

Year-end planning—Making the most of quick write-offs for capital goods purchases (Part I)

Practice Alert

Depreciation deductions under Code Sec. 168 and expensing deductions under Code Sec. 179 are far more generous this year than they will be next year. In short, for those businesses confident enough to expand in these challenging economic times, now is an excellent time to buy machinery and equipment (and make expensing-eligible qualified real estate purchases).

This is the first installment of a multi-part *Practice Alert* on how businesses may be able to lock in accelerated deductions by buying qualifying assets this year and placing them in service before year-end. It examines the bonus first-year depreciation allowance—100% for qualified assets placed in service this year, but declining to 50% for qualified assets placed in service next year. Part II will examine the increased Code Sec. 179 expensing (\$500,000 limit, with \$2 million phaseout threshold) that applies for tax years beginning in 2010 and 2011, but will then decline substantially (\$125,000 limit, as adjusted for inflation, with \$500,000 phaseout threshold). Part III will examine the qualified real property expensing allowance (\$250,000 limit) that applies for tax years beginning in 2010 and 2011.

Buy Depreciable Property and Place It in Service This Year to Lock in 100% Bonus First-Year Depreciation

The 100% bonus depreciation allowance under Code Sec. 168(k) applies only for qualified property acquired and placed in service after Sept. 8, 2010 and before Jan. 1, 2012 (placed in service before Jan. 1, 2013 for certain aircraft and long-production-period property). For qualified property acquired and placed in service after Dec. 31, 2011 and before Jan. 1, 2013 (before Jan. 1, 2014 for certain aircraft and long-production-period property), the first-year bonus depreciation allowance is scheduled to drop to 50%. (Code Sec. 168(k)(1), Code Sec. 168(k)(5)) Thus, enterprises planning to purchase new depreciable property this year or the next should try to accelerate their buying plans, if doing so makes sound business sense.

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

RIA illustration 1: Widget, Inc., a calendar-year business, needs to buy an additional \$500,000 of new five-year MACRS property. It is not eligible for expensing. If Widget makes the purchase before Jan. 1, 2012, and places the property in service before that date, it may write off the entire \$500,000 cost in 2011. If it waits to buy the property and place it in service until 2012, it may only claim a first-year depreciation allowance of \$300,000 [(\$500,000 × .50 = \$250,000 bonus first-year allowance) + (\$500,000 – \$250,000 × .20 table percentage for 5-year MACRS property = \$50,000)].

RIA caution: Accelerating a purchase into 2011 may not always be a good idea. For example, it may not produce good results for a taxpayer that has an about-to-expire net operating loss.

How to qualify for bonus depreciation for 2011. In general, an asset purchased in 2011 qualifies for the 100% bonus first-year depreciation allowance if:

- It is property to which the modified accelerated cost recovery system (MACRS) rules apply with a recovery period of 20 years or less; computer software other than computer software covered by Code Sec. 197; qualified leasehold improvement property; or certain water utility property;
- It is acquired and placed in service after Sept. 8, 2010 and before Jan. 1, 2012 (placed in service before Jan. 1, 2013 for certain long production property and aircraft); and
- Its original use commences with the taxpayer. (Code Sec. 168(k)(5))

Limited exception for components. Prior to Sept. 9, 2010, a taxpayer may have begun manufacturing, building, or producing a larger self-constructed property that is qualified property for use in its trade or business or for its production of income. If this larger self-constructed property meets the placed in service and original use requirements, the taxpayer may elect to treat any acquired or self-constructed component of that larger self-constructed property as being eligible for the 100% additional first-year depreciation deduction if the component is qualified property and is acquired or self-constructed by the taxpayer after Sept. 8, 2010 and before Jan. 1, 2012 (before Jan. 1, 2013, for certain long production property and aircraft).

In general, the election must be made by the due date (including extensions) of the federal tax return for the taxpayer's tax year in which it placed in service the larger self-constructed property, and by attaching a statement to that return indicating that the taxpayer is making the election under Sec. 3.02(2)(b) of Rev Proc 2011-26, and whether the taxpayer is making the election for all or some of the components. (Rev Proc 2011-26, 2011-16 IRB)

Reconditioned property. Additional capital expenses incurred by a business to recondition or rebuild property it acquired or owned satisfies the original use requirement, but the cost of reconditioned or rebuilt property acquired by the taxpayer does not. (Reg. § 1.168(k)-1(b)(3)(i))

Illustration 2: On Nov. 1, 2011, ABX Inc. buys a used machine for \$50,000 and reconditions it for \$15,000. The purchase price is ineligible for bonus depreciation but the \$15,000 reconditioning cost is eligible (assuming the other requirements are met), whether or not it is added to the cost of the machine or capitalized as a separate asset. (Reg. § 1.168(k)-1(b)(3)(v), Ex. 1)

The issue of whether property is reconditioned or rebuilt generally is a question of fact. However, a safe harbor provides that property containing used parts isn't treated as reconditioned or rebuilt if the cost of the used parts doesn't exceed 20% of its total cost. (Reg. § 1.168(k)-1(b)(3)(i))

RIA observation: In other words, for example, a taxpayer that buys a machine consisting of 80% new parts and 20% reconditioned parts is treated as having bought a new machine, not a reconditioned one.

Converted property. New property initially used by a taxpayer for personal use and then subsequently used by him in a trade or business meets the original use requirement. (Reg. § 1.168(k)-1(b)(3)(ii))

RIA illustration 3: In 2010, an individual bought a new pickup truck and used it for personal driving only, but in 2011, he began using it exclusively for his landscaping business. The truck is qualified properly eligible for bonus depreciation.

The 100% bonus first-year depreciation allowance applies to qualified property unless the taxpayer "elects out." The election out may be made for any class of property for any tax year, and if made applies to all property in that class placed in service during that tax year. Note that a step-down election from 100% to 50% bonus depreciation is permitted for property placed in service in a tax year that includes Sept. 9, 2010. (Rev Proc 2011-26)

RIA caution: There is no alternative minimum tax (AMT) depreciation adjustment for property written off under the bonus depreciation rules of Code Sec. 168(k). However, a taxpayer that "elects out" of additional first-year depreciation for a specific class of property is subject to the AMT depreciation adjustment for property in that class. That means AMT depreciation is computed using the 150% declining balance method (switching to straight-line in the year necessary to maximize the allowance), except that straight line is used for property for which straight line depreciation must be used for regular tax purposes. The recovery period is the same for AMT and regular tax purposes.

Special rule. Note that for property placed in service after Dec. 31, 2010, in tax years ending after that date, a corporation may elect to forego bonus depreciation and accelerated depreciation and instead increase its AMT credit limitation with respect to certain property placed in service after Dec. 31, 2010 and before Jan. 1, 2013 (before Jan. 1, 2014 in the case of certain longer-lived and transportation property). (Code Sec. 168(k)(4)) This option applies for "round 2 extension property," namely property that is eligible qualified property solely because it meets the requirements under the extension of the additional first-year depreciation deduction for certain property placed in service after Dec. 31, 2010.

Qualified Restaurant Property and Qualified Retail Improvement Property

Under Code Sec. 168(k)(2)(A)(i)(IV), qualified leasehold improvement property is eligible for 100% bonus first-year depreciation (if all the statutory conditions are met). By contrast, Code Sec. 168(e)(7)(B) and Code Sec. 168(e)(8)(B) provide that qualified restaurant property and qualified retail improvement property are not treated as qualified property for purposes of the bonus depreciation rules in Code Sec. 168(k) and thus aren't eligible for the 100% bonus depreciation allowance. IRS's interpretation is that an asset that is qualified restaurant property or qualified retail improvement property also may fall within the definition of qualified leasehold improvement property under Code Sec. 168(e)(6), which is eligible for bonus depreciation. If it does, such "dual character" property qualifies for 100%

bonus first-year depreciation in 2011 if it is qualified property under Code Sec. 168(k)(2), and is placed in service by end of 2011. (Rev Proc 2011-26)

RIA observation: For a detailed article on bonus depreciation for qualified restaurant property and qualified retail improvement property, see Federal Taxes Weekly Alert 02/24/2011.

100% First-Year Writeoff for Heavy SUVs

Under Code Sec. 280F, depreciation deductions (including Code Sec. 179 expensing) that can be claimed for passenger autos are subject to dollar limits that are adjusted annually for inflation. For example, for passenger autos first placed in service in 2011, the adjusted first-year limit is \$3,060. For light trucks or vans, the adjusted first-year limit is \$3,260. Light trucks or vans are passenger autos built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis that are subject to the Code Sec. 280F limits because they are rated at 6,000 points gross (loaded) vehicle weight or less. For passenger autos, light trucks or vans that are eligible for bonus first-year depreciation under Code Sec. 168(k), (i.e., generally, new vehicles acquired and placed in service after Dec. 31, 2007 and before Jan. 1, 2013), the regular first-year dollar cap on depreciation and Code Sec. 179 expensing is increased by \$8,000. (Code Sec. 168(k)(2)(F))

Heavy SUVs—those that are built on a truck chassis and are rated at more than 6,000 pounds gross (loaded) vehicle weight—are exempt from the luxury-auto dollar caps because they fall outside of the Code Sec. 280F(d)(5) definition of a passenger auto. As 5-year MACRS property, heavy SUVs are eligible for 100% bonus first-year depreciation (if they are otherwise qualified property and business use exceeds 50% of total use). Thus, for example, a calendar-year taxpayer that buys and places in service a new \$50,000 heavy SUV during 2011, and uses it 100% for business, may write off the entire cost on its 2011 tax return.

If the heavy SUV is bought and placed in service in 2012 instead of 2011, less generous rules will apply. Under Code Sec. 179(b)(6), not more than \$25,000 of the cost of a heavy SUV may be expensed under Code Sec. 179. And in the placed-in-service year, a taxpayer may claim a 50% bonus depreciation allowance for the cost of the heavy SUV that wasn't expensed, and depreciate the balance of the cost under the regular 5-year MACRS rules.

RIA illustration 4: If a calendar year taxpayer buys and places in service a \$50,000 heavy SUV in 2012, and uses it 100% for business, it may write off \$40,000 of the cost of the vehicle on its 2012 return, as follows:

- \$25,000 expensing deduction, plus
- \$12,500 of bonus first-year depreciation ($\$50,000 - \$25,000 \text{ of expensing} \times .50 = \$12,500$), plus
- \$2,500 of regular first-year depreciation ($\$50,000 - \$25,000 \text{ of expensing} - \$12,500 \text{ bonus depreciation} \times .20 = \$2,500$).

Year-end planning—Making the most of quick write-offs for capital goods purchases (Part II)

Practice Alert

Depreciation deductions under Code Sec. 168 and expensing deductions under Code Sec. 179 are far more generous this year than they will be next year. In short, for those businesses confident enough to expand in these challenging economic times, now is a good time to buy machinery and equipment (and make expensing-eligible qualified real estate purchases). This is the second installment of multi-part *Practice Alert* on how businesses may be able to lock in accelerated deductions by buying qualifying assets this year and placing them in service before year-end. It examines the generous Code Sec. 179 expensing rules that apply this year but will be curtailed next year.

Part I (see Newsstand e-mail 8/25/2011) examined the bonus first-year depreciation allowance—100% for qualified assets placed in service this year, but declining to 50% for qualified assets placed in service next year. Part III in the series will examine the qualified real property expensing allowance (\$250,000 limit) that applies for tax years beginning in 2010 and 2011.

Making the Most of Generous Code Sec. 179 Expensing Limits for 2011

Under Code Sec. 179, a taxpayer, other than an estate, trust, and certain noncorporate lessors, can elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in the taxpayer's trade or business (for 2010 and 2011, a limited amount of qualified real property also may be expensed). The maximum annual expensing amount generally is reduced dollar-for-dollar by the amount of Code Sec. 179 property placed in service during the tax year in excess of a specified investment ceiling. The amount eligible to be expensed for a tax year can't exceed the taxable income derived from the taxpayer's active conduct of a trade or business. Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding tax years.

Extraordinarily high expensing limits for 2011. For tax years beginning in 2011 (as well as tax years beginning in 2010): (1) the dollar limitation on the expense deduction is \$500,000; and (2) the investment-based reduction in the dollar limitation starts to take effect when property placed in service in a tax year exceeds \$2,000,000 (beginning-of-phaseout amount). (Code Sec. 179(b)(1) and Code Sec. 179(b)(2)) However, for tax years beginning in 2012, the dollar limitation will drop to \$125,000 (indexed for inflation with 2006 as the base year), and the beginning-of-phaseout amount will drop to \$500,000 (indexed for inflation with 2006 as the base year). (Code Sec. 179(b))

RIA observation: Thanks to the generous limits that currently apply, virtually all small businesses and many medium sized businesses that don't have costly machinery and equipment needs will be able to use Code Sec. 179 expensing to write off much, if not all, of their capital goods outlays. For property placed in service in tax years beginning in 2011 (as well as 2010), the Code Sec. 179 deduction doesn't phase out completely until the cost of

expensing-eligible property exceeds \$2,500,000 (\$2,000,000 (beginning-of-phaseout amount) + \$500,000 (dollar limitation)).

There is no pro rata reduction of the Code Sec. 179 expensing deduction depending on the portion of the year the asset is held. If the deduction is allowable, the amount that may be expensed is the same regardless of when the property is acquired during the year. (Code Sec. 179; Reg. § 1.179-1(c)(1))

RIA recommendation: The fact that the expense deduction may be deducted in full regardless of how long the property is held during the year can be a potent tool for year-end tax planning. Thus, property acquired and placed in service in the last days of a tax year, rather than at the beginning of the following year, can result in a full expense deduction for the earlier year.

Year-end move #1. Where possible, taxpayers should factor the annual expensing limits for 2011 and 2012 into their annual equipment-purchase plans so as to maximize the writeoff for this year and the next.

RIA illustration 1: During the first eleven months of 2011, ABC, a calendar-year corporation, bought and placed in service \$400,000 of expensing-eligible property. It plans to buy an additional \$200,000 of expensing-eligible property early next year. If it's feasible to do so from the business standpoint, ABC should consider accelerating \$75,000 of next year's purchases into 2011 (and place the additional assets in service before year-end). This way, ABC will be able to fully expense its purchases (total of \$475,000 for 2011 and \$125,000 for 2012).

Taxable income limit. The Code Sec. 179 expensing deduction is limited to taxable income from any of the taxpayer's active trades or businesses. This means that the taxable income limit doesn't bar an expense deduction just because the particular business in which the property is used doesn't produce any net income. So long as the taxpayer has aggregate net income from all his trades or businesses, the deduction is allowed. (Code Sec. 179(b)(3); Reg. § 1.179-2(c)(1)) In general, any amount that cannot be deducted because of the taxable income limit can be carried forward to later years until it is fully deducted. (Code Sec. 179(b)(3)(B))

Year-end move #2. Taxpayers should consider making the expense election even in a year where a less-than-full tax benefit is derived from the election because of the taxable income limit. This way, the taxpayer's right to carry the expensing deduction forward to other years is preserved.

RIA illustration 2: In December of 2011, Widget Products, a calendar year business, buys and places in service \$200,000 of qualified 5-year MACRS property subject to the half-year depreciation convention. The asset is used and thus isn't eligible for bonus depreciation. If Widget Products doesn't elect to expense any part of the \$200,000, then under the half-year depreciation convention (and under the 200% declining balance method) it is entitled to a \$40,000 depreciation deduction for this property for 2011 (\$200,000 × .20 first year allowance). On the other hand, electing to expense the cost of the asset would reduce business taxable income by \$200,000. Moreover, even if Widget Products does not have

sufficient taxable income to absorb the entire expensing deduction in 2011, the full amount of the excess will be available to offset taxable income in 2012.

Wages count for taxable income limit. Wages, salaries, tips and other compensation earned by employees count for purposes of their Code Sec. 179 taxable income limit. (Reg. § 1.179-2(c)(6)(iv))

Year-end move #3. Employees who run a sideline business may be able to reduce their 2011 tax bill by buying business equipment they need before the end of this year rather than in 2012.

RIA illustration 3: Jack is employed as a website designer and earns \$70,000 a year. In September of 2011, he starts a wedding and portrait photo sideline business but will earn only around \$2,000 from it this year. Jack is planning to buy \$3,000 of high-end photo and computer equipment for his sideline business. If he buys and places the equipment in service this year, Jack can fully offset his \$2,000 freelance income and \$1,000 of his regular employment income.

Investment-based phaseout of expensing. As we've said, for 2011, the maximum amount that can be expensed under Code Sec. 179 is reduced dollar-for-dollar for eligible property placed in service during the tax year in excess of \$2,000,000.

RIA illustration 4: XYZ Corp is a calendar-year taxpayer. In 2011, it buys and places in service \$2,200,000 of expensing-eligible used 5-year MACRS property. XYZ may only expense \$300,000 of its 2010 purchases [\$500,000 expensing limit – (\$2,200,000 purchases – \$2,000,000 beginning-of-phaseout amount)] and must depreciate the \$200,000 balance of its purchases over a period of years.

RIA caution: Amounts ineligible for expensing due to excess investments in expensing-eligible property can't be carried forward and expensed in a subsequent year. Rather, they can only be recovered through depreciation.

Year-end move #4. Businesses that are not equipment intensive enterprises should try to avoid buying and placing in service more than the ceiling amount of expensing-eligible property during the year, if it's possible from the business standpoint to defer additional purchases.

What's eligible for expensing. In general, property is eligible for Code Sec. 179 expensing if it is:

- tangible property that's Code Sec. 1245 property (generally, machinery and equipment), depreciated under the MACRS rules of Code Sec. 168, regardless of its depreciation recovery period (Code Sec. 179(d)(1)(A)(i));
- for any tax year beginning in 2010 or 2011, up to \$250,000 of qualified real property (Code Sec. 179(f)(1)); and
- if placed in service in a tax year beginning before 2013, off-the-shelf computer software. (Code Sec. 179(d)(1))

RIA observation: There's no requirement that the acquired property be new. Thus, taxpayers may claim expensing for otherwise eligible used property.

Year-end move #5. As a general rule, to maximize the tax benefit to be gained through expensing, a taxpayer should make the expensing election for eligible property with the longest recovery period.

RIA illustration 5: In 2011, ABZ, a calendar-year taxpayer, buys and places in service \$500,000 of new 5-year MACRS property and \$500,000 of new 7-year MACRS property. It doesn't purchase other property during the year and is subject to the half-year depreciation convention for 2011. If it elects to expense the 7-year property, ABZ can write off the balance of its purchases over the 5-year MACRS recovery period (effectively 6 years because of the half-year convention). By contrast, if it elects to expense the 5-year property, ABZ will have to write off the balance of its purchases over the 7-year MACRS recovery period (effectively 8 years because of the half-year convention).

RIA observation: As we'll explain in the third and final installment of this article, the general rule about making the expensing election for eligible property with the longest recovery period may not hold true for 2010 and 2011 where the taxpayer has purchased qualified real property eligible for expensing under Code Sec. 179.

Year-end planning—Making the most of quick write-offs for capital goods purchases (Part III)

Practice Alert

Depreciation deductions under Code Sec. 168 and expensing deductions under Code Sec. 179 are far more generous this year than they will be next year. In short, for those businesses confident enough to expand in these challenging economic times, now is a good time to buy machinery and equipment (and make expensing-eligible qualified real estate purchases). This is the third and final installment of a multi-part *Practice Alert* on how businesses may be able to lock in accelerated deductions by buying qualifying assets this year and placing them in service before year-end. It examines how to make the most of the qualified real property expensing allowance (\$250,000 limit), an allowance that is set to disappear for tax years beginning after 2011.

Part I (see Newsstand e-mail 8/25/2011) examined the bonus first-year depreciation allowance—100% for qualified assets placed in service this year, but declining to 50% for qualified assets placed in service next year). Part II (see Newsstand e-mail 9/1/2011) covered the generous Code Sec. 179 expensing rules that apply this year but will be curtailed next year.

Qualified Real Property Expensing—A Unique but Temporary Tax Saving Opportunity

Historically, Code Sec. 179 expensing has been available only for tangible personal property, but the Small Business Act of 2008 (P.L. 111-240) carved out a limited-time-only exception for certain types of real property. Specifically, under Code Sec. 179(f)(1), for any tax year beginning in 2010 or 2011, a taxpayer may elect to treat up to \$250,000 of qualified real property as Code Sec. 179 property. Otherwise eligible property placed in service in tax years beginning after 2011 generally will have to be depreciated over 39 years via the straight line method.

What is qualified real property for expensing purposes? Qualified real property is:

- (A) qualified leasehold improvement property described in Code Sec. 168(e)(6),
- (B) qualified restaurant property described in Code Sec. 168(e)(7), and
- (C) qualified retail improvement property described in Code Sec. 168(e)(8). (Code Sec. 179(f)(2)(C))

The qualified property must be depreciable, acquired for use in the active conduct of a trade or business, and can't be certain ineligible property (i.e., used for lodging, used outside the U.S., used by governmental units, foreign persons or entities, and certain tax-exempt organizations, air conditioning or heating units). (Code Sec. 179(f)(1)(C))

RIA observation: A number of assets installed in commercial buildings are personal property depreciable over five or seven years under MACRS. As a result, these assets are

subject to the general expensing rules for personal property, rather than the more-restrictive rules for qualified real property. Shorter-lived assets also are potentially eligible for the bonus first-year depreciation allowance if bought and placed in service this year.

Reason: Under Code Sec. 168(k)(2)(A)(i), property qualifying for the bonus first-year depreciation allowance includes MACRS property with a recovery period of 20 years or less, if the original use, timely acquisition, and placed-in-service requirements are met. These shorter-lived assets include carpeting, movable and removable partitions, and electrical and plumbing equipment necessary for the operation of specialized equipment (rather than for overall building maintenance and operation).

Qualified leasehold improvement property. Qualified leasehold improvement property is an interior building improvement that qualifies for bonus first-year depreciation, except that if a lessor makes an improvement that is a qualified leasehold improvement, it can't be qualified leasehold improvement property to any subsequent owner, subject to exceptions for nonrecognition and death transfers. (Code Sec. 168(e)(6))

In general, qualified leasehold improvement property includes interior improvements to a building if:

1. The improvement is Code Sec. 1250 property.
2. The improvement is made "under or pursuant to a lease" (as defined in Code Sec. 168(h)(7), namely any grant of a right to use property), either by the lessee, sublessee or lessor of the building portion.
3. The portion of the building is to be occupied exclusively by the lessee (or any sublessee) of the portion.
4. The improvement is placed in service more than three years after the date the building was first placed in service. (Code Sec. 168(k)(3)(A), Reg. § 1.168(k)-1(c)(1))

The Code doesn't define what types of building improvements are eligible to be treated as qualified leasehold improvement property. Rather, it lists the types of property that *can't* be so treated. Under Code Sec. 168(k)(3)(B), qualified leasehold improvement property does not include any improvement for which the expense is attributable to:

- the enlargement of the building,
- any elevator or escalator,
- any structural component benefiting a common area, and
- the internal structural framework of the building.

What kinds of improvements are qualified leasehold improvements after eliminating those that are ineligible? The following types of improvements would appear to qualify, if they benefit the tenant's space only rather than a common area:

- (1) electrical or plumbing systems (including a sprinkler system);
- (2) permanently installed lighting fixtures;
- (3) ceilings and doors; and
- (4) heating or cooling equipment, air conditioners, and other air handling equipment.

RIA observation: All of these assets, to the extent they aren't eligible for five or seven year depreciation, generally are treated as structural components of a building for depreciation purposes, but none of them is part of the internal structural framework of a building, a term defined by the investment tax credit regs (Reg. § 1.48-12(b)(3)(iii)) to include all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

RIA observation: Two breaks apply to qualified leasehold improvement property bought and placed in service this year. It qualifies for up-to-\$250,000 of expensing under Code Sec. 179, and there's a 100% bonus first-year depreciation allowance under Code Sec. 168(k)(2)(A) for the portion of such property that is not expensed. Qualified leasehold improvement property can't be expensed if placed in service in a tax year beginning after 2011. Also, the bonus first-year depreciation allowance generally will drop from 100% to 50% for qualified property placed in service after Dec. 31, 2011, and before Jan. 1, 2013 (before Jan. 1, 2014 for certain aircraft and long-production-period property).

Qualified restaurant property. Property is qualified restaurant property if it is any Code Sec. 1250 property which is a building or an improvement to a building, if more than 50% of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals. (Code Sec. 168(e)(7))

RIA observation: Under Code Sec. 168(e)(7)(B) and Code Sec. 168(e)(8)(B), neither qualified restaurant property nor qualified retail improvement property (see below) is eligible for bonus first-year depreciation. However, qualified restaurant property or qualified retail improvement property also may fall within the definition of qualified leasehold improvement property under Code Sec. 168(e)(6). If it does, Rev Proc 2011-26, says that such "dual character" property qualifies for 100% bonus first-year depreciation if it is qualified property under Code Sec. 168(k)(2), and is placed in service by end of 2011.

Qualified retail improvement property. Qualified retail improvement property is any improvement to an interior portion of a building that is nonresidential real property if:

- that portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and
- the improvement is placed in service more than three years after the date the building was first placed in service. (Code Sec. 168(e)(8))

An improvement made by the owner of that improvement will be qualified retail improvement property only so long as the improvement is held by that owner, if at all. Exceptions similar to the exceptions under Code Sec. 168(e)(6)(B) (e.g., for death, or like-kind exchange transactions) apply for purposes of this rule. (Code Sec. 168(e)(8)(B))

Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any

structural component benefitting a common area, or the internal structural framework of the building. (Code Sec. 168(e)(8)(C))

JCT guidance. The Joint Committee on Taxation (JCT) provides specific guidance on what will and won't be treated as qualified retail improvement property. It says retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods, such as grocery stores, clothing stores, hardware stores, and convenience stores. However, establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, aren't qualified retail improvement property. The JCT adds that "it is generally intended" that businesses defined as a store retailer under the current North American Industry Classification System (NAICS) (industry sub-sectors 441 through 453) will qualify while those in other industry classes won't. (JCX-55-10, the functional equivalent of a Committee Report on the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; and JCX-55-10, General Explanation of Tax Legislation Enacted in the 111th Congress)

Two Elections and Two Dollar Limits

To use the expensing break for qualified real property, the taxpayer must make what is effectively an election within an election. He must first elect under Code Sec. 179 to treat the cost of the property as not chargeable to capital account. Second, he must elect under Code Sec. 179(f) to treat qualified real property as Code Sec. 179 property. There also are two dollar limitations at play: The overall \$500,000 limitation (for 2010 and 2011) on the expense deduction, and the \$250,000 per-tax-year limitation on the aggregate cost of qualified real property that may be treated as Code Sec. 179 property for 2010 and 2011. (Code Sec. 179(f)(1))

Additionally, the reduction in the overall \$500,000 limitation on expensing starts to take effect when property placed in service in a tax year exceeds \$2,000,000 (beginning-of-phaseout amount). (Code Sec. 179(b)(2))

RIA recommendation: Before making the election to treat qualified real property as Code Sec. 179 property, taxpayers should consider: (1) whether the election will either (A) cause the total cost of their Code Sec. 179 property placed in service in the tax year to increase above \$2,000,000 or (B) increase the extent to which the total cost of such property placed in service in the tax year exceeds \$2,000,000; and (2) the extent, if any, that the increases will affect the availability of expensing deductions for Code Sec. 179 property other than qualified real property. This is so because, for tax years beginning in 2010 or 2011, \$2,000,000 is the amount above which placing Code Sec. 179 property into service causes the annual \$500,000 limitation amount on the expensing deduction, in effect for tax years beginning in 2010 or 2011, to be reduced on a dollar-for-dollar basis,

RIA illustration 1: Earlier this year, Eat Out Inc., a calendar-year restaurant chain, placed \$500,000 of five-year MACRS property in service, and before the end of the year it places in service \$2,000,000 of qualified real property consisting of qualified restaurant property. If it makes the Code Sec. 179(f) election to expense qualified real property, it will effectively wipe out its entire Code Sec. 179 deduction (\$500,000 expensing limit - (\$2,500,000 total

Code Sec. 179 property – \$2,000,000 beginning-of-phaseout amount) = zero). If it does not make the Code Sec. 179(f) election, Eat Out Inc. can expense the full \$500,000 of five-year MACRS property placed in service earlier this year (if it has enough taxable income) since the total amount of Code Sec. 179 property won't exceed the \$2,000,000 beginning-of-phaseout amount.

RIA observation: Taxpayers do have the opportunity to change their minds (e.g., because an election turns out to be disadvantageous). Under Code Sec. 179(d)(1)(A)(ii), taxpayers may revoke a Code Sec. 179 election made in 2010 or 2011 without IRS consent. A Code Sec. 179 revocation (or, for that matter, an election) may be made on a timely filed amended federal tax return for the tax year to which the revocation or election applies.

Special Carryover Rules

Notwithstanding the general carryover rule for expensing deductions, no amount attributable to qualified real property can be carried over to a tax year beginning after 2011. (Code Sec. 179(f)(4)(A))

RIA observation: Thus, there is *no* carryover for an unused expensing deduction for qualified real property placed in service in 2011.

To the extent that any amount is not allowed to be carried over to a tax year beginning after 2011 due to the qualified real property carryover limit, the Code is applied as if no Code Sec. 179 expensing election had been made for that amount. (Code Sec. 179(f)(4)(B)) Thus, any Code Sec. 179 deductions attributable to qualified real property that are carried over from 2010 to 2011, and that aren't used in 2011, plus any 2011 disallowed Code Sec. 179 deductions attributable to qualified real property, are treated as property placed in service in 2011 for purposes of computing depreciation. However, under Code Sec. 179(f)(4)(C), if the qualified real property carryover limitation applies to any amount (or portion of an amount) which is carried over from a tax year other than the taxpayer's last tax year beginning in 2011, that amount (or portion of an amount) is treated for purposes of the Code as attributable to property placed in service on the first day of the taxpayer's last tax year beginning in 2011.

RIA illustration 2: To demonstrate the effects of the no-carryover rule, assume that D, a calendar-year taxpayer, has no expensing carryovers from earlier years and places \$500,000 of qualified retail improvement property in service in 2011. He elects to expense \$250,000 of the cost of the property (the maximum 2011 expensing deduction before the taxable income limit). D's 2011 aggregate taxable income from all his trades or businesses in 2011 is \$100,000. The maximum expensing deduction D can elect for 2011 is \$100,000, the amount of his aggregate trade or business taxable income. His unused Code Sec. 179 deduction is \$150,000 (\$250,000 – \$100,000), which cannot be carried over. The Code is applied as if no expensing election had been made for the \$150,000 amount. Thus, D can depreciate the \$150,000 amount starting in 2011.

Allocation of amounts. For purposes of applying the qualified real property carryover limitation and the Code Sec. 179(b)(3)(B) general carryover rules to any tax year, the amount which is disallowed under Code Sec. 179(b)(3)(A) (the taxable income limitation)

for that tax year which is attributed to qualified real property is the amount which bears the same ratio to the total amount so disallowed as:

(i) the aggregate amount attributable to qualified real property placed in service during that tax year, increased by the portion of any amount carried over to that tax year from an earlier tax year which is attributable to qualified real property, bears to

(ii) the total amount of Code Sec. 179 property placed in service during that tax year, increased by the aggregate amount carried over to that tax year from any earlier tax year. (Code Sec. 179(f)(4)(D))

For purposes of the allocation rules, only Code Sec. 179 property for which an expensing election was made (determined without regard to amounts disallowed under Code Sec. 179(f)(4)(B), see above) is taken into account. (Code Sec. 179(f)(4)(D))

RIA observation: When taxpayers place in service multiple Code Sec. 179 properties that have a total cost in excess of the dollar limitation, the standard wisdom is to make the Code Sec. 179 for those properties that have the longest depreciation periods. This approach generally maximizes the acceleration of deductions. However, because of the qualified real property carryover limitations discussed above, taxpayers subject to the taxable income limitation on Code Sec. 179 deductions should, in some situations, choose not to make the Code Sec. 179 election for qualified real property, even if that property has a longer depreciation period than the taxpayer's other Code Sec. 179 properties.

RIA illustration 3: Earlier in 2011, ABC Inc., a calendar-year business, placed in service \$500,000 of five- and seven-year MACRS property. In its final quarter, it places in service \$250,000 of qualified real property consisting of qualified restaurant property. It has no Code Sec. 179 carryovers from previous years. ABC winds up with \$300,000 of taxable income for 2011 and \$200,000 for 2012.

If ABC elects to expense \$250,000 of the five- and seven-year MACRS property, and \$250,000 of the qualified real property, the amount disallowed under the taxable income limitation and attributable to the qualified real property will be \$100,000 ($(\$250,000 \text{ qualified real property for which expensing was elected} \div \$500,000 \text{ total expensing election}) \times \$200,000 \text{ disallowed amount because of the taxable income limitation}$). The amount disallowed under the taxable income limitation and attributable to the five- and seven-year MACRS property also will be \$100,000. None of the \$100,000 expensing carryover from 2011 attributable to qualified real property may be carried over to a tax year beginning after 2011, and ABC will be treated for depreciation purposes as if it had placed \$100,000 of qualified restaurant property in service in 2011. For 2012, ABC will be able to offset only \$100,000 of its taxable income with \$100,000 of carried-over expensing deductions from 2011. In essence it will have lost \$100,000 of expensing deductions.

Had ABC elected for 2011 to expense the entire \$500,000 of five- and seven-year MACRS property, and none of its \$250,000 of qualified real property, it would have been able to use expensing to offset \$300,000 of taxable income in 2011, and \$200,000 of taxable income in 2012.