The vehicle is 5-year property and qualifies for 100% bonus depreciation. The bonus depreciation deduction for 2019 is limited to $18,100. Troy can recover the excess amount of $31,900 ($50,000 – $18,100) beginning in 2025, which is the first year after the end of the 5-year MACRS recovery period, subject to the annual limitation of $5,760.

Safe Harbor Method. Under the provisions of Rev. Proc. 2019-13, taxpayers claiming bonus depreciation who have unadjusted depreciable basis exceeding the first-year depreciation cap can use a safe harbor method of accounting rather than be forced to wait until after the end of the vehicle's recovery period to recover their remaining adjusted basis.

This revenue procedure is effective on February 13, 2019, and applies to a passenger automobile (other than a leased vehicle) that meets the following conditions.

1. Is acquired and placed in service by the taxpayer after September 27, 2017
2. Is property qualifying for 100% bonus depreciation
3. Has an unadjusted depreciable basis exceeding the first-year depreciation limitation
4. For which the taxpayer did not elect §179 expensing for the cost or any portion of the cost

Practitioner Planning Tip

If the taxpayer elected §179 expensing for a passenger automobile acquired and placed in service after September 27, 2017, it may be prudent to amend the return to revoke the §179 election. This may allow the taxpayer to take advantage of the safe harbor.

58. Rev. Proc. 2019-13, 2019-09 IRB 744.

To take advantage of the safe harbor method of accounting offered by Rev. Proc. 2019-13, taxpayers must abide by the following requirements.

1. The taxpayer must use the applicable optional depreciation table for calculating the depreciation deductions for the automobile. (See Appendix A in IRS Pub. 946 for the applicable optional depreciation tables.)
2. The taxpayer deducts the first-year depreciation maximum amount (e.g., $18,100 for an automobile acquired after September 27, 2017, and placed in service in 2019).
3. For tax years after the year placed in service, the taxpayer computes depreciation on the remaining adjusted depreciable basis (i.e., the depreciable basis less the first-year depreciation) using the annual depreciation rate for each tax year specified in the applicable optional depreciation table.
4. In the first tax year succeeding the end of the recovery period, the depreciation deduction is the lesser of the remaining adjusted depreciable basis or $5,760.[59]
5. In the first tax year succeeding the year placed in service that the automobile is not predominantly used for a qualified business use (as defined in §280F(d)(6)(B) and (C)), the accounting safe harbor ceases to apply in that year and any subsequent tax year.

Example 14. In 2019, Eston, a calendar-year taxpayer, acquired and placed in service a $60,000 passenger automobile. Eston uses the automobile exclusively for his sole proprietorship business. The automobile is 5-year property and qualifies for 100% bonus depreciation. Eston does not claim the §179 deduction for any portion of the automobile's cost. He uses the Rev. Proc. 2019-13 safe harbor method.

Eston cannot fully expense the vehicle with 100% bonus depreciation in 2019 because of the first-year depreciation limitation. Accordingly, he claims an $18,100 depreciation deduction for the vehicle for 2019. The depreciation on the remaining adjusted depreciable basis of $41,900 is calculated using the annual depreciation rates for each tax year, as shown in Appendix A of IRS Pub. 946.

Eston's annual depreciation deductions for the automobile are shown in the following table.

Tax Year	Maximum Annual Depreciation Limitation [60]	Annual Depreciation Deduction Using Applicable Percentages
2019	$18,100	$18,100
2020	16,100	$41,900 × 32% = $13,408
2021	9,700	$41,900 × 19.2% = $8,045
2022	5,760	$41,900 × 11.52% = $4,827
2023	5,760	$41,900 × 11.52% = $4,827
2024	5,760	$41,900 × 5.76% = $2,413
2025	5,760	$5,760 [a]
2026	5,760	$2,620 [b]
Total		$60,000

[a] Lesser of $8,380 remaining adjusted basis or the $5,760 annual limit

[b] Lesser of $2,620 remaining adjusted basis or the $5,760 annual limit

Note. For an in-depth discussion about automobile depreciation, including examples, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: New Developments.

59. IRC §280F(a)(1)(B).

60. See Table 2 of Rev. Proc. 2019-26, 2019-24 IRB 1323.

CHANGE IN USAGE OF PROPERTY[61]

Conversion to Personal Use

If qualified property is converted from business or income-producing use to personal use in the same tax year in which the taxpayer places the property in service, the bonus depreciation deduction is not allowed for the property.

Conversion to Business or Income-Producing Use

During the Same Tax Year. If a taxpayer acquires property for personal use and converts it to business or income-producing use during the same tax year, the bonus depreciation deduction is allowable for the property in that tax year, assuming all other requirements for bonus depreciation are satisfied.

The depreciable basis of the property in the year of change is the lesser of its fair market value (FMV) or its adjusted depreciable basis at the time of the conversion to business or income-producing use.[62]

Subsequent to the Acquisition Year. If a taxpayer acquires property for personal use and converts it to business or income-producing use in a subsequent tax year, the bonus depreciation deduction is allowable for the property in the tax year the property is converted, assuming all other requirements for bonus depreciation are met.

The depreciable basis of the property in the year of change is the lesser of its FMV or its adjusted depreciable basis at the time of the conversion to business or income-producing use.[63]

Change in Use after Placed-in-Service Year

If the use of qualified property changes in the hands of the taxpayer subsequent to the tax year the property is placed in service, and, as a result of the change in usage, the property is no longer qualified property, the bonus depreciation deduction allowable for the property is **not** redetermined.

> **Example 15.** In February 2023, Brammer Inc., a calendar-year corporation, purchased and placed in service new equipment that cost $1 million for use in its Kentucky plant. The equipment is 5-year property, and Brammer depreciates it under the GDS using the 200% declining balance method, a 5-year recovery period, and the half-year convention. In June 2024, Brammer permanently moves the equipment to its facilities in Mexico.
>
> For 2023, Brammer is allowed an 80% bonus depreciation deduction of $800,000 ($1 million basis × 80%). In addition, Brammer's allowable GDS deduction in 2023 for the remaining adjusted depreciable basis of $200,000 is $40,000 ($200,000 remaining depreciable basis × 20% depreciation rate for year 1).
>
> For 2024, the equipment is used predominantly outside the United States.[64] Accordingly, the adjusted depreciable basis of $160,000 ($1 million – $800,000 bonus depreciation – $40,000 GDS depreciation) is required to be depreciated under the ADS.[65] However, the $800,000 bonus depreciation deduction allowed for the equipment in 2023 is not redetermined.[66]

Note. Depreciation on foreign property is discussed later in this chapter.

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61. Treas. Reg. §1.168(k)-2(g)(6).
62. Treas. Reg. §1.168(i)-4(b)(1).
63. Ibid.
64. Treas. Reg. §1.48-1(g)(1)(i).
65. IRC §168(g)(1).
66. Adapted from an example in Treas. Reg. §1.168(k)-2(g)(6).

If depreciable property is not qualified property in the tax year the taxpayer places it in service, the bonus depreciation deduction is not allowable for the property even if a change in the use of the property in a later tax year results in the property being qualified property in the later year.

Example 16. On January 1, 2019, Davesu Inc., a calendar-year corporation, purchased and placed in service several new computers that cost a total of $100,000. Davesu used these computers in the United States for three months in 2019 and then moved and used the computers outside the United States for the rest of 2019. On January 1, 2020, Davesu permanently returned the computers to the United States for use in the business.

For 2019, the computers are considered used predominantly outside the United States.[67] Consequently, the computers are required to be depreciated under the ADS.[68] Therefore, the computers are not qualified property in 2019. Bonus depreciation is not allowed for these computers, even though they were permanently returned to the United States in 2020.[69]

ELECTING OUT[70]

Taxpayers can **elect out** of bonus depreciation for any class of property. This election then applies to **all such property in the class** placed in service during the tax year.

The taxpayer makes the election 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.

Eastridge Products, Inc.

EIN: 36-9999555

Year Ended December 31, 2020

Election to Not Claim Special 100% Depreciation Allowance

Under IRC §168(k)(7), taxpayer hereby elects to not claim the special depreciation allowance for the following asset class placed in service during the tax year ended December 31, 2020.

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.

Once made, the election cannot be revoked without IRS consent. A request to revoke the election is made by requesting a letter ruling.

67. Treas. Reg. §1.48-1(g)(1)(i).

68. IRC §168(g)(1).

69. Adapted from an example in Treas. Reg. §1.168(k)-2(g)(6).

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

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 tax year with the total estimated contract costs.[71] 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.[72]

Under the TCJA, relief is provided when determining the percentage of completion under IRC §460(b)(1)(A) for purposes of the long-term contract method of accounting. This relief applies to the cost of property with a MACRS recovery period of seven years or less that qualifies for bonus depreciation. Such cost is considered as a cost allocated to the contract as if bonus depreciation had not been enacted.[73] This provision applies to property placed in service before January 1, 2027 (before January 1, 2028, in the case of property with longer production periods).[74] Instead, taxpayers calculate the percentage of completion as if MACRS depreciation were taken on the qualified property in lieu of bonus depreciation.

BONUS DEPRECIATION VERSUS §179 DEDUCTION

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

- 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. Any elected §179 deduction not allowed because of the business income limit can be carried forward to the next year. **There is no business income limitation on property qualifying for bonus depreciation.**

Example 17. Ferry Company has net income of $300,000 in 2020 before taking into account any §179 expense or bonus depreciation. Ferry purchased new assets totaling $500,000 during the tax year. If Ferry utilizes the §179 deduction, it is limited to $300,000. However, Ferry can take 100% bonus depreciation on the full $500,000 of assets purchased, generating a $200,000 loss. The loss can be carried forward.

71. Treas. Reg. §1.460-4(b)(1).

72. *General Explanation of Tax Legislation Enacted in the 111th Congress.* Mar. 2011. Joint Committee on Taxation. [www.jct.gov/publications.html?func=startdown&id=3775] Accessed on Mar. 3, 2020.

73. IRC §460(c)(6).

74. IRC §460(c)(6)(B).

Note. For tax years ending after 2017, the TCJA eliminated NOL carrybacks, except for NOLs attributable to farming losses and certain insurance companies.[75] In addition, under the TCJA, the NOL deduction was limited to 80% of taxable income for NOLs arising in tax years beginning after December 31, 2017.

However, the CARES Act, which was enacted on March 27, 2020, provides that any NOL arising in a tax year beginning after December 31, 2017, and before January 1, 2021, can be carried back to the five tax years preceding the year of the loss, as well as carried forward indefinitely.[76] Moreover, the application of the 80% taxable income limitation is suspended for tax years beginning after December 31, 2017, and before January 1, 2021.[77]

For more information about these changes as well as other options available to taxpayers, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Net Operating and Excess Business Losses and Volume A, Chapter 1: New Developments.

- The taxpayer can elect to recover all or a portion of the cost of **specific** items of qualifying property under §179, up to the annual dollar limitation amount. The bonus depreciation allowance is calculated by multiplying the full amount of the depreciable basis of qualifying property by the applicable percentage. When a taxpayer elects out of one or more classes of property for purposes of bonus depreciation, the election applies to the **entire** class (or classes) of property.
- 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. Listed property must be **used more than 50%** for business purposes in order to take bonus depreciation.
- If business use of property for which a §179 deduction has been taken drops to 50% or less during the property's recovery period, the §179 expense is subject to recapture. This does not apply to bonus depreciation deductions other than bonus depreciation taken on listed property.[78]

Caution. Many states have not adopted the federal rules regarding §179 expensing and/or bonus depreciation. This creates different state and federal depreciation computations in the year of acquisition, for each year of ownership, and in the year of disposition. Practitioners are advised to consult the laws of the states in which their clients conduct business.

75. See IRC §172(b).

76. IRC §172(b)(1)(D).

77. CARES Act §2303; *Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act* (JCX-12R-20). Apr. 23, 2020. Joint Committee on Taxation. [www.jct.gov/publications.html?func=startdown&id=5256] Accessed on Apr. 30, 2020.

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

The following table compares various attributes of bonus depreciation versus §179 expensing.

	Bonus Depreciation	IRC §179
Maximum amount (2020)	Unlimited	$1.04 million
Maximum qualifying property (2020)	Unlimited	$2.59 million
Business income limit	No	Yes
Provision end date	100% through 2022 (one year longer for certain property), then phased down by 20% per year	None—amounts adjusted annually for inflation
Qualifying property	• Tangible property with 20 years or less recovery period • Water utility property • Computer software • Qualified film, television, and live theatrical productions • Specified plants	• Tangible personal property • Other tangible property • Single-purpose agricultural or horticultural structures • Storage facilities used for petroleum • Computer software • Qualified real property
Allowable for used property	Yes	Yes
Election required	No—can elect out for any class of property; otherwise, bonus depreciation is automatic	Yes; can elect specific items of property
Effect on mid-quarter convention[79]	Amounts depreciated do **not** reduce basis for purposes of determining if convention applies	Amounts expensed reduce basis for purposes of determining if convention applies

DEPRECIATION OF VEHICLE USING STANDARD MILEAGE RATE[80]

Taxpayers who use a vehicle for business purposes may be able to deduct car expenses. They generally can determine their deductible expenses using either the standard mileage rate (SMR) or actual car expenses. If a taxpayer decides to use the SMR for a car they own, they **must** choose to use it in the first year the car is available for use in their business. Then, in subsequent years, they can choose to use either the SMR or actual expenses. However, if a taxpayer wants to use the SMR for a car they lease, they must use it for the entire lease period.

> **Note.** For information about using the actual expense method to deduct car expenses, see IRS Pub. 463, *Travel, Gift, and Car Expenses.*

79. Ibid.

80. IRS Pub. 463, *Travel, Gift, and Car Expenses.*

A taxpayer must make the decision to use the SMR by the due date (including extensions) of their return. This decision cannot be revoked; however, in later years, the taxpayer can switch from the SMR to the actual expenses method. If the taxpayer switches to the actual expenses method in a later year, they must estimate the remaining useful life of the car and use straight-line depreciation if the car is not fully depreciated.

A taxpayer cannot use the SMR if they:

- Use five or more cars at the same time,
- Claimed a depreciation deduction for the car using any method other than straight-line,
- Claimed a §179 deduction on the car,
- Claimed bonus depreciation on the car, or
- Claimed actual car expenses after 1997 for a car they leased.

Depreciation is included in the SMR. The SMR and the depreciation component of the SMR are shown in the following table for the years 2012–2020.[81]

Year	SMR per Mile	Depreciation Component of SMR
2020	$0.575	0.27
2019	0.58	0.26
2018	0.545	0.25
2017	0.535	0.25
2016	0.54	0.24
2015	0.575	0.24
2014	0.56	0.22
2013	0.565	0.23
2012	0.555	0.23

A taxpayer using the SMR must reduce their basis in their car (but not below zero) by the amount of the depreciation included in the SMR. **If the taxpayer reduces their basis to zero through the use of the SMR and they continue to use their car for business, no reduction to the SMR is necessary.** The taxpayer can continue to use the full SMR for business miles driven to determine their deductible car expenses.

Self-employed taxpayers deduct their car expenses using Schedule C, *Profit or Loss From Business,* or Schedule F, *Profit or Loss From Farming.*[82] They must also complete Form 4562, to report the depreciation claimed on their vehicles.[83]

81. *Standard Mileage Rates.* Jan. 17, 2020. IRS. [www.irs.gov/tax-professionals/standard-mileage-rates] Accessed on Feb. 25, 2020; IRS Notice 2019-02, 2019-02 IRB 281; IRS Notice 2020-05, 2020-4 IRB 380; IRS Pub. 463, *Travel, Gift, and Car Expenses*.

82. *Topic No. 510 Business Use of Car.* Aug. 23, 2019. IRS. [www.irs.gov/taxtopics/tc510] Accessed on Dec. 3, 2019.

83. Instructions for Form 4562.

Example 18. David purchased a car for $12,000 in 2012 and used it entirely in his sole proprietor business. He elected to use the SMR to determine his deductible car expenses. The following table shows David's allowable expenses for 2012–2019, including the depreciation component.

Year	Total Miles (100% Business)	SMR Factor	Deductible Car Expenses	Depreciation Component of SMR	Total Depreciation
2012	6,000	$0.555	$ 3,330	$0.23	$ 1,380
2013	6,800	0.565	3,842	0.23	1,564
2014	5,400	0.56	3,024	0.22	1,188
2015	5,450	0.575	3,134	0.24	1,308
2016	5,950	0.54	3,213	0.24	1,428
2017	6,490	0.535	3,472	0.25	1,623
2018	6,650	0.545	3,624	0.25	1,663
2019	7,220	0.58	4,188	0.26	1,846 [a]
Totals			$27,827		$12,000

[a] Total depreciation calculated using SMR is $1,877 (7,220 × $0.26). Depreciation limited to $1,846 because vehicle cannot be depreciated below zero.

In 2020, David drove the car 5,500 miles for business purposes. His deductible car expenses are $3,163 (5,500 miles × $0.575 SMR for 2020). He can deduct this full amount on his Schedule C.

Practitioner Planning Tip

This information becomes especially useful because personal property no longer qualifies for like-kind exchange treatment in years after 2017. The disposition of the vehicle can result in ordinary loss or ordinary gain.

Note. For a discussion about the disposition of vehicles using the SMR, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

DEPRECIATION TRANSACTIONS INVOLVING RELATED PARTIES[84]

Related taxpayers can easily manipulate various tax provisions in ways that give them an unfair advantage over unrelated taxpayers. To address this situation, Congress enacted several provisions that restrict the use of certain tax benefits between related parties. However, the term **related parties** is defined differently for various Code provisions. Practitioners must therefore be careful to use the right definition when determining the tax treatment of a specific transaction between parties who may or may not be deemed related.

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

GENERAL RULES

Defining Related Parties

The term **related parties** includes people and entities that have connections to the taxpayer. The connections may be familial, or they may be created through an ownership interest in an entity.

For transactions involving property, related parties are **generally** defined as follows.

1. An individual and a member of their family, including only a spouse, child, parent, brother, sister, half-brother, half-sister, ancestor, and lineal descendant
2. A corporation and an individual who directly or indirectly owns more than 10% of the value of the corporation's outstanding stock
3. Two corporations that are members of the same controlled group
4. A trust fiduciary and a corporation, if more than 10% of the value of the outstanding stock is directly or indirectly owned by or for the trust or grantor of the trust
5. The grantor and the fiduciary, and the fiduciary and beneficiary, of any trust
6. The fiduciaries of two different trusts, and the fiduciaries and the beneficiaries of two different trusts, if the same person is the grantor of both trusts
7. A tax-exempt educational or charitable organization and any person (or, if that person is an individual, a member of that person's family) who directly or indirectly controls the organization
8. Two S corporations, or an S corporation and a C corporation, if the same persons own more than 10% of the value of each corporation's outstanding stock
9. A corporation and a partnership, if the same persons own both of the following
    a. More than 10% of the value of the corporation's outstanding stock
    b. More than 10% of the capital or profits interest in the partnership
10. The executor and the beneficiary of any estate
11. A partnership and a person who directly or indirectly owns more than 10% of the partnership's capital or profits interest
12. Two partnerships, if the same persons directly or indirectly own more than 10% of the capital or profits interest in each
13. The related person and a person who is engaged in trades or businesses under common control (See IRC §§52(a) and (b) for more information.)

Date for Determining if a Transaction Involves Related Parties

For transactions involving property, the determination of whether a taxpayer is related to another person is generally made as of **the date the property is acquired.** However, a partnership acquiring property from a terminating partnership must determine whether it is related to the terminating partnership immediately before the event causing the termination.

Rules for Determining How Much of an Interest a Person Holds

To determine whether a person directly or indirectly owns any of the outstanding stock of a corporation or an interest in a partnership, the following rules are applied.

1. Stock or a partnership interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries. However, for a partnership interest owned by or for a C corporation, this rule applies only to shareholders who directly or indirectly own 5% or more of the value of the corporation's stock.
2. An individual is considered to own the stock or partnership interest directly or indirectly owned by or for the individual's family.
3. An individual who owns (except by applying rule 2) any stock in a corporation is considered to own the stock directly or indirectly owned by or for the individual's partner.
4. For purposes of rules 1, 2, or 3, stock or a partnership interest considered owned by a person under rule 1 is treated as owned by that person. However, stock or a partnership interest considered owned by an individual under rule 2 or 3 is not treated as owned by that individual for purposes of reapplying either rule 2 or 3 to attribute ownership of the same stock or partnership interest to another person.

Example 19. Robert, Wilma, James, and Mildred each own 25% of the corporation Robbins Jones, Inc. Robert and Wilma have the same mother; however, they have different fathers. Wilma is James's daughter, and Mildred is James's sister.

Robert directly owns 25% of the shares. He indirectly owns another 25% through his half-sister, Wilma. Therefore, Robert is considered to have a 50% ownership in the company when determining whether related-party limitations apply.

Wilma owns 25% of the shares directly. She indirectly owns another 25% through her half-brother, Robert, and another 25% through her father, James. She therefore has a 75% interest for purposes of determining if related-party limitations apply.

Robert must add Wilma's directly-owned shares to his for purposes of determining if related-party limitations apply. However, he does not have to add James's shares, which are attributed to Wilma indirectly under rule 2.

LISTED PROPERTY RESTRICTIONS

As mentioned earlier, listed property must be used predominantly for qualified business use during the year it is placed in service to claim the §179 deduction or bonus depreciation. If the property is not used predominantly for qualified business use during any year, MACRS depreciation must be calculated using the straight-line method over the ADS recovery period. Excess depreciation on property previously used predominantly for qualified business use must be recaptured in the first year in which it is no longer used predominantly for qualified business use. **Qualified business use** of listed property **does not include** the following.

- The leasing of property to any 5% owner or related person (to the extent the property is used by a 5% owner or person related to the owner or lessee of the property)
- The use of property as pay for the services of a 5% owner or related person
- The use of property as pay for services of any person (other than a 5% owner or related person), unless the value of the use is included in that person's gross income and income tax is withheld on that amount where required

Example 20. Sharon owns 100% of the stock in a medical supply company. The company provides vehicles for Sharon and her seven managers to use for business and personal purposes. None of the seven managers are related to her in any way.

Every person who uses a company vehicle documents their mileage. The FMV of each employee's use of an automobile for any personal purpose is reported as income to the employee. In addition, taxes are withheld on the income.

The employees' use of company vehicles for personal purposes constitutes payment for services. It is reported as income to each employee, and required taxes are withheld. Therefore, the vehicles used by the unrelated employees are treated as being used 100% for business.

Sharon's personal use of a company vehicle is not qualified business use, even though the company properly reports her personal use as income on her Form W-2, *Wage and Tax Statement.* If the business miles for the vehicle do not exceed 50% of the total miles, the vehicle must be depreciated using the straight-line method. In addition, recapture rules apply if the vehicle was previously used more than 50% for business.

Note. Depreciation recapture is discussed later in this chapter.

Example 21. Use the same facts as **Example 20,** except in addition to the vehicles provided to Sharon and her seven managers, the company also provides Sharon's husband, Ray, with a vehicle to use for business and personal purposes. The use of the vehicle is part of Ray's pay. Moreover, the company includes the value of the personal usage in Ray's gross income and withholds tax on it. However, as Sharon's husband, Ray indirectly owns 100% of the company stock. Therefore, his personal use is **not** qualified business use.

IRC §179 RESTRICTIONS

Property acquired from a related person or by one component member of a controlled group from another component member of the same group does not qualify for the §179 deduction. For these purposes, related parties are defined using the same items listed earlier in the "General Rules" section, except an individual's family is treated as including only the individual's spouse, ancestors, and lineal descendants. In addition, 50% should be substituted for 10% each place it appears.

BONUS DEPRECIATION RESTRICTIONS

As mentioned earlier, used property may qualify for bonus depreciation if it meets certain acquisition requirements. An acquisition is not considered a purchase if it is acquired from a close family member or is acquired by one member of a controlled group of corporations from another member. Family members for this purpose include only an individual's spouse, ancestors, and lineal descendants.[85]

TERM INTERESTS THAT INVOLVE RELATED PARTIES

With certain exceptions, taxpayers **cannot** depreciate a term interest in property for any period during which the remainder interest is held, directly or indirectly, by a related person. A **term interest** is defined as a life interest in property, an interest in property for a term of years, or an income interest in a trust.

This rule does **not** apply if the taxpayer acquired the term interest in the property by gift, bequest, or inheritance.

Related persons for this purpose include items 1 through 10 listed under "Defining Related Parties," except 50% is substituted for 10% each place it appears.

Note. For more information about property held by life tenants and remainder holders, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis.

85. IRC §179(d)(2)(A).

If the taxpayer is not allowed a depreciation deduction for a term interest in property because the holder of the remainder interest is related to them, the taxpayer must still reduce their basis in the term interest by any depreciation or amortization not allowed. The holder of the remainder interest increases their basis in the remainder interest by the depreciation not allowed to the term interest holder. However, the remainder interest holder does not increase their basis for depreciation not allowed for any period during which either of the following circumstances applies.

- The term interest is held by an organization exempt from tax.
- The term interest is held by a nonresident alien individual or foreign corporation, and the income from the term interest is not effectively connected with the conduct of a trade or business in the United States.

Example 22. Bertha purchased a rental house. She transferred the deed on the house to her granddaughter, Caroline. However, Bertha reserved the right to the income from the rental property for the rest of her life. Bertha must report the income from the rental on her tax return, but she cannot claim any depreciation for the term interest she retained. This is because Caroline, a related party, owns the remainder interest.

Each year that Bertha lives, the depreciation that would have been allowed except for this rule reduces her basis in the term interest. The amount that reduces Bertha's basis passes to Caroline as an addition to her basis.

DEPRECIATION RULES FOR LIKE-KIND EXCHANGE

Starting in 2018, like-kind exchange treatment is only available for **real property.**[86] Before 2018, the like-kind exchange rules also applied to depreciable tangible personal property and intangible and nondepreciable personal property.

> **Note.** For a thorough discussion of the general rules that apply to like-kind exchanges, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

GENERAL RULE[87]

The taxpayer recognizes no gain or loss when only like-kind property is exchanged and all pertinent requirements are met. The taxpayer's adjusted basis in the relinquished property carries over to the replacement property.[88]

For property acquired after February 27, 2004, the regulations under §168 control the method and manner of depreciating MACRS property acquired in a like-kind exchange. The regulations provide that 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. The new basis is the boot, if any, paid in the exchange. This is required to be separately depreciated as newly purchased MACRS property.

However, a taxpayer can elect not to apply these regulations. If this election is made, when property is acquired in a like-kind exchange (or involuntary conversion), the remaining basis in the relinquished property is added to any new basis in the acquired property and the total is depreciated over the life of the acquired property.

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86. IRC §1031, as amended by PL 115-97.

87. TD 9314, 2007-14 IRB 845.

88. IRC §§1031(a) and (d).

Acquired Property with Same or Shorter Recovery Period[89]

The following rules apply to acquired property with the same or a shorter recovery period and the same or more accelerated depreciation method than the property exchanged or involuntarily converted.

- The taxpayer generally must depreciate the carryover basis of property (transferor's adjusted basis) acquired in a like-kind exchange or involuntary conversion over the remaining recovery period of the property exchanged or involuntarily converted.
- The taxpayer generally continues to use the same depreciation method and convention used for the exchanged or involuntarily converted property.
- The taxpayer treats the excess basis, if any, of the acquired property as property newly placed in service.

Example 23. Willdor Partnership exchanged an office building for a warehouse in a like-kind exchange. Willdor relinquished the office building in July 2020 and the warehouse is acquired and placed in service in October 2020. The unadjusted depreciable basis of the office building was $4.68 million when it was placed in service in July 2013. Willdor also pays $100,000 cash at the time of the exchange.

The recovery period and depreciation method prescribed in §168 for the office building is 39 years using the straight-line method. The same recovery period and depreciation method is prescribed in §168 for the warehouse. Therefore, the warehouse is depreciated over the remaining recovery period and using the same depreciation method and convention (mid-month) as the office building.

The office building is deemed disposed of on July 15, 2020, and the warehouse is placed in service on October 15, 2020. The warehouse is depreciated using the straight-line method over the office building's remaining recovery period of 32 years beginning in October 2020.

The total depreciation claimed through July 2020 on the office building is $840,000, calculated as follows.

Year	Depreciation Allowance	Computation
2013	$ 55,000	(($4.68 million ÷ 39 years) × (5.5 months ÷ 12 months))
2014	120,000	($4.68 million ÷ 39 years)
2015	120,000	($4.68 million ÷ 39 years)
2016	120,000	($4.68 million ÷ 39 years)
2017	120,000	($4.68 million ÷ 39 years)
2018	120,000	($4.68 million ÷ 39 years)
2019	120,000	($4.68 million ÷ 39 years)
2020	65,000	(($4.68 million ÷ 39 years) × (6.5 months ÷ 12 months))
Total	$840,000	

Beginning in October 2020, the depreciable exchanged (carryover) basis of the warehouse is depreciated over the remaining recovery period of 32 years. The depreciable exchanged basis is $3.84 million ($4.68 million depreciable basis for office building – $840,000 total depreciation on office building). The depreciation on the warehouse is calculated as follows.

Year	Depreciation Allowance	Computation
2020	$ 25,000	(($3.84 million ÷ 32 years) × (2.5 months ÷ 12 months))
2021–2051	120,000 per year	($3.84 million ÷ 32 years)
2052	95,000	(($3.84 million ÷ 32 years) × (9.5 months ÷ 12 months))

Willdor also has $100,000 of excess basis, which is the cash boot paid at the time of the exchange. This amount is depreciated over 39 years, using the straight-line method and the mid-month convention.

89. IRS Pub. 946, *How To Depreciate Property;* Treas. Reg. §1.168(i)-6(c)(3).

Acquired Property with Longer Recovery Period[90]

The following rules apply to acquired property that has a longer recovery period or less accelerated depreciation method than the exchanged or involuntarily converted property.

- The taxpayer generally must depreciate the carryover basis of the acquired property as if it were placed in service in the same tax year as the exchanged or involuntarily converted property. Therefore, the exchanged basis is depreciated over the remaining recovery period of the replacement property.
- The taxpayer generally continues to use the longer recovery period and less accelerated depreciation method of the acquired property.
- The applicable convention for the exchanged basis is determined as follows.[91]
  - If either the relinquished MACRS property or the replacement MACRS property is property for which the mid-month convention applies (as determined under §168(d)), the exchanged basis must be depreciated using the mid-month convention. Under §168(d)(2), the mid-month convention applies to nonresidential real property, residential rental property, and any railroad grading or tunnel bore.
  - If neither the relinquished MACRS property nor the replacement MACRS property is property to which the mid-month convention applies, the applicable convention for the exchanged basis is the same convention that applied to the relinquished MACRS property.

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.[92] In addition, bonus depreciation is not taken into account in determining whether the mid-quarter convention applies.[93]

- The taxpayer treats the excess basis, if any, of the acquired property as property newly placed in service.[94]

Practitioner Planning Tip

Tax practitioners must determine how to link the different components of the same asset after 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.

90. IRS Pub. 946, *How To Depreciate Property;* Treas. Reg. §1.168(i)-6(c)(4).
91. Treas. Reg. §1.168(i)-6(c)(4)(v).
92. Treas. Reg. §1.168(i)-6(f).
93. REG-106808-19 (Sep. 13, 2019), p. 27.
94. Treas. Reg. §1.168(i)-6(d)(1).

Electing Out[95]

Instead of using the rules outlined above, the taxpayer can elect to treat the adjusted basis of the exchanged or involuntarily converted property as if disposed of at the time of the exchange or involuntary conversion. The carryover basis and excess basis (if any) for the acquired property is treated as if placed in service on the later of the date the taxpayer acquired it or the time of the disposition of the exchanged or involuntarily converted property.

The depreciable basis of the new property is the adjusted basis of the exchanged or involuntarily converted property plus any additional amount (boot) the taxpayer paid for it.

The election applies to both the acquired property and the exchanged or involuntarily converted property. It does not affect the amount of gain or loss the taxpayer recognizes on the exchange or involuntary conversion.

The taxpayer makes the election by attaching a statement to a timely filed return (including extensions) for the year of replacement. The statement should state "Election made under section 1.168(i)-6(i)."[96] For a partnership, S corporation, or consolidated group, the election is made by the partnership, S corporation, or the common parent of a consolidated group, respectively. The election is irrevocable without IRS consent.

Example 24. Use the same facts as **Example 23.** The following table summarizes Willdor's depreciation amounts for the like-kind exchange.

Date	Property	Accumulated Depreciation as of December 31, 2019	2020 Depreciation
July 2013	Office building (cost $4.68 million)	$775,000	$65,000
October 2020	Warehouse (exchanged basis $3.84 million)	0	25,000
October 2020	Boot paid for warehouse ($100,000)	0	534 [a]
Total			$90,534

[a] (($100,000 ÷ 39 years) × (2.5 months ÷ 12 months))

If Willdor made the election under Treas. Reg. §1.168(i)-6(i), its 2020 depreciation for the exchange would be $86,047, as shown in the following table.

Date	Property	Accumulated Depreciation as of December 31, 2019	2020 Depreciation
July 2013	Office building (cost $4.68 million)	$775,000	$65,000
October 2020	Warehouse (exchanged basis $3.84 million + $100,000 boot)		21,047 [a]
Total			$86,047

[a] (($3.94 million ÷ 39 years) × (2.5 months ÷ 12 months))

95. IRS Pub. 946, *How To Depreciate Property;* Treas. Reg. §1.168(i)-6(i).

96. Instructions for Form 4562.

BONUS DEPRECIATION[97]

If the taxpayer acquired qualified property (defined earlier) in a like-kind exchange or involuntary conversion after September 27, 2017, and the qualified property is **new** property, the carryover basis and any excess basis of the acquired property are eligible for bonus depreciation.

If the taxpayer acquired qualified property in a like-kind exchange or involuntary conversion after September 27, 2017, and the qualified property is **used** property, only the excess basis of the acquired property is eligible for bonus depreciation. After calculating the bonus depreciation, the taxpayer can take regular MACRS depreciation on the remaining carryover basis.

IRC §179 ELECTION[98]

When applying the §179 election to a like-kind exchange, only the excess basis (if any) of the replacement MACRS property is taken into account.

CHANGE IN ACCOUNTING METHOD FOR DEPRECIATION[99]

A taxpayer must generally obtain IRS approval to change their method of accounting. To request a change in the method of accounting for depreciation, the taxpayer generally must file Form 3115.

The following are examples of a change in method of accounting for depreciation.

- A change from an impermissible method of determining depreciation for depreciable property, if the impermissible method was used in two or more consecutively filed tax returns
- A change in the treatment of an asset from nondepreciable to depreciable or vice versa
- A change in the depreciation method, period of recovery, or convention of a depreciable asset
- A change from not claiming to claiming the bonus depreciation allowance if the taxpayer did not make the election to not claim any bonus depreciation

Some changes in depreciation are not a change in method of accounting and may only be made by filing an amended return. These include the following.

- An adjustment in the useful life of a depreciable asset for which depreciation is determined under §167
- A change in the use of an asset in the hands of the same taxpayer
- Making a late depreciation election or revoking a timely valid depreciation election (including the election not to deduct the bonus depreciation allowance)
- Any change in the placed-in-service date of a depreciable asset

Note. For an explanation of how to correct depreciation using Form 3115, including a detailed example with a completed form, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

97. IRS Pub. 946, *How To Depreciate Property;* Treas. Reg. §1.168(k)-2(g)(5)(iii).

98. Treas. Reg. §1.168(i)-6(g).

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

QUALIFIED BUSINESS INCOME ISSUES

The TCJA introduced the qualified business income deduction (QBID), which provides a deduction of up to 20% from a noncorporate taxpayer's taxable income, subject to certain limitations. The QBID is available for tax years starting after December 31, 2017, and before January 1, 2026. This section contains a brief explanation of how the depreciation rules affect the calculation of the QBID.

All taxpayers with qualified business income (QBI) whose 2020 taxable income (computed before the QBID) exceeds the threshold amounts ($326,600 for married filing jointly (MFJ) taxpayers and $163,300 for all other taxpayers)[100] are subject to a W-2 wages/qualified property (QP) limit based either on wages paid or on wages paid plus a capital element. This limitation, referred to as the W-2 wages/QP limit, is the greater of:[101]

- **50%** of the W-2 wages paid with respect to the qualified business, **or**
- **25%** of the W-2 wages with respect to the qualified business **plus 2.5%** of the unadjusted basis immediately after acquisition (UBIA) of all QP.

For these taxpayers, the initial QBID for **each** business is the **lesser** of:[102]

- 20% of the QBI for that business, **or**
- The W-2 wages/QP limit (defined above).

For MFJ taxpayers with 2020 taxable income between $326,600 and $426,600 ($163,300–$213,300 for all other taxpayers), additional calculations are required.[103]

The taxable income phase-in ranges are indexed annually for inflation.

> **Note.** The W-2 wages/QP limit is calculated on Form 8995-A, *Qualified Business Income Deduction,* part II, lines 5 through 10.

> **Note.** For information about the definition of W-2 wages, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update and the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. The 2018 chapter can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

QUALIFIED PROPERTY[104]

QP is defined in the Code as tangible depreciable property that meets **all** the following requirements.

- It is subject to the allowance for depreciation under IRC §167.
- It is held by and available for use in the qualified trade or business at the **close** of the tax year.
- It is used at any point during the tax year in the production of QBI.
- The property's depreciable period has **not ended** before the close of the tax year.

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100. Rev. Proc. 2019-44, 2019-47 IRB 1093.
101. IRC §199A(b)(2)(B).
102. IRC §199A(b)(2).
103. IRC §199A(b)(3)(B).
104. IRC §199A(b)(6).

The **depreciable period** refers to the date the property was first placed in service by the taxpayer and ends on the **later** of the following.

- The date that is 10 years after the placed-in-service date
- The last day of the last full year in the applicable recovery period that would apply to the property under §168 (excluding property required to be depreciated under ADS)

Note. Bonus depreciation does not affect the applicable recovery period for QP.[105]

Note. See the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues for more information on the §199A depreciable periods for different property classes. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Under the regulations, the term UBIA, for purposes of the W-2 wages/QP limit, refers to the basis of the QP on its placed-in-service date before **any** adjustments for depreciation.[106]

Example 25. In January 2012, Windy Co. purchased a warehouse for $1 million and placed it in service in Windy's business. The warehouse is QP under §199A and Windy's basis in the property is $1 million. As of December 31, 2018, Windy's basis in the warehouse, as adjusted for depreciation, is $821,550. Windy's UBIA of the real property is its cost basis of $1 million.[107]

The final regulations provide several clarifications regarding QP. The remainder of this section summarizes the issues clarified in the final regulations that are impacted by adjustments to depreciation.

QP of an RPE[108]

TD 9847, which is applicable on or after February 8, 2019, contains some modifications to the methodology for allocating QP held by a relevant pass-through entity (RPE). Treas. Reg. §1.199A-1 defines **RPE** as a partnership (other than a publicly traded partnership) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other pass-through entities, including common trust funds, are also treated as RPEs if the entity files a Form 1065 and is owned, directly or indirectly, by at least one individual, estate, or trust.

Proposed regulations provide that each partner/shareholder's share of the UBIA of QP is allocated in the same proportion that the partner/shareholder's share of tax depreciation has to the RPE's total tax depreciation for the property for the year. For a partnership with QP that does not produce tax depreciation during the year, each partner's share of the UBIA of QP is based on how gain would be allocated to the partners under IRC §§704(b) and (c) if the QP were sold in a hypothetical transaction for cash equal to the FMV of the QP.

Several commenters suggested that only §704(b) should be used for this purpose because the use of §704(c) allocation methods would be unduly burdensome and could lead to unintended results. The Treasury Department and the IRS agree that relying on §704(c) to allocate UBIA could lead to unintended shifts in the allocation of UBIA. Therefore, the final regulations provide that each partner's share of the UBIA is determined in accordance with how depreciation would be allocated for §704(b) book purposes under Treas. Reg. §1.704-1(b)(2)(iv)(g) on the last day of the tax year. To the extent a partner has depreciation expense as an ordinary deduction and as a rental real estate deduction, the allocation of the UBIA should match the allocation of the expenses.

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105. Treas. Reg. §1.199A-2(c)(2)(ii).

106. Treas. Reg. §1.199A-2(c)(3).

107. Based on an example in Treas. Reg. §1.199A-2(c)(4).

108. TD 9847, 2019-09 IRB 670, 677; Treas. Reg. §1.199A-2(a)(3).

For QP held by an S corporation, each shareholder's share of UBIA is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the tax year over the total issued and outstanding shares of the S corporation.

QP Received in a Like-Kind Exchange or Involuntary Conversion[109]

Under proposed §199A regulations, the UBIA of replacement property would have been the same as the transferor's adjusted basis in the relinquished property. Several commenters on the proposed regulations observed that this rule would discourage taxpayers from conducting like-kind exchanges because the UBIA of the replacement property would be less than the UBIA of the relinquished property by the amount of §168 depreciation deductions taken. Consequently, the IRS modified the rule in the proposed regulations.

Under the final regulations, the UBIA of qualified like-kind property that a taxpayer receives in an IRC §1031 like-kind exchange or an IRC §1033 involuntary conversion is generally the **UBIA of the relinquished property.** When the exchange also involves cash or other property, the UBIA is:

1. Decreased by excess boot, or
2. Increased by the cash or the FMV of other property paid by the acquiring taxpayer.

Excess boot for this purpose is the excess of the cash or FMV of other property received by the taxpayer in the exchange over the amount of the taxpayer's appreciation in the relinquished property. **Appreciation** means the excess of the FMV of the relinquished property on the date of the exchange over its FMV when acquired by the taxpayer. **Other property** is defined as property that is not of a like kind to the relinquished property.

If the replacement property in a §1031 like-kind exchange or a §1033 involuntary conversion consists of multiple items of QP that are of a like kind to the relinquished property, UBIA is apportioned between or among the replacement properties in proportion to their relative FMVs. Any other property received by the taxpayer in the transaction that is QP has a UBIA equal to its FMV.

The placed-in-service date of replacement property is the same as the relinquished property's placed-in-service date.

> **Example 26.** Use the same facts as **Example 25.** In January 2019, Windy enters into a like-kind exchange in which Windy exchanges its warehouse for a larger warehouse facility. At that time, the original warehouse has appreciated in value to $1.3 million, but the larger warehouse has a value of $1.5 million. Windy therefore adds $200,000 in cash to acquire the larger facility. On the date Windy places the larger facility in service, its basis in the original warehouse is $820,482.
>
> Windy's UBIA in the replacement warehouse is $1.2 million ($1 million in UBIA from the original warehouse + $200,000 cash paid to acquire the larger warehouse). Because the UBIA of the replacement warehouse exceeds the UBIA of the relinquished warehouse, the new warehouse is treated as being two separate items of QP. The first piece of QP has a UBIA of $1 million and a placed-in-service date of January 2012 (same as the original warehouse). The other item of property has a UBIA of $200,000 and a placed-in-service date of January 2019, which is the date the replacement warehouse was first placed in service by Windy.[110]

QP Acquired from a Decedent[111]

The preamble to the proposed §199A regulations stated that the UBIA of QP acquired from a decedent and immediately placed in service is generally its FMV at the date of the decedent's death under IRC §1014. In response to a comment received, the IRS formalized this rule in the final regulations. Additionally, the final regulations clarify that a new depreciable period begins on the date of the decedent's death.

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109. TD 9847, 2019-09 IRB 670, 677; Treas. Reg. §1.199A-2(c)(3).

110. Based on an example in Treas. Reg. §1.199A-2(c)(4).

111. TD 9847, 2019-09 IRB 670, 680; Treas. Reg. §1.199A-2(c)(3)(v).

QUALIFYING FOR QBID VERSUS IRC §179

Because some items are included in income for one purpose, but not the other, it is possible for a taxpayer to qualify for the QBID even if their business income is insufficient for the §179 deduction. It is also possible for the §179 deduction to be allowed even though a taxpayer's QBI is zero or negative for the year.

As mentioned earlier, QBI includes all items of income, gain, deduction, and loss from trades or businesses that are included or allowed in determining taxable income for the year. Thus, regardless of the type of income that is used to qualify for the §179 deduction, the deduction is included in QBI. For example, if an individual has a Schedule C business loss that includes the §179 deduction that is allowed because the taxpayer's wages are included in the calculation of income for §179 purposes, the taxpayer's QBI from all businesses is also reduced by the §179 deduction.

It is possible for the §179 deduction to be limited because of insufficient qualified income but for the taxpayer to still have a QBID. In this case, the deferred §179 deduction is not included in QBI until the year that it is included in expenses on the return.

Example 27. Hershel is the sole shareholder of an S corporation that rents its office building from him personally. The S corporation's income, deductions, and other information is reported on a Schedule K-1. His involvement in the rental activity does **not** rise to the level of active conduct of a trade or business. In 2019, he also started a new unrelated business venture that he operated as a sole proprietorship. His 2019 tax return included the following.

Net ordinary income from box 1 of the Schedule K-1	$21,000
Business loss from sole proprietorship	(25,000)
Pass-through §179 deduction from box 11 of the K-1	(15,000)
Net real estate rental income from corporate office	80,000

Hershel's 2019 business income for the §179 limitation was $0 because the sole proprietorship loss was combined with the net ordinary income from the S corporation to yield a $4,000 loss ($21,000 income – $25,000 loss). The rental income does not qualify for purposes of the §179 deduction because Hershel's involvement does not rise to the level of active conduct of a trade or business. The $15,000 §179 deduction carried forward to 2020. Hershel's 2019 QBI was calculated as follows.

QBI reported in box 17, code V ($21,000 ordinary income – $15,000 §179)	$ 6,000
Plus: deferred §179 deduction	15,000
Less: business loss from sole proprietorship	(25,000)
Plus: net real estate rental income from corporate office	80,000
Total net QBI	$76,000

The deferred §179 deduction was not included in the QBI calculation because it was not included on the 2019 return. It will be taken into account in the year the deduction is allowed.

Example 28. Use the same facts as **Example 27,** except Hershel's involvement in the rental activity **does** rise to the level of active conduct of a trade or business. As a result, Hershel's 2019 business income for purposes of the §179 limitation is $76,000 ($21,000 S corporation income – $25,000 sole proprietorship loss + $80,000 rental income), and he can take the $15,000 §179 deduction.

Hershel's 2019 QBI takes into account the §179 deduction allowed. Therefore, his net QBI is $61,000, which is calculated as follows.

QBI reported in box 17, code V ($21,000 ordinary income – $15,000 §179)	$ 6,000
Less: business loss from sole proprietorship	(25,000)
Plus: net real estate rental income from corporate office	80,000
Total net QBI	$61,000

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.[112] **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 that the taxpayer was **entitled to claim.**[113]

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[114]

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.

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

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112. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

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

114. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

Example 29. In February 2017, Reid bought and placed in service office furniture that cost $15,000. His MACRS deductions for the furniture totaled $5,817 for 2017–2018. Reid sold the furniture in May 2019 for $13,000. The MACRS deduction for 2019, the year of sale, is $1,312. The gain subject to recapture as ordinary income is calculated as follows.

1	Amount realized		$13,000
2	Cost	$15,000	
3	Less: depreciation	(7,129)	
4	Adjusted basis	$ 7,871	(7,871)
5	Gain realized		$ 5,129
6	Gain treated as ordinary income (lesser of line 3 or line 5)		$ 5,129

The transaction is reported on Form 4797, part III.

Form 4797 (2019) Page **2**

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	02/01/2017	05/10/2019
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	7,129			
23	Adjusted basis. Subtract line 22 from line 21	23	7,871			
24	Total gain. Subtract line 23 from line 20	24	5,129			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	7,129			
b	Enter the **smaller** of line 24 or 25a.	25b	5,129			

…roperty: If straight line depreciation was used

§1245 Recapture is QBI

To calculate the QBID, it is necessary to determine the taxpayer's QBI. QBI includes the net amount of qualified items of income, gain, deduction, and loss for any qualified trade or business of a noncorporate taxpayer. QBI does not include capital gains or losses but **does** include ordinary income and losses.[115] This was clarified in the preamble to TD 9847, which states, "To the extent an item is not treated as an item of capital gain or capital loss under any other provision of the Code, it is taken into account as a qualified item of income, gain, deduction, or loss unless otherwise excluded by section 199A or these regulations."[116]

Because §1245 recapture generates ordinary income, it **is included** in the calculation of QBI.

> **Note.** For a thorough explanation of QBI, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update and the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. The 2018 chapter can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

115. IRC §§199A(a) and (c).

116. TD 9847, 2019-09 IRB 670, 684.

§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 straight-line depreciation generally is reported as ordinary income. IRC §1250 property includes all depreciable real property that is not §1245 property.[117]

MACRS Property

IRC §1250 recapture does **not** apply to dispositions of the following MACRS property placed in service after 1986.[118]

- 27.5-year (30- or 40-year, if elected) residential rental 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 accelerated cost recovery system (ACRS) rules generally is subject to recapture under §1245. However, the following types of property are treated as §1250 property for purposes of recapture.[119]

- 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 straight-line election was made
- Low-income rental housing as described in §§1250(a)(1)(B)(i)–(iv)

§1250 Recapture is QBI

As stated earlier, §1250 recapture is reported as ordinary income. Therefore, it is included in the calculation of a taxpayer's QBI, for the same reasons set forth earlier in the section titled "§1245 Recapture is QBI."

Additional Corporate Recapture[120]

Under IRC §291, a C corporation that realizes a gain on §1250 property disposed of during the tax 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:

1. The amount that 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 straight-line method of depreciation, the ordinary income is 20% of the amount calculated under §1245. This is entered on line 26f of Form 4797.

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117. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

118. Instructions for Form 4797.

119. Ibid.

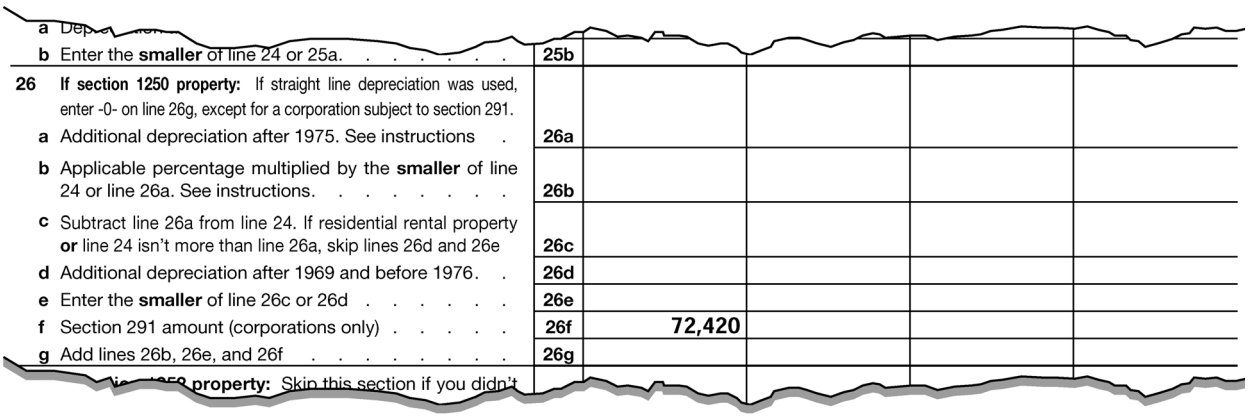
120. Ibid; IRC §291(a).

Example 30. Cumberland, Inc., a C corporation, placed nonresidential real property in service in 2009. The building cost $1 million and was sold in 2019 for $1.3 million. For the years 2009–2019, Cumberland claimed $362,100 of depreciation on the property. Although the building is not subject to recapture under §1250, Cumberland is subject to recapture under §291.

The amount of 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	(362,100)	
4 Adjusted basis	$ 637,900	(637,900)
5 Gain realized		$ 662,100
6 Gain treated as ordinary income (lesser of line 3 or line 5)		$ 362,100

Because the amount that would be treated as ordinary income under §1245 exceeds the amount treated as ordinary income under §1250 by $362,100 ($362,100 − $0), the amount recaptured as ordinary income under §291 is $72,420 ($362,100 × 20%). This is entered on line 26f of Form 4797.



a Depreciation					
b Enter the **smaller** of line 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 isn't 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**	72,420			
g Add lines 26b, 26e, and 26f	**26g**				
27 **Intangible property:** Skip this section if you didn't					

Because there is no preferential capital gains rate for corporations, the §291 adjustment is usually not a major consideration. However, the recharacterization of income has 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. A corporation's capital loss may be carried back three years and forward five years.[121]

IRC §291 also applies to an S corporation that was a C corporation in any of the three immediately preceding tax years.[122]

§1252 PROPERTY

Gains from the disposition of certain farmland held for less than 10 years are subject to recapture as ordinary income under §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.

121. IRC §1212(a)(1).

122. IRC §1363(b)(4).

§1254 PROPERTY

Under §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.[123]

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 as intangible drilling costs, depletion, mine exploration costs, and development costs under IRC §§263, 616, or 617
        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 would be reflected in the adjusted basis of the property if they were not deducted, **reduced by**
        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 §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 §1255 does not pertain to recapture of depreciation, the details are not covered here. For more information, see Treas. Reg. §16A.1255-1.

§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 tax year in which the usage of the property drops below 50%. 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.[124]

If the property is **not listed property,** the recapture amount is calculated as follows.[125]

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

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123. Treas. Reg. §1.1254-1; Instructions for Form 4797.

124. Treas. Reg. §1.179-1(e); Instructions for Form 4797.

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

Example 31. In January 2017, Alec bought and placed in service a copier costing $5,000. The copier is 5-year property and is used in Alec's accounting practice. Alec elected to expense the entire purchase price under §179. He used the copier solely for business purposes in 2017 and 2018. In 2019, Alec's wife used the copier in her volunteer activities, which reduced Alec's business use of the copier to 40%. He calculates his recapture amount as follows.

§179 deduction claimed in 2017		$5,000
Allowable depreciation under MACRS for 2017	$1,000	
Allowable depreciation under MACRS for 2018	1,600	
Allowable depreciation under MACRS for 2019 ($960 full MACRS depreciation × 40% business use)	384	
Total allowable depreciation	$2,984	(2,984)
2019 recapture amount		$2,016

He reports the recapture on part IV of his Form 4797, which follows.

32 Subtract line 3[illegible] other than casualty or theft on Form 4797, line [illegible] 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	

Form **4797** (2019)

Alec reports the $2,016 recapture as ordinary income on his 2019 Schedule C. His basis in the copier is increased by the $2,016 recapture income.

The recapture amount on **listed property** is calculated as the excess, if any, of:[126]

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 straight-line method and the ADS recovery period.

Practitioner Planning Tip

When business use drops to less than 50% during the recovery period, the taxpayer can have income that was not caused by disposing of the property. It is important to verify the taxpayer's business use of the property **each year** during its depreciable life.

126. Ibid.

DEPRECIATION ON FOREIGN PROPERTY

Depreciation on property used predominantly outside the United States is determined under ADS.[127] Property is considered used predominantly outside the United States if it is physically located outside the United States during more than 50% of the tax year. If the property is placed in service after the first day of the tax year, the relevant period for determining whether the property is located outside the United States more than 50% of the year begins on the date on which the property is placed in service and ends on the last day of the tax year.[128]

The depreciation deduction under ADS is determined using the straight-line method, the applicable convention, and the recovery period as shown below.[129]

Description of Property	Recovery Period
Personal property with no class life	12 years
Residential rental property	30 years
Nonresidential real 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.[130]

- Aircraft registered with the Federal Aviation Agency and operated to and from the United States or operated under contract with 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

127. IRC §168(g)(1).

128. Treas. Reg. §1.48-1(g)(1).

129. IRC §168(g)(2).

130. IRC §168(g)(4).

REAL PROPERTY DEPRECIATION CHANGE AFTER 2017[131]

ELECTING REAL PROPERTY OR FARMING BUSINESSES

Effective for tax years beginning after December 31, 2017, the taxpayer's deduction for business interest is limited under IRC §163(j) in any given tax year to the **sum of the following.**

1. Business interest income
2. The following percentage of adjusted taxable income for the year (cannot be less than zero)
   - 30% for 2018
   - 50% for 2019 and 2020
   - 30% for years beginning after 2020
3. Floor plan financing interest

Note. Under the TCJA, the applicable percentage of adjusted taxable income under §163(j) (item 2 in preceding list) was 30% for all tax years beginning after December 31, 2017. The CARES Act increased the applicable percentage to 50% for 2019 and 2020. For more information about this provision and other tax provisions contained in the CARES Act, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

An exemption from the business interest limitation is provided for a small business with average annual gross receipts for the immediately preceding 3-tax-year period that does not exceed $25 million.[132] (The $25 million limit is adjusted annually for inflation. For tax years beginning in 2020, the limit is $26 million.)[133] In addition, certain electing trades or businesses are not subject to the limitation.

For tax years beginning after December 31, 2017, real property trades or businesses or farming businesses that elect out of the §163(j) business interest deduction limitation must use the ADS. Under the ADS, there is a 30-year recovery period for residential rental property placed in service after December 31, 2017, in contrast to the 40-year period for the property if it was was placed in service before January 1, 2018.[134]

131. Rev. Proc. 2019-08, 2019-03 IRB 347 (§4).

132. IRC §§163(j)(3) and 448(c).

133. Rev. Proc. 2019-44, 2019-47 IRB 1093.

134. *New rules and limitations for depreciation and expensing under the Tax Cuts and Jobs Act*. Sep. 6, 2019. IRS. [www.irs.gov/newsroom/new-rules-and-limitations-for-depreciation-and-expensing-under-the-tax-cuts-and-jobs-act] Accessed on Oct. 16, 2019.

For this purpose, an **electing real property trade or business** is defined as follows.[135]

- A taxpayer that is **not** a small business taxpayer (i.e., has average annual gross receipts for the relevant 3-year period that exceed $25 million, adjusted for inflation)[136] and is not a tax shelter (as defined in IRC §448(a)(3))[137]
- Any real property trade or business that makes an election out of §163(j) and is described in IRC §469(c)(7)(C) as engaged in one of the following
  - Development/redevelopment
  - Construction/reconstruction
  - Acquisition
  - Conversion
  - Rental
  - Operation
  - Management
  - Leasing
  - Brokerage trade or business

The ADS applies to the following MACRS property held by an **electing real property trade or business.**

- Nonresidential real property (§1250 property that is not residential rental property or property with a class life of less than 27.5 years[138])
- Residential rental property (buildings or structures with 80% or more of the gross rental income from dwelling units[139])
- QIP (defined earlier)

For tax years beginning after December 31, 2017, the ADS recovery period is 30 years for residential rental property (as stated earlier) and 40 years for nonresidential real property.[140] The ADS recovery period for QIP is 20 years.[141]

Practitioner Planning Tip

Before the CARES Act made a technical correction to the recovery period for QIP, the ADS recovery period applied to QIP was 40 years for tax years beginning after December 31, 2017.[142] Practitioners can file an amended return or a change in accounting method for their clients to take advantage of the shorter depreciation period. QIP is covered in more detail earlier in the chapter.

135. IRC §§163(j)(7)(B) and 469(c)(7)(C).

136. IRC §448(c).

137. IRC §163(j)(3).

138. IRC §168(e)(2)(B).

139. IRC §168(e)(2)(A).

140. IRC §168(g)(2)(C).

141. IRC §§168(e)(3)(E)(vii) and 168(g)(3)(B).

142. IRC §168(g)(3)(B), prior to amendment by the CARES Act; *Tax Geek Tuesday: Changes To Depreciation In The New Tax Law.* Nitti, Tony. Jan. 2, 2018. Forbes. [www.forbes.com/sites/anthonynitti/2018/01/02/tax-geek-tuesday-changes-to-depreciation-in-the-new-tax-law/#1b99c5df2c4b] Accessed on Apr. 1, 2020.

Example 32. J&J operates a real property development business and has average annual gross receipts for the immediately preceding 3-year period of $30 million. Therefore, it is not a small business taxpayer.

J&J elects out of the §163(j) business interest deduction limitation. Accordingly, J&J must use the ADS for the nonresidential real property, residential rental property, and QIP that it owns. J&J can deduct business interest expense without limitation.

Similarly, for tax years beginning after December 31, 2017, a farm business that elects out of the §163(j) business interest deduction limitation must use the ADS for MACRS property with a recovery period of 10 years or more (under the GDS).

For this purpose, an **electing farm business** is defined as follows.

- A taxpayer that is **not** a small business taxpayer (i.e., has average annual gross receipts for the relevant 3-year period that exceed $25 million, adjusted for inflation)[143] and is not a tax shelter (as defined in §448(a)(3))[144]
- A farming business that is in the trade or business of farming and makes an election out of §163(j) (A farming trade or business for this purpose includes certain agricultural/horticultural cooperatives, operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.[145])

ADS recovery periods for MACRS farm property with a GDS recovery period of 10 years are as follows.[146]

Farm Property	GDS Recovery Period	ADS Recovery Period
Single-purpose agricultural or horticultural structures	10 years	15 years
Trees or vines bearing fruit or nuts	10 years	20 years

For the first tax year for which an electing real property trade or business or an electing farming business makes an election under §163(j)(7), that trade or business must begin depreciating the applicable properties in accordance with the ADS. The treatment of property subject to the ADS depends upon whether it is existing or newly acquired property, as discussed next.

Existing Property

For the year of election, electing businesses determine the depreciation deduction for existing property using the rules provided by Treas. Reg. §1.168(i)-4(d). These rules consider factors such as the adjusted basis of the property, the applicable convention, and short tax years of less than 12 months.

This change from GDS to ADS is **not** considered a change in accounting method.[147] Bonus depreciation previously claimed on existing property is not redetermined.[148]

143. IRC §448(c).

144. IRC §163(j)(3).

145. IRC §163(j)(7)(C).

146. IRC §§168(e)(3)(D)(i) and (ii); IRS Pub. 946, *How To Depreciate Property.*

147. Treas. Reg. §1.168(i)-4(f).

148. Treas. Reg. §1.168(k)-1(f)(6)(iv)(A).

Newly Acquired Property

Depreciation of newly acquired property is determined in accordance with the ADS for its placed-in-service year and the subsequent tax years. Such property is not eligible for bonus depreciation.

> **Note.** Taxpayers who fail to calculate depreciation under the ADS on property subject to the ADS have adopted an impermissible accounting method. Correcting this requires the taxpayer to request a change in method of accounting using Form 3115.[149]

Making the Election[150]

A real property trade or business or a farming business makes the election by attaching an election statement to a timely filed original tax return (including extensions).

> **Note.** Prior to the passage of the CARES Act, the election was irrevocable. Under the CARES Act, the election can be revoked for 2018, 2019, and 2020. For more information, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

The statement should be titled "Section 1.163(j)-9 Election" and must contain the following information for each electing trade or business.

- The taxpayer's name
- The taxpayer's address
- The taxpayer's social security number or employer identification number
- A description of the taxpayer's electing trade or business, including the principal business activity code
- A statement that the taxpayer is making an election under §163(j)(7)(B) (as an electing real property trade or business) or §163(j)(7)(C) (as an electing farming business), as applicable

> **Note.** For more information about the business interest limitation, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

OPTIMIZING THE DEPRECIATION DEDUCTION

Maximizing depreciation via §179 or bonus depreciation can result in a lower current tax liability and can also result in immediate tax benefits such as the premium tax credit, earned income tax credit, etc. However, considering all facts and circumstances, it may be more beneficial over the long run to save some of the depreciation deduction for future years. When tax professionals advise clients about tax planning opportunities, it is important to include a discussion of the various depreciation options available.

149. See Rev. Proc. 2019-08, 2019-03 IRB 347, §4.02(3) for more information on changing the accounting method.

150. Instructions for Form 8990.

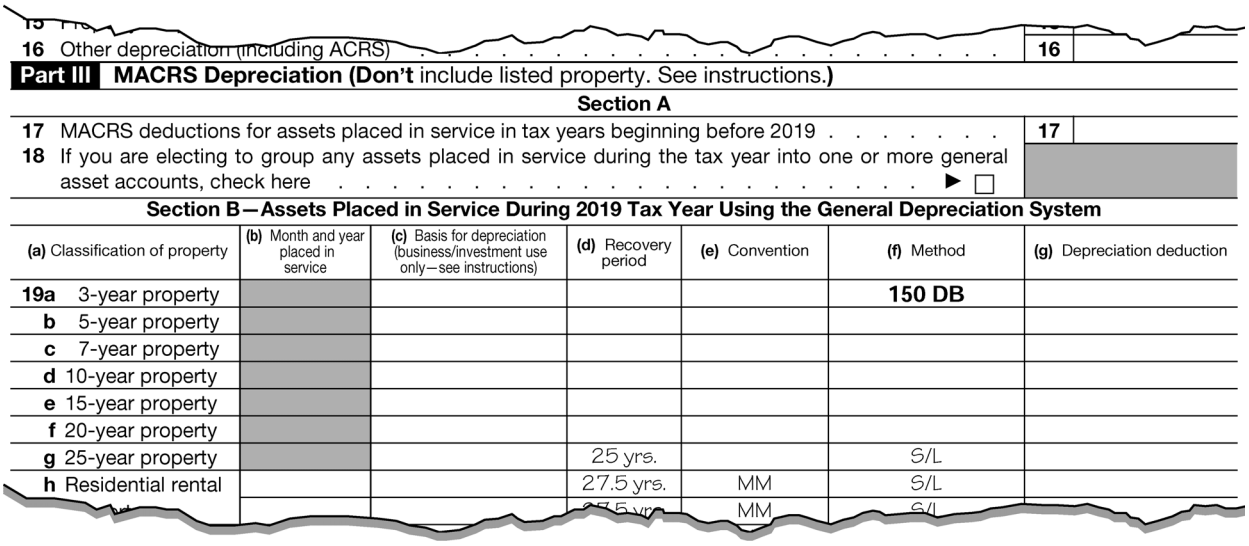
MACRS ELECTIONS

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 the 150% declining balance (DB) method instead, using the same recovery period that would have applied under the 200% DB method.[151] This election is irrevocable and must be made separately for each property class.[152]

> **Note.** Under the TCJA, the recovery period for new farming equipment and machinery placed in service after December 31, 2017, is shortened from seven to five years. Used farming equipment remains 7-year property.[153]

The election is made by entering "150 DB" under column (f) in part III of Form 4562.[154]



16	Other depreciation (including ACRS)					16	
Part III	**MACRS Depreciation (Don't** include listed property. See instructions.**)**						
	Section A						
17	MACRS deductions for assets placed in service in tax years beginning before 2019					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 2019 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	
h	Residential rental			27.5 yrs.	MM	S/L	
				27.5 yrs.	MM	S/L	

> **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.[155]

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.[156] 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.

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151. IRS Pub. 946, *How To Depreciate Property;* IRC §168(b)(2)(C).

152. IRC §168(b)(5).

153. *Tax reform changes to depreciation deduction affect farmers' bottom line.* Sep. 6, 2019. IRS. [www.irs.gov/newsroom/tax-reform-changes-to-depreciation-deduction-affect-farmers-bottom-line] Accessed on Nov. 14, 2019.

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

155. Ibid.

156. IRC §56(a)(1)(A)(ii).

Straight-Line Election[157]

Instead of using either the 200% or 150% DB methods over the applicable GDS recovery period, the taxpayer can elect the straight-line method using 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.[158]

For property placed in service after December 31, 1998, no AMT adjustment is necessary on property for which the taxpayer makes the straight-line election.[159]

ADS Election[160]

Taxpayers can elect ADS for property that qualifies for GDS. ADS applies the straight-line method using fixed ADS recovery periods. Except for real estate, the taxpayer makes a separate ADS election for each property class. For residential rental and nonresidential real estate, the taxpayer can make the election on a property-by-property basis. Once the election is made, it is irrevocable. 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 straight-line depreciation is used for regular tax purposes.[161]

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 straight-line 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.

Depreciation Reduces QBID[162]

As mentioned earlier, a noncorporate taxpayer may be able to deduct up to 20% of taxable income using the QBID provisions under §199A. The QBID is available for tax years starting after December 31, 2017, and before January 1, 2026.

Because depreciation reduces taxable income, it also reduces the QBID amount. Taking advantage of the §179 deduction and/or bonus depreciation in a tax year could eliminate the QBID entirely in that year. Determining whether the QBID or accelerated depreciation is more advantageous for a taxpayer requires careful planning.

> **Note.** The QBID calculation is complex. For a thorough explanation, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update and the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. The 2018 chapter can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

157. Ibid.

158. Instructions for Form 4562.

159. IRC §56(a)(1)(A)(ii).

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

161. IRC §56(a)(1)(A)(ii); Instructions for Form 6251.

162. IRC §199A.

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 when 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 greater tax savings.

> **Note.** With the expiration of the TCJA in 2025, future tax rates are scheduled to increase. This may give taxpayers further incentive to defer depreciation to future years.

Expiring NOL Carryforward

An NOL arises when a taxpayer's business deductions exceed its gross income. Before the TCJA, an NOL could generally be carried back two years and carried forward 20 years, and it could offset 100% of income.[163]

For tax years ending after 2017, the TCJA provided an unlimited carryforward period and generally eliminated NOL carrybacks.[164] However, the CARES Act, which was enacted on March 27, 2020, provides that any NOL arising in a tax year beginning after December 31, 2017, and before January 1, 2021, is carried back to the five tax years preceding the year of the loss.[165] During this period, losses can still be carried forward indefinitely.

> **Note.** The TCJA also introduced a new limitation such that NOLs arising in tax years beginning after 2017 can only reduce 80% of taxable income.
>
> However, the CARES Act suspends the application of the 80% taxable income limitation for tax years beginning after December 31, 2017, and before January 1, 2021. The 80% limitation continues to apply for any tax year beginning after December 31, 2020, and to NOLs arising in tax years beginning after December 31, 2017, carried to such year.[166]
>
> For more information, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments and Volume A, Chapter 3: Net Operating and Excess Business Losses.

Practitioner Planning Tip

If a business has an NOL carryforward from a year ending before 2018 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.

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163. IRC §§172(a) and (b) prior to amendment by the TCJA.

164. IRC §172(b) after amendment by the TCJA.

165. IRC §172(b)(1)(D).

166. CARES Act §2303; *Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act* (JCX-12R-20). Apr. 23, 2020. Joint Committee on Taxation. [www.jct.gov/publications.html?func=startdown&id=5256] Accessed on Apr. 30, 2020.

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 SE income but recapture from depreciation is generally not subject to SE tax. However, depreciation recapture for listed property and property for which the taxpayer took a §179 deduction is subject to SE tax.[167]

More information about depreciation recapture is provided earlier in this chapter.

Self-Employment Tax

Maximizing the depreciation deduction can reduce or eliminate SE taxes. However, a taxpayer may want to increase their SE tax so that they can earn credit toward their social security coverage and/or increase their social security benefit amount after they retire. In this situation, the taxpayer may want to minimize or reduce their depreciation deduction so they can report more SE income.

Practitioner Planning Tip

Self-employed taxpayers may be able to use the optional method of calculating SE tax to obtain credit toward their social security coverage even though they have a loss or a small amount of SE income. Using the optional method may qualify them to claim the earned income credit, additional child tax credit, or child and dependent care credit or to qualify for a larger credit if the taxpayer's net earnings from self-employment (calculated without using the optional method) are less than $5,640 (for 2020).[168]

Example 33. Susie, who is single and self-employed, has a small business providing charter helicopter flights to tourists. In 2019, she purchased a used helicopter for $250,000. The helicopter has a MACRS recovery period of five years and qualifies for bonus depreciation.

Susie's tax preparer, Barbara, provided the following summary of the results Susie will obtain if she takes bonus depreciation on the helicopter purchase.

Business income (before depreciation)	$200,000
100% bonus depreciation on helicopter purchase	(250,000)
Schedule C loss	($ 50,000)
SE tax	$ 0
Income tax	$ 0

Note. Susie's Schedule C loss creates an NOL and a qualified business loss (QBL). For more information about NOLs, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Net Operating and Excess Business Losses. For more information about QBLs, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

167. Instructions for Form 4797.

168. 2019 Instructions for Schedule SE; *OASDI and SSI Program Rates & Limits, 2020.* Social Security Administration. [www.ssa.gov/policy/docs/quickfacts/prog_highlights/RatesLimits2020.html] Accessed on Dec. 4, 2019.

Example 34. Use the same information as **Example 33,** except Barbara presents Susie with the option of electing out of bonus depreciation and taking a §179 deduction of $105,000 on the helicopter purchase. The remaining depreciable basis of the helicopter would be depreciated under MACRS.

Following is a summary of Susie's 2019 tax information using this option.

Business income (before depreciation)	$200,000
§179 deduction for helicopter	(105,000)
MACRS depreciation on helicopter ($250,000 cost − $105,000 §179 expense) × 20% MACRS rate)	(29,000)
Schedule C income	$ 66,000
Less: ½ SE tax	(4,663)
Adjusted gross income	$ 61,337
Less: Standard deduction	(12,200)
Less: QBID, which is the **lesser of:**	
• ($66,000 Schedule C income − $4,663 SE tax adjustment) × 20% = $12,267, **or**	
• $49,137 taxable income before QBID × 20% = $9,827	(9,827)
Taxable income	$ 39,310
Income tax (10% and 12%)	$ 4,525
SE tax	9,326
Total tax liability	$ 13,851

Opting out of bonus depreciation and instead claiming total depreciation of only $134,000 (§179 and MACRS) increases Susie's tax liability from $0 to $13,851. However, this preserves $116,000 of the helicopter's depreciable basis to use in future years. In addition, paying SE tax allows Susie to earn credit toward social security coverage and may increase her social security benefit amount when she retires.

Example 35. Use the same information as **Example 34.** Susie told Barbara that she understood the value of preserving depreciable basis to use in future years and earning credit for social security purposes, but she could not afford to pay federal taxes of $13,851. She said the most she could manage to pay would be in the range of $5,000 to $6,000.

Barbara then presented the following option to Susie.

Business income (before depreciation)	$200,000
§179 deduction for helicopter	(150,000)
MACRS depreciation on helicopter ($250,000 cost − $150,000 §179 expense) × 20% MACRS rate)	(20,000)
Schedule C income	$ 30,000
Less: ½ SE tax	(2,120)
Adjusted gross income	$ 27,880
Less: Standard deduction	(12,200)
Less: QBID, which is the **lesser of:**	
• ($30,000 Schedule C income − $2,120 SE tax adjustment) × 20% = $5,576, **or**	
• $15,680 taxable income before QBID × 20% = $3,136	(3,136)
Taxable income	$ 12,544
Income tax (10% and 12%)	$ 1,309
SE tax	4,239
Total tax liability	$ 5,548

As shown above, Susie would pay $5,548 in federal taxes. In addition, she would preserve depreciable basis of $80,000 ($250,000 cost – $150,000 §179 expense – $20,000 MACRS depreciation) to use in future years. She would also earn credit towards social security coverage, although it would be a smaller amount than she would obtain under **Example 34.**

Contributions to Retirement Plans

Lower depreciation results in higher profit, which could lead to increased allowable contributions to retirement plans.

> **Note.** For more discussion about the various types of retirement plans, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Retirement Plans for Small Businesses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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