HIGHLIGHTS
- $500 De Minimis Limit Increased to $2,500
- Retail and Restaurant Safe Harbor for Remodeling Projects
- Updated Accounting Method Procedures for Repair Regs.
- Bonus Depreciation Extended Through 2019
- 15-Year Real Property Provisions Made Permanent
- Permanent $500,000 Section 179 Expensing Limit
- Permanent Section 179 Deduction for Qualified Real Property
- Depreciation Provisions for Special Taxpayers Extended

INSIDE
Background.................................1
De Minimis Safe Harbor ................. 2
Remodel-Refresh Safe Harbor ......... 2
Accounting Method Changes.......... 4
Bonus Depreciation ..................... 5
15-Year Real Property .................. 6
Code Sec. 179 Expensing ............... 7
Depreciation For Special Taxpayers 8
Conclusion................................. 9

Special Report
Tax Briefing
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$500 De Minimis Limit Increased to $2,500
Retail and Restaurant Safe Harbor for bonus depreciation and the Section 179 expense allowance. These changes are also discussed in this briefing.

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Repair v. Capitalization and Depreciation Changes Will Affect 2016 Business Returns

Every taxpayer that uses tangible real or personal property in a business needs to understand the tax rules relating to the distinction between a repair and capital expenditure, as well as the depreciation of those capitalized expenditures and other depreciable assets that are purchased or produced.

This briefing covers recent developments relating to repair, capitalization, and depreciation as embodied in the final “tangible property regulations,” also known as the “repair regulations.” In addition, significant changes to depreciation provisions, such as bonus depreciation and the Section 179 allowance, were made by the Protecting American from Tax Hikes Act of 2015 (PATH Act) (P.L. 114-113). Many of these changes first went into effect in 2016 and will need to be considered when preparing 2016 returns. This briefing also details these changes.

Recent developments to the repair regulations discussed in this briefing include an increase in the elective de minimis safe harbor per-item expensing limit for 2016 for taxpayers without an applicable financial statement (AFS) from $500 to $2,500, a new remodel-refresh safe harbor that allows certain taxpayers to deduct 75 percent of remodel-refresh costs (Rev. Proc. 2015-56), and the issuance of a new automatic accounting method procedure (Rev. Proc. 2016-29) that now governs changes to comply with the tangible property regulations.

The final tangible property regulations were issued in 2013 under T.D. 9636 (9/13/2013) and provide rules for distinguishing between a currently deductible repair and a capitalized expenditure (Reg. §§ 1.263-1, -2, and -3) (the “repair regulations”). The tangible property regulations also include rules relating to MACRS general asset accounts (Reg. § 1.168(i)-1), MACRS multiple asset and item accounts (Reg. §1.168(i)-7), and dispositions of MACRS property (Reg. § 1.168(i)-8). These regulations were issued in 2014 under T.D. 9689 (8/14/2014). Although taxpayers—other than “small qualifying taxpayers” with total assets of less than $10 million and average annual gross receipts of less than $10 million, as described in Rev. Proc. 2015-20—should have filed accounting method changes on Form 3115, Application for Change in Accounting Method, to comply with the tangible property regulations for tax years beginning on or after January 1, 2014 (the effective date of the tangible property regulations), these changes may continue to be made for any subsequent tax year by taxpayers not under audit by using the automatic accounting method change procedure of Rev. Proc. 2016-29.
DE MINIMIS SAFE HARBOR

The tangible property regulations dealing with repairs include a de minimis expensing safe harbor that allows taxpayers to annually elect to deduct the cost of materials and supplies and units of property produced or acquired subject to a per-item dollar limit (Reg. § 1.263(a)-1(f)).

The maximum per-item de minimis safe harbor dollar limit is increased from $500 to $2,500 for taxpayers without an applicable financial statement (AFS), effective for tax years beginning on or after January 1, 2016 (Notice 2015-82). The maximum $5,000 per-item limit for taxpayers with an AFS is unchanged. In general, an AFS is a certified audited financial statement (Reg. § 1.263(a)-1(f)).

**COMMENT:** Although taxpayers without an AFS are not required to have a written accounting policy implementing the safe harbor, an unwritten policy employing a $2,500 per-item deduction limit must still be in effect as of the beginning of the 2016 tax year in order for the $2,500 limit to apply for the 2016 tax year. The per-item deduction limit may exceed $2,500 but only items costing $2,500 or less receive safe harbor protection. Similarly, for each tax year beginning after 2016, an unwritten policy with a $2,500 per-item limit must be in effect as of the beginning of that tax year in order for the higher limit to apply.

For tax years beginning before January 1, 2016, the IRS will allow a taxpayer without an AFS to qualify for the $2,500 limit if all requirements for the safe harbor are satisfied. Consequently, if a taxpayer had a per-item deduction limit in excess of $500 in effect at the beginning of a pre-2016 tax year, items that cost no more than the limit set (but not in excess of $2,500) will receive safe harbor protection. The IRS will not challenge deductions within the $2,500 limit (or a lesser limit set by the taxpayer’s policy in effect at the beginning of the tax year) in an audit, assuming the taxpayer meets all requirements for the safe harbor. If an audit is currently being conducted solely on such deductions, it will be discontinued.

REMODEL-REFRESH SAFE HARBOR

**COMMENT:** This section makes occasional reference to “informal IRS guidance.” This refers to informal opinions expressed by IRS representatives during the Capital Recovery and Leasing panel discussion of the American Bar Association’s (ABA) Section of Taxation 2016 Mid-Year meeting held in Los Angeles, California, January 28–30, 2016. These opinions are not binding on the IRS.

The IRS supplemented the tangible property regulations with a safe harbor that allows a taxpayer operating a retail establishment or a restaurant to change to a method of accounting that allows the taxpayer to treat 25 percent of qualified remodel-refresh costs as capital expenditures under Code Sec. 263 and 75 percent of such costs as currently deductible repair and maintenance expenses (Rev. Proc. 2015-56; Rev. Proc. 2016-29, Section 10.10 (Accounting method change #222)). The 25 percent capitalization amount also applies for purposes of the uniform capitalization rules of Code Sec. 263A.

Once the accounting method change is filed, all future remodel-refreshes for all of a taxpayer’s qualified buildings in the same trade or business are subject to the safe harbor. A taxpayer would need to file a nonautomatic method change seeking advance consent to switch out of the safe harbor.

**COMMENT:** The 75 percent allocation to current deductible expenditures is considered by most practitioners as generous when compared to the typical allocation that results when the repair regulations are applied on an item-by-item basis to remodel-refresh costs. However, the safe harbor imposes some complexities and restrictions that may discourage its use.

The 25 percent capitalized portion is generally treated as nonresidential real property depreciable over a 39-year recovery period. However, some or all of capitalized amount may instead be eligible for a 15-year recovery period as qualified leasehold improvement property, qualified retail improvement property, or qualified restaurant property. For example, if the remodel-refresh is made to the internal structure of the building pursuant to the terms of a lease and the building is at least three years old, some or all of the capitalized portion may be considered 15-qualified leasehold improvement property and is also eligible for bonus depreciation.

AFS Required

The safe harbor may only be used by taxpayers with an applicable financial statement (AFS). Consequently, the method is not usually available to small business taxpayers who typically operate one or two stores.

An AFS is an audited financial statement or certain other similar statements (Reg. § 1.263(a)-1(f)).

**COMMENT:** An IRS spokesperson indicated that the IRS limited the safe harbor to taxpayers with an AFS because such taxpayers were in greater need of relief due to the large number of remodel-refreshes conducted by these taxpayers. Small business taxpayers, on the other hand, can generally apply the tangible property regulations on the occasional remodel-refresh without undue burden.

Excluded Retailers

Certain retailers may not use the remodel-refresh safe harbor (Sec. 4.01 of Rev. Proc. 2015-56). These excluded retailers include:
Automotive dealers;
Other motor vehicle dealers;
Gas stations;
Manufactured home dealers; and
Nonstore retailers.

**Excluded Costs**

Certain costs paid during a remodel-refresh project are specifically excluded from the safe harbor (Sec. 6.04 of Rev. Proc. 2015-56). Excluded remodel-refresh costs must be deducted or capitalized in accordance with the provisions of the tax code and regulations that are otherwise applicable.

**Code Sec. 110 construction allowances.**
Amounts paid by a lessor to a lessee for making improvements may constitute a qualified lessee construction allowance under Code Sec. 110. The allowance must be capitalized and depreciated by the owner-lessee in accordance with Code Sec. 110.

**Section 1245 property.**
Amounts paid for section 1245 property during a remodel-refresh are not subject to the safe harbor. Thus, section 1245 property that would otherwise be treated as a separately depreciable asset must be capitalized and depreciated under the cost segregation rules, usually over a five-year period (Asset Class 57.0 of Rev. Proc. 87-56).

**IMPACT:** It is common for taxpayers to forgo a cost segregation study and depreciate the entire cost of a building, including section 1245 components of the building, as 39-year nonresidential real property or 27.5 year residential rental property, as applicable. An IRS spokesperson informedly indicated that this treatment is technically incorrect but that IRS auditors generally allow or disregard such improper treatment because the treatment favors the government. Now, however, if the remodel-refresh safe harbor applies, the IRS would be disadvantaged if the taxpayer were to treat 75 percent of section 1245 property costs as currently deductible. Consequently, in the case of taxpayers using the remodel-refresh safe harbor, auditors will not likely overlook the failure to properly categorize property connected with a remodel-refresh as section 1245 property that is excluded from the safe harbor.

**Code Sec. 179 deductions.**
Amounts expensed under Code Sec. 179 are also not subject to the safe harbor. For example, remodel-refresh improvements that a taxpayer elects to expense as qualified real property (Code Sec. 179(f)) are not taken into account under the safe harbor. The same rule applies to amounts deducted under Code Sec. 179D (energy efficient commercial building property) and Code Sec. 190 (expenses to remove architectural and transportation barriers).

**Temporary closings.**
Remodel-refresh costs incurred during a temporary closing are not eligible for the safe harbor. A temporary closing is a closing of the qualified building during normal business hours for more than 21 consecutive calendar days.

**Remodel-upgrades prior to placing building in service.**
Remodel-upgrades performed prior to the date that the taxpayer places a building in service are not eligible for the safe harbor. No portion of these costs is a repair expense. The costs are treated as part of the capitalized acquisition cost of the building (Reg. § 1.263(a)-2(d)(1)).

**Initial buildout for lessee.**
The costs of an initial buildout of a building for a new lessee do not qualify under the safe harbor.

**General Asset Account Required**

In order to apply the safe harbor, the building (if depreciable under MACRS) and improvements capitalized under the safe harbor must be placed in separate MACRS general asset accounts (GAAs) (Sec. 5.02(6) of Rev. Proc. 2015-56).

**CAUTION:** Only buildings and improvements that are depreciable under MACRS may be placed in a general asset account. The safe harbor, however, also applies to buildings that are not depreciable under MACRS. Additions and improvements made after 1986 to a building, including capitalized remodel-refresh costs, are depreciated under MACRS even if the building is not MACRS property and must be placed in a GAA.

A taxpayer changing to the safe harbor accounting method will need to make a late GAA election for all existing buildings that are eligible for the safe harbor at the time the change in accounting method is filed. The late election is considered an accounting method change. However, it is made as part of the accounting method change to elect the safe harbor (Sec. 11.10(4)(b) of Rev. Proc. 2016-29).

Late GAA elections must also be made for any addition or improvement that was previously made to the building and that is depreciable under MACRS. The late election for additions and improvements must be made whether or not the addition or improvement related to a prior remodel-refresh project (Sec. 5.02(6) (a) (iii) of Rev. Proc. 2016-56).

**COMMENT:** The remodel-refresh safe harbor makes no specific reference regarding the treatment of future improvements that are made to a building that is subject to the remodel-refresh safe harbor. Nevertheless, it appears that these future improvements, like all past improvements, must be placed in a GAA even if they are unrelated to the remodel-refresh project.

**Partial Disposition Elections**

A taxpayer may not make a partial disposition election (Reg. § 1.168(i)-8(d)) to claim retirement losses on building components (such as a replaced original roof) after the building is placed in the GAA (Sec. 5.02(4) of Rev. Proc. 2015-56). The partial disposition election does not apply to assets that are in a GAA. Also, it does not apply assets that are not depreciated under MACRS.

The safe harbor method must be applied on a cut-off basis to a building if a taxpayer previously claimed one or more retirement losses on structural components of the building by
making a timely partial disposition election or by filing an accounting method change to make a late partial disposition election unless the taxpayer revokes those earlier elections (Sec. 11.10(4)(c) of Rev. Proc. 2016-29). Application of the safe harbor on a cut-off basis means that the taxpayer may not apply the safe harbor method to any remodel-refresher on that building that took place prior to the year for which the change to the safe harbor method is made.

The election to revoke a prior partial disposition election is a separate accounting method change that is described in Section 6.20 of Rev. Proc. 2016-29.

CAUTION: An accounting method change to revoke a prior-year partial disposition election must be filed no later than for a tax year beginning after December 31, 2013, and ending before December 31, 2016 (6.20(3) of Rev. Proc. 2016-29).

COMMENT: A taxpayer that wants to apply the safe harbor on a cut-off basis may deliberately choose not to revoke prior partial disposition elections.

ACCOUNTING METHOD CHANGES


Repair Regulations

The accounting method change procedures relating to the repair regulation portion of the tangible property regulations (generally, Reg. §§ 1.263(a)-1, -2, and -3), which were previously described in Section 10.11 of Rev. Proc. 2015-14, are now found in Section 11.08 of Rev. Proc. 2016-29. Modifications made to Sec. 10.11 of Rev. Proc. 2015-14 by Rev. Proc. 2015-20, which allowed small business taxpayers with total assets and average annual gross receipts of less than $10 million to comply with the repair regulations without filing Form 3115, are now incorporated into the text of Section 11.08. The designated accounting number change for each particular method change is the same under both procedures.

Waiver of eligibility limitations extended one year. The most significant substantive change made by Rev. Proc. 2016-29 to the changes for complying with the repair regulations contained in superseded Rev. Proc. 2015-14 is a one-year extension of the waiver of the eligibility limitations of Section 5.01(d) of Rev. Proc. 2015-13 (preventing a taxpayer from filing a Form 3115 under the automatic procedure in its last year of a trade or business) and Section 5.01(f) (preventing a taxpayer from filing the same accounting method change for the same item under the automatic procedure in a five-year period, ending in the year of change) (Section 10.11(2)(a) of Rev. Proc. 2016-29).

The waiver of these eligibility limitations has been extended one year to tax years beginning before January 1, 2016 (Rev. Proc. 2016-29, Section 11.08(2)). For example, a taxpayer may file a change using the automatic procedures for a tax year that begins in 2015 even though it filed the same change for a tax year that began in 2012.

IMPACT: For a tax year beginning on or after January 1, 2016, if a taxpayer may not file a change under the automatic procedure because of the eligibility limitations, the taxpayer must file the change using the advance consent procedure of Rev. Proc. 2015-13. Under the advance consent procedure, the taxpayer must receive actual consent from the IRS to make the change and will pay an $8,600 filing fee. Immediate consent to change accounting methods is granted under the automatic procedure unless the IRS advises otherwise and no fee is charged.

Advance consent required if credit claimed. Another significant change adds a rule that prevents a taxpayer from using the automatic method procedure to change from capitalizing and depreciating an asset to deducting its cost as a repair expense if the taxpayer claimed any type of income tax credit on the asset. If a credit was claimed, a taxpayer must file a change from capitalizing to deducting using the advance consent procedure.

COMMENT: The IRS is concerned about situations where a taxpayer changes from capitalizing to expensing an asset and winds up claiming both a credit on the capitalized amount and a repair deduction for the previously capitalized amount (double dipping).

Furthermore, the automatic consent procedure may not be used to change from capitalizing to deducting if the taxpayer is a corporation that made an election under Code Sec. 168(k)(4) to forgo bonus depreciation on the capitalized amount and claim an unused alternative minimum tax credit (Sec. 11.08(1)(b) of Rev. Proc. 2016-29).

MACRS Tangible Property Regs

The final tangible property regulations include regulations under the modified accelerated cost recovery system (MACRS) dealing with general asset accounts (Reg. § 1.168(i)-1), item and multiple asset accounts (Reg. § 1.168(i)-7), and dispositions of assets (Reg. § 1.168(i)-8).

Various accounting method changes to comply with these MACRS regulations, which were effective for tax years beginning on and after January 1, 2014, were previously contained in Sections 6.32 through 6.40 of Rev. Proc. 2015-14, as modified by Rev. Proc. 2015-20. Changes to comply with these MACRS regulations now appear in Sections 6.10 through 6.18 of Rev. Proc. 2016-29, which supersedes Rev. Proc. 2015-14, effective for Form 3115s filed on or after May 5, 2016, for a year of change ending on or after September 30, 2015.

Changes described in Sections 6.27 through 6.31 in Rev. Proc. 2015-14 related to accounting methods that were permitted under
the temporary or proposed MACRS tangible property regulations. These changes are obsolete because 2013 was the last tax year in which methods in the temporary and proposed regulations could be applied. Consequently, they are not included in Rev. Proc. 2016-29.

Rev. Proc. 2016-29 also removes the accounting method change allowed by Rev. Proc. 2015-14 to make a late MACRS general asset account election for assets placed in service in tax years beginning before January 1, 2012 (Section 6.32 of Rev. Proc. 2015-14). This election was required to be made no later than a taxpayer's last tax year beginning before January 1, 2014, and is now obsolete.

The accounting method change to revoke these late GAA elections (Section 6.34 of Rev. Proc. 2015-14) was retained by Rev. Proc. 2016-29 (Section 6.11) because certain fiscal-year taxpayers, as of the May 5, 2016, issuance date of Rev. Proc. 2016-29, still had time to meet the deadline for filing this change. The deadline requires the late GAA election to be revoked by filing an accounting method change for the taxpayer's last tax year beginning before January 1, 2015.

Eligibility rule extended. An important substantive change made by Rev. Proc. 2016-29 extends the waiver of the eligibility rule in Section 5.01(1)(f) of Rev. Proc. 2015-13 by one year to any tax year beginning before January 1, 2016, for most of the retained MACRS accounting method changes.

As discussed earlier, the eligibility rule in Sec. 5.01(1)(f) prevents a taxpayer from using the automatic consent procedure if the taxpayer has made or requested a change for the same specific item during any of the five tax years ending with the year of change.

Advance consent required for change #7 if credit claimed. Another important change prevents a taxpayer from changing from an impermissible method of depreciation to a permissible method (change #7) described in Section 6.01 of Rev. Proc. 2016-29 if the taxpayer has claimed any type of federal income tax credit on the property for which the change is being made (Section 6.01(1)(c)(xvi) of Rev. Proc. 2016-29). In the past, this rule only applied if the taxpayer claimed the rehabilitation credit.

**BONUS DEPRECIATION**

The PATH Act made several important changes to bonus depreciation that will affect the preparation of tax returns for 2016 and beyond (Code Sec. 168(k), as amended by the PATH Act).

If a credit was claimed, a taxpayer must file a change from capitalizing to deducting using the advance consent procedure.

First and foremost, bonus depreciation, which was scheduled to expire after 2014, was extended to apply to property placed in service through 2019. The 50 bonus percent rate continues to apply to property placed in service in 2015, 2016, and 2017. The rate, however, is reduced to 40 percent for property placed in service in 2018 and to 30 percent for property placed in service in 2019 (Code Sec. 168(k)(6), as added by the PATH Act). Unless extender legislation is again enacted, bonus depreciation will expire after 2019.

**Qualified Improvement Property**

Effective for property placed in service on or after January 1, 2016, qualified improvement property qualifies for bonus depreciation. The “qualified improvement property” category replaces the “qualified leasehold improvement property” category of property qualifying for bonus depreciation.

“Qualified improvement property” is defined as 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” (Code Sec. 168(k)(3), as amended by the PATH Act).

**IMPACT:** The use of the phrase “first placed in service” means that the improvement can qualify if the building was first placed in service by any person. For example, if a taxpayer buys an existing building that was previously placed in service by another person, qualified improvements made by the taxpayer prior to the date that the taxpayer places the building in service can qualify for bonus depreciation as long as the improvements are placed in service on or after January 1, 2016. In this situation, the improvements would generally be considered placed in service when the taxpayer places the building in service.

Qualified improvement property does not include expenditures attributable to the enlargement of a building, any elevator or escalator, or the internal structural framework of the building. Qualified leasehold improvement property (which qualifies for bonus depreciation if placed in service prior to 2016) was defined similarly to qualified improvement property except that the following additional limitations apply:

- The improvement needed to be made pursuant to the terms of a lease by the lessor or lessee (or sublessee) and the lessee (or sublessee) must occupy the building;
- The improvement needed to be placed in service more than three years after the building was first placed in service by any person; and
- Improvements that were structural components benefiting a common area of the building did not qualify (Code Sec. 168(k)(3), prior to amendment by the PATH Act).

**IMPACT:** Qualified improvement property is defined much more broadly than qualified leasehold improvement property because the improvement does not need to be made pursuant to a lease and improvements to common areas qualify. Any property that meets the definition of qualified leasehold improvement property will
necessarily meet the definition of qualified improvement property and will be eligible for bonus depreciation beginning in 2016.

CAUTION: Qualified improvement property does not qualify for a 15-year recovery period unless the qualified improvement property is:
- 15-year leasehold improvement property;
- 15-year retail improvement property; or
- 15-year restaurant improvement property, as discussed below.

Specified Plants

Effective for “specified plants” that are planted or grafted beginning in 2016, a taxpayer engaged in a farming business may elect to claim a depreciation deduction equal to 50 percent of the adjusted basis of the specified plant in the tax year in which it is planted or grafted (Code Sec. 168(k)(5), as added by the PATH Act).

A specified plant is:
- Any tree or vine that bears fruits or nuts; and
- Any other plant that will have more than one yield of fruits or nuts and that generally has a preproductive period of more than two years from the time of planting or grafting to the time at which the plant begins bearing fruits or nuts.

The deduction reduces the adjusted basis of the specified plant. If an election to claim the 50 percent deduction is made, the regular bonus depreciation deduction may not be claimed when the specified plant is placed in service.

The “qualified improvement property” category replaces the “qualified leasehold improvement property” category of property qualifying for bonus depreciation.

IMPACT: A depreciable tree, vine, or plant is considered placed in service in the tax year that it first becomes productive, i.e., bears fruit, nuts, etc. in a commercial quantity (Reg. § 1.46-3(d)(2)), flush language). This new provision in effect accelerates the 50 percent bonus depreciation deduction that would otherwise apply in the year that the specified plant became productive to the year of planting or grafting.

CAUTION: Although a 50 percent deduction may be claimed in the year of planting or grafting, the provision does not accelerate the regular depreciation deductions on the remaining basis to the year of planting or grafting.

The specified plant must be planted or grafted in the United States.

The election is made annually. It is only revocable with IRS consent.

If the 50 percent deduction is claimed, neither the 50 percent deduction nor any regular depreciation deductions on the specified plant are subject to AMT adjustments (i.e., the deductions are claimed in full for AMT purposes).

The 50 percent deduction is not subject to capitalization under the uniform capitalization rules of Code Sec. 263A (Code Sec. 263A(c)(7), as added by the PATH Act).

In the case of a specified plant that is planted or grafted in 2018, the applicable deduction percentage is reduced to 40 percent and if planted or grafted in 2019 is reduced to 30 percent. This reduction corresponds to the reduction required on property for which the regular bonus depreciation deduction is claimed. The 50 percent rate applies to specified plants that are planted or grafted in 2016 or 2017.

Long-Term Method of Accounting

The PATH Act extended through 2019 the special rule which disregards bonus depreciation for purposes of determining the percentage of completion of a long-term contract. Under this rule, the cost of property with an MACRS recovery period of seven years or less that qualifies for bonus depreciation is taken into account as a cost allocable to the contract as if bonus depreciation had not been enacted (Code Sec. 460(c)(6)(B)(ii), as amended by the PATH Act).

15-YEAR REAL PROPERTY

The PATH Act permanently extends the 15-year recovery (depreciation) period under MACRS for:

FILM AND THEATRICAL PRODUCTION COSTS

The election to treat the cost of a qualified film or television production as a currently deductible expense was extended by the PATH Act for two years to apply to productions commencing before January 1, 2017. In addition, the election was expanded to apply to live productions of a play (with or without music) that commence in 2016 (Code Sec. 181, as amended by the PATH Act). A qualified live theatrical production commences production on the date of the first public performance of the production for a paying audience (Act Sec. 169(d)(3) of the PATH Act).

The election applies regardless of the cost of the film or theatrical production and the first $15 million of production costs are deductible ($20 million if a significant portion of the production costs are incurred in low-income communities and certain financially distressed areas).
- Qualified leasehold improvement property;
- Qualified retail improvement property; and
- Qualified restaurant property.

Although the recovery period is only 15 years, the applicable depreciation method is the straight-line method. The half-year or mid-quarter convention applies.

The 15-year recovery periods were scheduled to expire after 2014 but are now permanent. Without the extension, a 39-year recovery period would have applied.

The definition of “qualified leasehold improvement property” that is eligible for bonus depreciation prior to 2016 continues to apply after 2015 for purposes of the 15-year recovery period (Code Sec. 168(e)(6)). This definition is discussed above under the rules for bonus depreciation but generally means an improvement to the internal portion of a building by a lessor or lessee pursuant to the terms of a lease. The leasehold improvement must be made more than three years after the building was placed in service by any person (i.e., not necessarily the lessor or lessee making the improvement).

“Qualified retail improvement property” is defined the same way as qualified leasehold improvement property except that the improvement must be made to the internal portion of a building used in the retail trade or business of selling tangible personal property to the general public; it does not matter if the improvement is made under a lease by a lessor or a lessee (Code Sec. 168(e)(8)).

“Qualified restaurant property” is broadly defined as any improvement to a restaurant building. Improvements to the internal or external structure may qualify. The improvement does not need to be made to a building that has been in service more than three years. The improvement does not need to be made pursuant to a lease (Code Sec. 168(e)(7)).

**Bonus depreciation**

As discussed earlier, beginning in 2016, qualified improvement property qualifies for bonus depreciation (Code Sec. 168(k)(3), as amended by the PATH Act). A 15-year qualified leasehold improvement property and 15-year qualified retail improvement placed in service in 2016 and later will necessarily qualify for bonus depreciation because qualified leasehold improvement property and retail improvement property are defined in such a way that they will necessarily meet the definition of qualified improvement property.

A 15-year qualified restaurant property that is a restaurant building cannot meet the definition of qualified improvement property and, therefore, cannot qualify for bonus depreciation in 2016 or later. However, an improvement to the interior of a restaurant may qualify for bonus depreciation in 2016 or later if the improvement meets the definition of qualified improvement property. External improvements to a restaurant building qualifying for a 15-year recovery period but do not constitute “qualified improvement property” for bonus depreciation purposes.

For property placed in service prior to 2016, bonus depreciation may only be claimed on 15-year qualified retail improvement property and 15-year qualified restaurant improvement property if such property also met the definition of qualified leasehold improvement property under the bonus depreciation rules.

**CODE SEC. 179 EXPENSING**

The PATH Act permanently extended the $500,000 annual cap on the Code Sec. 179 deduction and the $2 million investment limitation.

However, beginning in 2016, the $500,000 annual cap on the Code Sec. 179 deduction and the $2 million investment limitation are adjusted annually for inflation (Code Sec. 179(b)(6), as added by the PATH Act).

For tax years beginning in 2016, the annual cap, as adjusted for inflation, remains at $500,000. The investment limitation, however, is increased from $2 million to $2,010,000 (Rev. Proc. 2016-14).

**COMMENT:** The investment limitation causes the annual cap to be reduced by

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**BONUS DEPRECIATION AND PROPERTY WITH A LONG PRODUCTION PERIOD**

Although bonus depreciation will generally expire after 2019, long production property produced (i.e., constructed) by or for a taxpayer and placed in service in 2020 will continue to qualify for bonus depreciation at the 30 percent rate. The 40 percent rate will apply to long production property placed in service in 2019. The 50 percent rate applies to long production property placed in service before 2019 (Code Sec. 168(k)(6), as added by the PATH Act).

If long production property constructed by or for a taxpayer is placed in service in 2020, the cost attributable to 2020 production (2020 “progress expenditures”) is not eligible for bonus depreciation (Code Sec. 168(k)(2)(B)(ii), as amended by the PATH Act).

“Long production property” is defined as property that:

- Has a recovery (depreciation) period of at least 10 years or is tangible personal property used in the trade or business of transporting persons or property, such as commercial aircraft;
- Is subject to the uniform capitalization rules of Code Sec. 263A; and
- Has a production period exceeding one year and a cost exceeding $1 million (Code Sec. 168(k)(2)(B)).
the cost of a taxpayer’s purchases of Section 179 property during the tax year in excess of the investment limitation amount. Consequently, if a taxpayer purchases more than $2,510,000 of Section 179 property in a tax year beginning in 2016, the $500,000 cap is completely phased out and no amount may be expensed under Section 179 ($2,510,000 – $2,010,000 = $500,000 reduction to the $500,000 cap).

Qualified Real Property
The PATH Act also permanently extended the option to elect to treat the three categories of property with a 15-year recovery period (qualified leasehold improvement, retail improvement, and restaurant property) as Section 179 property. For purposes of Code Sec. 179, these three categories of property are collectively referred to as “qualified real property” (Code Sec. 179(f), as amended by the PATH Act).

In tax years beginning on or after January 1, 2016, the $250,000 limitation on the amount of qualified real property that may be expensed under Code Sec. 179 is eliminated.

CAUTION: Any amount of qualified real property that is expensed under Code Sec. 179 is subject to ordinary income recapture under Code Sec. 1245 to the extent of gain upon disposition of the property (Code Sec. 1245(a)(3)(C)). Bonus depreciation claimed on qualified real property (because of its status as qualified leasehold improvement property (before 2016) or qualified improvement property (after 2015)) is treated as an accelerated depreciation deduction and is subject to recapture under Code Sec. 1250 in an amount equal to the difference between the bonus deduction and straight-line depreciation that could have been claimed on the bonus deduction (Reg. § 1.168(k)-1(f)(3)).

Air Conditioning and Heating Units
In tax years beginning on or after January 1, 2016, the Code Sec. 179 deduction may be claimed on portable air conditioning and heating units (Code Sec. 179(d), as amended by the PATH Act).

CAUTION: Property used in the provision of lodging does not qualify for expensing (Code Sec. 179(d)(1)). Therefore, portable air conditioning and heating units used in a residential rental unit may not be expensed. Hotels and motels that provide lodging on a transient basis are excepted from this rule (Reg. § 1.48-1(h)).

In tax years beginning on or after January 1, 2016, the $250,000 limitation on the amount of qualified real property that may be expensed under Code Sec. 179 is eliminated.

COMMENT: Heating, ventilating, and air conditioning (HVAC) units used to cool and heat a building do not qualify for expensing because HVACs are permanently affixed structural components and, therefore, constitute section 1250 property. Unless a specific exception applies, such as that for qualified real property, only section 1245 property may be expensed under Code Sec. 179.

Additional Changes
Effective for tax years beginning on or after January 1, 2015 (one year earlier than the preceding changes), the new law made the following Section 179 provisions permanent:

- Expensing of “off-the-shelf” computer software (Code Sec. 179(d)(1), as amended by the PATH Act);
- Allowing taxpayers to file amended returns without IRS permission to make, revoke, or change a Section 179 election (Code Sec. 179(c)(2), as amended by the PATH Act); and
- The expensing deduction for qualified real property (the $250,000 annual limit is also increased to $500,000 in tax years beginning after 2015 as explained above) (Code Sec. 179(f), as amended by the PATH Act)).

DEPRECIATION FOR SPECIAL TAXPAYERS
The PATH Act temporarily extended the following targeted depreciation provisions.

Corporate Election to Claim AMT Credits
The PATH Act extends the election for corporations to forgo bonus depreciation and instead claim unused AMT credits for four years to apply to property placed in service through 2019 (2020 for long production property and certain noncommercial aircraft). In tax years beginning in 2016, the election is made annually and the amount of unused credits that may be claimed is no longer subject to an annual limitation of $30 million dollars or 6 percent of unused pre-2006 AMT credits (Code Sec. 168(k)(4), as amended by the PATH Act).

If the election is made, the Code Sec. 53(c) limitation on the amount of unused AMT credits that may be claimed in a tax year continues to be increased by the “bonus depreciation amount” for all assets placed in service during the tax year. The bonus depreciation amount, for each asset placed in service in a tax year, as in the past, is equal to 20 percent of the difference between (1) the first year depreciation (including bonus depreciation) that could be claimed on the asset if the bonus is claimed and (2) the first-year depreciation that could be claimed on the asset if bonus depreciation is not claimed.

The “maximum increase amount” limitation on the bonus depreciation amount is removed effective for tax years ending after
2015. Under this limitation, the bonus amount could not exceed the lesser of $30 million or 6 percent of the taxpayer’s unused AMT credits attributable to tax years beginning before 2006.

The maximum increase amount is replaced with a new limitation on the bonus depreciation amount (Code Sec. 168(k)(4)(B)(ii), as amended by Act Sec. 143(b)(3) of P.L. 114-113).

Under the new limitation the bonus depreciation amount computed for a tax year may not exceed the lesser of:

- 50 percent of the corporation’s minimum tax credit under Code Sec. 53(b) for the corporation’s first tax year ending after 2015; or
- The minimum tax credit for the tax year, determined by taking into account only the adjusted net minimum tax (as defined in Code Sec. 53(d)) for tax years ending before January 1, 2016 (determined by treating credits as allowed on a first-in, first-out basis).

Race Horses

The three-year MACRS recovery period for race horses regardless of age is extended two years to apply to property placed in service before January 1, 2017 (Code Sec. 168(e)(3), as amended by the PATH Act).

Motorsports Complexes

The seven-year recovery period for motorsports entertainment complexes is extended two years to apply to property placed in service before January 1, 2017 (Code Sec. 168(i)(15), as amended by the PATH Act).

Indian Reservation Property

Special shortened recovery periods apply to property located on an Indian reservation. This provision was extended two years by the PATH Act to apply to property placed in service before January 1, 2017 (Code Sec. 168(j), as amended by the PATH Act).

Effective for tax years beginning on or after January 1, 2016, taxpayers are permitted to make an election out of the special depreciation periods for any class of property. For example, an election out could be made for all MACRS five-year property (which is eligible for a shortened three-year recovery period) placed in service during 2016 on an Indian reservation. The election out is irrevocable (Code Sec. 168(j)(8), as added by the PATH Act).

IMPACT: The election will permit taxpayers to use the regular depreciation periods to recover the cost of Indian reservation property in order to claim smaller amounts of depreciation in the earlier tax years of the recovery period. Under current law, a taxpayer wishing to reduce up-front depreciation deductions could also elect the alternative depreciation system (ADS), which is based on the straight-line depreciation method and recovery periods that are generally longer than the regular depreciation periods that would apply if the new election out is made.

CAUTION: There is no alternative minimum tax (AMT) adjustment on depreciation deductions claimed using the shortened recovery periods for Indian reservation property. Consequently, an election out could inadvertently trigger an AMT liability unless bonus depreciation is claimed. AMT adjustments do not apply to any property for which bonus depreciation is claimed.

CONCLUSION

Although the IRS has provided the foundational rules for distinguishing between repairs and capital expenditures in the final tangible property regulations dealing with repairs and capital expenditures, the future will undoubtedly bring additional modifications and refinements. Practitioners will need to keep pace with new developments in this evolving practice area in order to best serve their clients. This briefing is aimed to help in this regard and also in keeping pace with changes relating to depreciation in general.