DEPRECIATION AND EXPENSING PROVISIONS IN THE "PROTECTING AMERICANS FROM TAX HIKES"

Late on December 18, Congress passed and the President signed into law a bipartisan, bicameral agreement on tax extenders i.e., the 50 or so temporary tax provisions routinely extended by Congress on a one- or two-year basis - and numerous other tax provisions in the "Protecting Americans from Tax Hikes (PATH) Act of 2015" (the Act). The agreement, which makes permanent many of the individual and business extenders and contains provisions on Real Estate Investment Trusts (REITs), IRS administration and the Tax Courts and miscellaneous other provisions.

As explained in this *Hot Topic*, the PATH Act makes permanent the enhanced expensing and phaseout limits; and 15-year writeoff for qualifying leasehold improvements, restaurant buildings and improvements and retail improvements. In addition, the Act provides for a retroactive extension of a host of other depreciation provisions for businesses which had expired at the end of 2014, including the extension of 50% bonus first-year depreciation (at a rate that gradually decreases).

Enhanced Expensing Made Permanent

A taxpayer, other than an estate, a trust and certain noncorporate lessors, may 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. The maximum annual expensing amount generally is reduced dollar-for-dollar by the amount of property placed in service during the tax year in excess of a specified investment ceiling. 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. 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. And any amount not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding tax years.

For tax years beginning in 2014: (1) the dollar limitation on the expensing deduction was $500,000; and (2) the investment-based reduction in the dollar limitation began to take effect when property placed in service in the tax year exceeds $2 million (the investment ceiling). Under the 2014 limits, the deduction didn't phase out completely until the cost of expensing-eligible property exceeded $2.5 million ($2 million (investment ceiling) + $500,000 (dollar limit).

Under pre-Act law, for tax years beginning after 2014, the maximum expensing limit dropped to $25,000, and the investment ceiling dropped to $200,000. Thus, the deduction phased out completely when the cost of expensing-eligible property exceeded $225,000 ($200,000 (investment ceiling) + $25,000 (dollar limit)).

In general, under pre-Act law, property is eligible for expensing if it is:

- Tangible personal property which is property (generally, machinery and equipment), depreciated under the MACRS rules of the Code, regardless of its depreciation recovery period;

- For any tax year beginning in 2010 through 2014, up to $250,000 of qualified real property - qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property - (under a carryover limitation for qualifying real property no portion of the disallowed expensing could be carried to a tax year beginning after 2014); or

- Off-the-shelf computer software, but only if placed in service in a tax year beginning before 2015.

Under pre-Act law, for tax years beginning before 2015, an expensing election or specification of property to be expensed may be revoked without IRS's consent, but, if revoked, can't be reelected.

New law. The Act retroactively extends and makes permanent the $500,000 expensing limitation and $2 million phase-out amounts. Both the $500,000 and $2 million limits are indexed for inflation. The special rules which allow expensing for computer software is also permanently extended. In addition, an expensing election or specification of property to be expensed may be revoked without IRS's consent; thus, the ability to revoke a election without IRS consent is made permanent.

For tax years beginning before 2016, qualified real property is eligible to be expensed. No portion of the disallowed expensing could be carried to a tax year beginning after 2015. For tax years beginning after December 31, 2015, expensing of qualified real property is made permanent without a carryover limitation, as amended and the $250,000 expensing limitation with respect to qualifying real property is eliminated. The carryover limitation for qualifying real property is removed.

For property placed in service after December 31, 2015, the Act provides that air conditioning and heating units are treated as eligible for expensing.

Observation: The expensing break is enhanced by the de minimis safe harbor in the capitalization regulations which allows businesses to elect to expense their outlays for "lower-cost" business assets. Under this safe harbor, which applies to an amount paid during the tax year to acquire or produce a unit of property (UOP), or acquire a material or supply, and generally applies to amounts paid in tax years beginning on or after January 1, 2014, qualifying businesses with an applicable financial statement (AFS) can expense eligible property if the amount paid doesn't exceed $5,000 per invoice (or per item as substantiated by the invoice). If the taxpayer does not have an AFS, the same rule applies except the amount paid for eligible property can't exceed $2,500 per invoice (or per item as substantiated by the invoice); this amount was $500 before 2016, but IRS won't challenge an earlier use of the higher amount. Both the $5,000 and $2,500/$500 amounts

can be changed by published IRS guidance.

Observation: Assets to which the de minimis election applies (and which aren't capitalized and depreciated) are not be counted in determining either the maximum expensing limit or the investment ceiling.

Illustration: MidCorp, a calendar year corporation has an AFS, has a written accounting policy at the beginning of 2015, which it follows, to expense amounts paid for property costing $5,000 or less. In 2015, it pays $750,000 to buy 500 computers at $1,500 each, and $250,000 to buy 50 high-speed network printers at $5,000 each. Each computer and printer is a UOP, and the amounts paid for them meet the requirements for the de minimis safe harbor. During 2015, MidCorp also spends a total of $1,000,000 on other equipment and business assets which are not eligible for the de minimis safe harbor and instead must be capitalized. MidCorp elects to apply to amounts paid in tax years beginning on or after January 1, 2014. Under the final regulations, MidCorp should be able to deduct $1.5 million of the total cost of its machinery and equipment purchases during 2015 ($1 million under the de minimis safe harbor, and $500,000 under the expensing election).

15-Year Writeoff for Qualified Leasehold and Retail Improvements and Restaurant Property Made Permanent

Qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property which was placed in service before January 1, 2015 was included in the 15-year MACRS class for depreciation purposes - that is, such property was depreciated over 15 years under MACRS.

Under pre-Act law, the above rules didn't apply to property placed in service after December 31, 2014.

New law. The Act retroactively extends and makes permanent the inclusion of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property in the 15-year MACRS class.

Bonus First-Year Depreciation Extended Through 2019

Under pre-Act law, the Code generally allows an additional first-year depreciation deduction (also called bonus first-year depreciation) equal to 50% of the adjusted basis of qualified property acquired and placed in service after December 31, 2011, and before January 1, 2015 (before January 1, 2016 for certain longer-lived and transportation property). The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax (AMT) purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer may elect out of additional first-year depreciation for any class of property for any tax year.

In general, an asset qualifies for the bonus depreciation allowance if:

- It falls into one of the following categories: property to which the modified accelerated cost recovery system (MACRS) rules apply with a recovery period of 20 years or less; certain computer software; qualified leasehold improvement property; or certain water utility property.

- It is placed in service before January 1, 2015. (Certain long-production-period property and certain transportation property may be placed in service before January 1, 2016.)

- Its original use commences with the taxpayer. Original use is the first use to which the property is put, whether or not that use corresponds to the taxpayer's use of the property.

Under pre-Act law, these bonus depreciation provisions didn't apply to property placed in service after December 31, 2015 (December 31, 2016 for certain longer-lived and transportation property).

New law. The Act retroactively extends 50% first-year bonus depreciation for two years so that it applies to qualified property acquired and placed in service before January 1, 2017 (before January 1, 2018 for certain longer-lived and transportation property). The Act provides that 40% first-year bonus depreciation applies to qualified property acquired and placed in service in 2018, and that 30% first-year bonus depreciation applies to qualified property acquired and placed in service in 2019. For property placed in service after December 31, 2015, in tax years ending after that date, bonus depreciation applies to qualified improvement property - any improvement to an interior portion of a building which is nonresidential real property - if such improvement is placed in service after the date that building was first placed in service. For plants planted or grafted after December 31, 2015, and before January 1, 2020, 50% bonus depreciation is allowed for certain trees, vines, and plants bearing fruit or nuts when planted or grafted, rather than when placed in service.

Enhanced First-Year Depreciation Cap for Autos and Trucks Extended Through 2019

Under the luxury auto dollar limits, depreciation deductions (including expensing) which can be claimed for passenger autos are subject to dollar limits that are annually adjusted for inflation. For passenger automobiles placed in service in 2015, the adjusted first-year limit is $3,160. For light trucks or vans, the adjusted first-year limit is $3,460. Light trucks or vans are passenger automobiles built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis that are subject to limits because they are rated at 6,000 points gross (loaded) vehicle weight or less.

The applicable first-year depreciation limit is increased by $8,000 (not indexed for inflation) for any passenger automobile that is "qualified property" under the bonus depreciation rules and isn't subject to a taxpayer election to decline bonus depreciation.

Under pre-Act law, qualified property didn't include property placed in service after December 31, 2014 (except for certain aircraft and certain long-production-period property that had,

instead, a December 31, 2015, placed-in-service deadline). Thus, under pre-Act law, the $8,000 boost in first-year depreciation allowances wasn't available for new cars and trucks purchased after 2014.

> **New law.** For property placed in service after December 31, 2015, and before January 1, 2018, the Act provides that the limitation for a passenger auto which is qualified property is increased by $8,000. For an auto placed in service in 2018, the limitation is increased by $6,400. For an auto placed in service in 2019, the limitation is increased by $4,800.

Choice to Forego Bonus Depreciation and Claim Credits Instead Is Extended

The Code generally permits a corporation to increase the alternative minimum tax (AMT) credit limitation by the bonus depreciation amount with respect to certain property placed in service after December 31, 2010, and before January 1, 2015 (January 1, 2016 in the case of certain longer-lived and transportation property) if it forgoes bonus depreciation on that property.

Under pre-Act law, the above provision didn't apply to such property placed in service after December 31, 2014 (December 31, 2015 in the case of certain longer-lived and transportation property).

> **New law.** For property placed in service during 2015, the Act allows taxpayers to elect to accelerate the use of AMT credits in lieu of bonus depreciation under special rules. Beginning in 2016, the Act modifies the AMT rules by increasing the amount of unused AMT credits that may be claimed in lieu of bonus depreciation.

Expensing Election for Costs of Film and TV Production Extended Through 2016 and Expanded

Taxpayers may elect to expense production costs of qualified film and television (TV) productions in the U.S. Expensing doesn't apply to the part of the cost of any qualifying film or TV production that exceeded $15 million for each qualifying production. The limit is $20 million if production expenses were "significantly incurred" in areas (1) eligible for designation as a low-income community or (2) eligible for designation by the Delta Regional Authority (a federal-state partnership covering parts of certain states) as a distressed county or isolated area of distress.

Under pre-Act law, these rules didn't apply to qualified film and TV productions beginning after December 31, 2014.

> **New law.** The Act retroactively extends for two years the expensing election for costs of film and TV production for productions beginning before January 1, 2017. For productions beginning after December 31, 2015, the expensing election is expanded to also apply to any "qualified live theatrical production," which is defined as a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a commercial entity in any venue which has an audience

capacity of not more than 3,000, or a series of venues, the majority of which have an audience capacity of not more than 3,000. In addition, qualified live theatrical productions include any live staged production which is produced or presented by a taxable entity no more than 10 weeks annually in any venue which has an audience capacity of not more than 6,500.

7-Year Writeoff for Motorsport Racing Track Facilities Extended Through 2016

A short 7-year cost recovery period applies to property used for land improvement and support facilities at motorsports entertainment complexes.

Under pre-Act law, the short writeoff period only applied for property placed in service on or before December 31, 2014.

New law. The Act retroactively extends for two years the 7-year straight line cost recovery period for motorsports entertainment complexes. The quick writeoff applies to qualifying motorsports entertainment complexes placed in service before January 1, 2017.

Miscellaneous Provisions Extended Through 2016

In addition to the above, The Act retroactively extends the following provisions for two years:

- Classification of certain race horses as 3-year property, for horses placed in service before January 1, 2017 (regardless of age when placed in service).

- Accelerated depreciation for business property on an Indian reservation, for property placed in service before January 1, 2017. For tax years beginning after December 31, 2015, taxpayers can make an irrevocable election out of these accelerated depreciation rules for any class of property.

- Election to treat 50% of the cost of any qualified mine safety equipment as an expense in the tax year in which the equipment is placed in service, for property placed in service before January 1, 2017.

This *Hot Topic* is an informative publication for our clients and friends of the Firm. It is designed to provide accurate information on the subject matter covered. We recommend you consult with your legal and other advisors to determine if the information is applicable in your specific circumstances. If these advisors are not available to you, please feel free to contact Barry N. Finkelstein, CPA at 903/473-3540.