YEAR-END PLANNING - MAKING THE MOST OF QUICK WRITEOFFS FOR CAPITAL GOODS PURCHASES (PART III)

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 *Hot Topic* 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 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 covered the generous Code Sec. 179 expensing rules which 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 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,
  © qualified retail improvement property described in Code Sec. 168(e)(8).

  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).

  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 which qualifies for bonus first-year depreciation, except that if a lessor makes an improvement which is a qualified leasehold improvement, it can't be qualified leasehold improvement property to any subsequent owner, subject to exceptions for non-recognition and death transfers.

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

The improvement is Code Sec. 1250 property.

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, sub-lessee or lessor of the building portion.

The portion of the building is to be occupied exclusively by the lessee (or any sub-lessee) of the portion.

The improvement is placed in service more than three years after the date the building was first placed in service.

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:

(a) the enlargement of the building,
(b) any elevator or escalator,
(c) any structural component benefitting 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.

> **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 regulations to include all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members which are essential to the stability of the building.

> **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 December 31, 2011, and before January 1, 2013 (before January 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.

> **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 which is nonresidential real property if:

  (a) 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

  (b) the improvement is placed in service more than three years after the date the building was first placed in service.

  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.

  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.

- ***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 which 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.

- ***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 which may be treated as Code Sec. 179 property for 2010 and 2011.

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-phase out amount).

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.

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-phase out 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-phase out amount.

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.

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. 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)©, 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.

> **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,

(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.

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.

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.

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 qualified real property for which expensing was elected ÷ $500,000 total expensing election) × $200,000 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.