However, partners in partnerships that are eligible for the “small partnership exception” to the TEFRA audit rules do not file Form 8082. (See discussion in Key Issue 6B.)

A partner does *not* have to file Form 8082 to report a loss, deduction, or credit that is not reported on his return because the amount is otherwise limited—such as a loss limited at the partner level due to lack of basis or the application of the at-risk or passive activity loss rules.

AAR Under the Centralized Partnership Audit Regime

The rules for filing an AAR under the centralized partnership audit regime apply to partnership tax years beginning after 2017 and for partnerships with tax years beginning after November 2, 2015, and before January 1, 2018, for which a valid election under Reg. 301.9100-22(a) is in effect [Reg. 301.6227-1(h)].

An AAR can be filed only by the partnership representative (PR), and only after the partnership return has been filed. When filing the AAR, the partnership must determine whether the partnership-related adjustments requested in the AAR result in an imputed underpayment in accordance with Reg. 301.6227-2(a) for the reviewed year. If they do, the partnership must take the adjustments into account under the rules described in Reg. 301.6227-2(b) unless the partnership made a a push-out election in which case each reviewed year partner must take the adjustments into account. (See Form 8978, Partner’s Additional Reporting Year Tax.) The AAR cannot be filed more than three years after the later of the date the partnership return was filed or the last day for filing such partnership return (determined without regard to extensions) [Regs. 301.6227-1(a) and -1(b)].

Under Reg. 301.6227-1(c)(2), an AAR filed with the IRS must include the following:

- The adjustments requested.
- If a push-out election has been made, the IRS as well as the reviewed year partners must receive a statement containing the information listed in Reg. 301.6227-1(e) on the date the AAR is filed with the IRS.
- Other information prescribed by the IRS in forms, instructions, or other guidance.

New Forms to Use When Filing AARs. The IRS has released the following forms that partnerships will be required to use with regards for administrative adjustment requests (AARs). These forms will be filed in addition to Form 1065X or 8082, whichever is applicable. The new forms will replace the use of amended Schedules K-1.

- Form 8985 (Pass-Through Statement—Transmittal/Partnership Adjustment Tracking Report)
- Form 8985-V (Tax Payment by a Pass-Through Partner)
- Form 8986 [Partner’s Share of Adjustments(s) to Partnership-Related Item(s)]

Practice Tip: Partnerships are required to provide certain information to each partner on or before the due date of the partnership return. This information is provided via Schedule K-1 of Form 1065. The required information may not be amended after the due date of the partnership return [IRC Sec. 6031(b)]. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provides retroactive tax relief that could impact partnership tax returns for 2018 and 2019 tax years. Partnerships that have already filed their 2018 or 2019 tax return would usually have to file an administrative adjustment request (AAR) to take benefit from the advantageous provisions of the CARES Act, since IRC Sec. 6031(b) prohibits amendment. The CARES Act is intended to provide immediate relief to taxpayers and filing an AAR would significantly slow down this relief. Rev. Proc. 2020-23 allows eligible partnerships to file amended tax returns for tax years beginning in 2018 and 2019. Eligible partnerships are those subject to the centralized partnership audit regime, that filed their 2018 or 2019 tax return prior to the issuance of this revenue procedure. Partnerships wanting to take advantage of Rev. Proc. 2020-23 must file Form 1065 with the “Amended Return” box on page one checked, and the “Amended K-1” box checked on each partner’s Schedule K-1. The amended return must be filed before September 30, 2020, and must clearly indicate that the partnership is taking advantage of this revenue procedure by writing “FILED PURSUANT TO REV PROC 2020-23” at the top of Form 1065, page one. The same notation should be included on an attachment with each partner’s Schedule K-1.

KEY ISSUE 6D Statute of Limitations.

TEFRA Partnerships

Where TEFRA is applicable, generally partners must treat partnership items (items more appropriately determined at the partnership level) on their personal return in a manner consistent with the way the partnership reports them on its return, unless the partner discloses the inconsistent treatment on his return. Because of this consistency requirement, the IRS can only adjust partnership items via a partnership-level examination (IRC Sec. 6221).

Generally, the statute of limitations for TEFRA partnership items extends three years from the later of (1) the date on which the partnership return is due (without extensions)—for example, March 15 for calendar-year returns and the 15th day of the third month following the close of the fiscal year, or (2) the date on which the partnership return is filed [former IRC Sec. 6229(a)]. However, the three year statute is extended for the following reasons:

- *Fraud.* The statute of limitations never expires for partnership items with respect to which a partner has (with the intent to evade tax) signed or participated directly or indirectly in the preparation of a return which includes false or fraudulent items. When the partner did not participate in the fraud, his statute of limitations to report partnership income or loss from a fraudulent return is extended from three years to six years [former IRC Sec. 6229(c)(1)].
- *Substantial Understatement.* If a partnership reports income that is understated by more than 25%, or reports an understatement of gross income by reason of an overstatement of unrecovered cost or other basis, such as a gain on sale, the statute of limitations is extended from three to six years [former IRC Sec. 6229(c)(2)].
- *No Return Filed.* If a partnership fails to file an income tax return, the statute for that year never expires [former IRC Sec. 6229(c)(1)].

The rules outlined in this key issue do not apply to small partnerships exempt from the TEFRA consolidated audit procedures. (See Key Issue 6B for a discussion on TEFRA.) The statute of limitations runs separately for each partner in such a partnership and generally extends three years from the later of (1) the date on which the partner's income tax return is due (without extensions), or (2) the date on which the partner actually filed an income tax return (*Siben*). For tax years beginning before 2018, small partnerships exempt from TEFRA are those that have 10 or fewer partners at all times during the tax year. (For this purpose, a taxpayer and spouse and their estates are considered one partner.) In addition, all of the partners must be individuals (other than nonresident aliens), estates, or C corporations. The determination of the partnership's status as a small partnership is made annually. Such small partnerships may elect to be subject to TEFRA. The election is effective for all future years and is revocable only with IRS consent. [See Reg. 301.6231(a)(1)-1.]

Partnership Items Become Nonpartnership Items. If partnership items become nonpartnership items before the regular statute expires (or any agreed-upon extensions of the statute), the statute is automatically extended until one year after the partnership items become nonpartnership items [former IRC Sec. 6229(f)]. (See Key Issue 6B for a discussion on how and when partnership items become nonpartnership items.) The statute for assessing additional tax remains open until the last partnership item is resolved [former IRC Sec. 6229(f)(2)]. Thus, settling some items earlier than others does not limit the period for assessing tax on those settled items.

Even if an item is not a partnership item, an extended statute of limitations may apply. For example, in *Estate of Robert W. Quick*, the Tax Court held that the determination of whether the taxpayers materially participated in an activity was an affected item which, although determined at the individual partner level, still was covered by former IRC Sec. 6229(d). Thus, the IRS had until one year after the partnership determination became final to issue a notice of deficiency to the taxpayers. Reg. 301.6231(a)(5)-1 now provides the same result. The application of IRC Sec. 469 to a partner is an affected item to the extent it is not a partnership item.

Centralized Partnership Audit Regime

Except as otherwise provided for in IRC Sec. 6235 or IRC Sec. 905(c), the statue of limitations runs at the partnership level and expires on the later of the following dates [IRC Sec. 6235; Reg. 301.6235-1]:

1. Three years after the latest of—
   a. the date the partnership return was filed,
   b. the return due date, or
   c. the date on which the partnership filed an AAR for such year under IRC Sec. 6227.
2. 270 days after all required information was submitted to the IRS if the imputed underpayment was modified under IRC Sec. 6225(c) [plus the number of days of an extension of the period for requesting modification as agreed to by the IRS under IRC Sec. 6225(c)(7) and Reg. 301.6225-2(c)(3)(ii)] after the date on which everything required to be submitted to the IRS is submitted.
3. 330 days [plus the number of days of an extension of the modification period described in Reg. 301.6225-2(c)(3)(i) agreed to by the IRS under IRC Sec. 6225(c)(7) and Reg. 301.6225-2(c)(3)(ii)] after the

last notice of proposed partnership adjustment (NOPPA) under IRC Sec. 6231(a)(2) is mailed, regardless of whether modification is requested by the partnership under IRC Sec. 6225(c).

In the case of a false or fraudulent partnership return being filed, an adjustment may be made at any time [IRC Sec. 6235(c)(1)].

If a substantial amount of income is omitted from the partnership return , the statute of limitations is six years [IRC Sec. 6235(c)(2)].

If no return is filed by the partnership an adjustment may be made at any time [IRC Sec. 6235(c)(3)].

KEY ISSUE 6E Form 1065 Penalties.

Preparer Penalties

Basic Penalty—Understatement Due to Unreasonable Position. A practitioner who prepares a tax return that has an understatement of tax due to an unreasonable position and who knew or should have known about the position is liable for a penalty under IRC Sec. 6694(a) equal to the greater of $1,000 or 50% of the income derived or to be derived from preparing the return. A position is unreasonable unless there was substantial authority for the position, as defined in Reg. 1.6662-4(d), or the position was properly disclosed and had a reasonable basis as defined in Reg. 1.6662-3(b)(3). However, the prior (and stricter) more-likely-than-not standard continues to apply to tax shelters and reportable transactions.

The underlying Committee Report to the 2008 Extenders Act says that the substantial authority standard conforms the return preparer standard to the taxpayer standard. Therefore, substantial authority under IRC Sec. 6694 should be similar to substantial authority under IRC Sec. 6662.

Increased Penalty—Willful or Reckless Conduct. IRC Sec. 6694(b) imposes an increased penalty on the preparer of a return or refund claim with a tax understatement due to willful or reckless conduct. The increased willful or reckless conduct penalty is the greater of $5,000 or 75% of the income derived or to be derived from the return preparation. However, this penalty is reduced by the penalty paid by the preparer under IRC Sec. 6694(a) for an unreasonable position. *Willful or reckless conduct* includes a willful attempt to understate the tax liability on the return or claim, or a reckless or intentional disregard of the rules or regulations.

See Checklist C108 for guidance in avoiding a penalty. Reg. 1.6664-4 retains the good faith, reasonable cause exception, meaning that a practitioner can get an abatement of a preparer penalty if he or she has office procedures in place that promote accuracy and consistency in return preparation. The office procedures will generally include checklists (such as the long and short Form 1065 preparation checklists found at Checklists C102 and C103), methods for obtaining necessary information from the taxpayer (see the Form 1065 organizers at Practice Aids O107 and O108), a review of the prior year's return, and other review procedures.

Who Is a *Preparer*?

According to Reg. 301.7701-15(a), a tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of a return or claim for refund. However, the regulations differentiate *signing preparers* from *nonsigning preparers*. A *signing preparer* has primary responsibility for the overall substantive accuracy of the tax return or claim for refund. A *nonsigning preparer* is not a signing tax return preparer, but prepares all or a substantial portion of the return or claim for refund "with respect to events that have occurred at the time the advice is rendered" (e.g., an accountant who provides advice to a corporate taxpayer on a completed corporate transaction).

Practice Tip: Two factors, among others, that are used to determine whether a position is substantial are the (1) size and complexity of the item relative to the taxpayer's gross income, and (2) size of the understatement attributable to the item compared to the taxpayer's reported tax liability.

Regs. 301.7701-15(b)(2) and (3) provide the following exceptions for nonsigning preparers:

1. Time spent providing advice about a position after the event has occurred that is less than 5% of the total time spent on advising the client about the position is ignored. However, time spent on pre-transaction advice will be taken into account in determining whether the time spent on post-transaction advice exceeds 5% [Reg. 301.7701-15(b)(2)(i)].

2. A position is not considered a substantial portion of a return if it is (a) less than $10,000, or (b) less than $400,000 and also less than 20% of the gross income shown on the return or refund claim. For an

individual, the income measure is adjusted gross income (AGI). However, where a nonsigning preparer handles more than one position, all positions are aggregated to see whether the income threshold is met.

There is only one individual within a firm who is primarily responsible for each position on the return giving rise to an understatement [Reg. 1.6694-1(b)]. In identifying the individual who is primarily responsible for the position, the IRS may advise multiple practitioners within the firm that it may conclude one of them is the primarily responsible individual. In some circumstances, there may be more than one tax return preparer who is primarily responsible for the position(s) if multiple tax return preparers are employed by, or associated with, different firms.

The signing tax return preparer [within the meaning of Reg. 301.7701-15(b)(1)] generally will be considered the person who is primarily responsible for all positions on the return giving rise to an understatement. If there is no signing tax return preparer or the IRS concludes that the signing tax return preparer is not primarily responsible for the position, the nonsigning tax return preparer [within the meaning of Reg. 301.7701-15(b)(2)] within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement generally will be considered the tax return preparer for Section 6694 purposes.

To the extent provided in Regs. 1.6694-2(a)(2) and 1.6694-3(a)(2), an individual and his or her firm, or the firm of which the individual is a partner, member, shareholder, or other equity holder, can both be subject to a penalty for position(s) on the return giving rise to an understatement. If an individual (other than the sole proprietor) who is employed by a sole proprietorship is subject to a penalty under IRC Sec. 6694, the sole proprietorship is considered to be the firm for these purposes.

A *tax return preparer* for purposes of IRC Sec. 6694 is a person who is a tax return preparer under IRC Sec. 7701(a)(36) and Reg. 301.7701-15 [Reg. 1.6694-1(b)(1)]. According to Reg. 301.7701-15(f)(1)(ix), the phrase *tax return preparer* does not include an individual who prepares the return of a business, or an officer, general partner, member, shareholder, or employee of a business, if the individual is regularly and continuously employed or compensated by the business, or the individual is a general partner in the business (i.e., a business that is operated as a partnership).

The IRS concluded that the former version of IRC Sec. 6694 applied to a general partner whose preparation of the partnership return resulted in a tax understatement on a limited partner's tax return (Rev. Rul. 81-270). This was because (1) Reg. 301.7701-15 did not preclude a general partner from being the preparer of a limited partner's return—only a general partner's return, (2) the entries on the Schedule K-1 constituted a substantial portion of the limited partner's return, and (3) the general partner was compensated for preparing the Form 1065 and Schedule K-1. However, the current version of Reg. 301.7701-15 includes the word "member" in the category of persons' returns that can be prepared without being considered to be a tax return preparer. The version of the regulation in effect in Rev. Rul. 81-270 only referred to officers, general partners, or employees.

The preparer definitions are important because the regulations use a position-by-position penalty analysis, which replaces the one-return-one-preparer rule. When more than one position results in an understatement, more than one penalty can be assessed, making it possible for multiple penalties to be assessed for a single return, particularly when nonsigning preparers are responsible for positions on the tax return.

Any return preparer, except a signing preparer, who prepares all or a substantial portion of a tax return for compensation, with respect to completed events, is a nonsigning preparer and can be subject to the penalty. This means advice on prospective transactions does not make a practitioner a nonsigning preparer. To be subject to a preparer penalty, the advice or other consultation must occur after the event or events have already occurred. Additionally, the nonsigning preparer must be responsible, at a minimum, for one or more positions that constitute a substantial portion of the return. Whether a position is a substantial portion of a return is determined by the facts and circumstances. Thus, a single, large capital gain for which a nonsigning preparer is responsible can constitute a substantial portion of a return and subject that nonsigning preparer to a penalty if there is an understatement attributable to the capital gain.

Form 1065 Preparer as Preparer of Partners' Returns

Rev. Proc. 2009-11 cites Reg. 301.7701-15(b)(3), which says the preparer of one return is not considered to be the preparer of another return merely because an entry or entries reported on the first return may affect an entry reported on the other return, unless the entry or entries reported on the first return are directly reflected on the other return and constitute a substantial portion of the other return. The regulations specifically state that the preparer of a partnership

3. Whether the client understands the issue, acts out of emotion rather than reason, or possesses incorrect or incomplete information.
4. Whether the client's position can be slightly changed, thereby meeting one of the penalty standards without substantially affecting the amount of tax owed.
5. Whether the risk of the penalty is worth the client's continued business.

Observation: No client is worth the loss of a professional license or suspension of practice before the IRS.

KEY ISSUE 6G Failure to Timely File Penalty.

A penalty is imposed on the partnership, rather than the partners, for failure to file a timely or complete Form 1065 (IRC Sec. 6698). The penalty is assessed for each month (or fraction of a month) of the failure, not to exceed 12 months. The penalty is $435 per partner per month for 2019 returns filed in 2020. (See Table T613 for taxpayer and return preparer penalties.)

Note: The failure-to-file penalty can also be charged if a timely filed tax return does not provide all of the required information.

Note: IRS Program Manager Technical Advice (PMTA) 2013-015 supplies questions and answers regarding penalties for failure to timely file S corporation and partnership federal income tax returns. Search for “PMTA” on **www.irs.gov** and click on the link for legal advice issued to program managers.

Example 6G-1: Penalty for failure to timely file partnership return.

The Quick Bucks Limited Partnership was formed several years ago with two general partners and 38 limited partners and has a calendar year end. On March 15, 2020, the managing general partner failed to file an extension request for the 2019 return. Since the 2019 return was not timely filed, the partnership (not the partners) is liable for a failure to file penalty of $17,400 (40 partners × $435) per month. The penalty does not apply if there was reasonable cause for the failure to file.

As with the other penalties, showing reasonable cause for the failure to timely file or complete the partnership Form 1065 will avoid the penalty. In one case, the district court held that reliance on an outside accountant did not constitute reasonable cause for the failure to file and pay withholding amounts in a timely manner: “It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing” under IRC Sec. 6651(a)(1) (*Huffman, Carter & Hunt*).

Reg. 301.7502-1 provides that a return postmarked by the due date is timely filed even if received after the due date. However, the return must be properly addressed and mailed with sufficient postage, if U.S. mail is used. If a private carrier is used, the postmark must be legible, made on or before the due date of the return, properly addressed, and received on or before the date the return would ordinarily be received if delivered by the U.S. Postal Service. Under Reg. 301.7502-1(d), electronically transmitted documents are deemed to be filed on the date of the electronic postmark given by the electronic return submitter.

Tax returns or other documents will be treated as timely filed if delivered to (or picked up by) a designated private delivery service on or before the due date of the return or document. In Notice 2016-30, the IRS provided the latest list of private delivery services. The notice also specifies which delivery services of these carriers qualify. Only the delivery services listed in the notice qualify for the *timely mailed is timely filed* exception. Generally, the notice provides that the date the item is electronically recorded in the service's data base or marked on the cover of the item is the *postmark date*. However, there is a presumption that the *postmark* date is the day that precedes the delivery date by an amount of time it would normally take for an item to be delivered under the terms of the delivery service used. This presumption may be overcome by showing that the delivery date is on or before the due date.

KEY ISSUE 6H Extending Due Date for Filing Partnership Returns.

Partnerships use Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns) to request an automatic six month extension to file Form 1065. This means that the extended due date for a partnership return with a calendar year end is September 15th.

Note: Notice 2020-23 extends the filing deadline for fiscal or calendar year partnership returns due between April 1 2020, and July 15, 2020. The due date is automatically postponed to July 15, 2020. Taxpayers need take no action to obtain the benefit of this relief.

It can be expensive for a partnership to miss filing an extension. IRC Sec. 6698 imposes a $205 per month per partner penalty for not filing a timely a 2019 tax return. In addition, missing the filing deadline can preclude a partnership from extending the contribution date for retirement plan contributions as well as limit the partnership's ability to make various elections that are required to be made on a timely filed return, including any extensions. While a partnership can get the failure to file penalties abated for reasonable cause, it is often much more difficult to get relief for missed elections. (See Chapter 5.)

The regulations also provide the IRS the authority to terminate the automatic extension of a partnership (as well as that of a trust, REMIC, or individual) at any time by mailing a notice of termination at least 10 days prior to the termination date designated in the notice [Reg. 1.6081-2(f)]. The termination notice must be mailed to the address shown on the automatic extension form or to the taxpayer's last known address.

KEY ISSUE 6I Other Return Preparation Considerations.

The Section 6694 tax return preparer penalty regulations discussed in Key Issue 6E stress documentation, communication with clients, and most of all, due diligence. Preparers will be expected to exercise appropriate due diligence in all tax return preparation tasks. Even if the answer is wrong, a preparer who has the proper preparation and review procedures in place, asks appropriate questions, does the necessary research, documents what has been done, and acts in good faith should not be assessed a preparer penalty. See the due diligence review at Checklist C101 for assistance in meeting the tax return preparer responsibilities.

Tax Return Preparation Engagement Letter

With increased preparer penalties and a more aggressive IRS, a well drafted engagement letter is an important aspect of tax practice because it defines the relationship with the client and reduces the chances of a misunderstanding. Properly drafted, an engagement letter is a great practice management tool, one that practitioners should use frequently, and certainly for engagements of any size, importance, or complexity.

See Practice Aid O101 for a sample tax return engagement letter for a business entity. An engagement letter is a legal contract, so an attorney should be consulted to ensure that the terms provide the anticipated result. A legal review is also important since state law can impact how the agreement may be interpreted should a dispute arise. If the client wants to change the terms, the practitioner, with assistance from legal counsel, must decide if the proposed changes are reasonable, and if not, how to respond. If the client refuses to sign or even look at the letter, the practitioner should consider whether to continue the relationship.

AICPA Statement of Standards on Tax Services (SSTSs)

Tax return preparers are expected to exercise a level of ethics and professionalism with all tax returns prepared. The AICPA has established standards to assist practitioners with meeting these expectations. The Statement on Standards for Tax Services (SSTSs) is as follows:

1. *Tax Return Positions.* Sets forth the applicable standards for members when recommending tax return positions, or preparing or signing tax returns filed with any taxing authority. This statement also addresses a member's obligation to advise a taxpayer of relevant tax return disclosure responsibilities and potential penalties.

2. *Answers to Questions on Returns.* Sets forth the applicable standards for members when signing the preparer's declaration on a tax return if one or more questions on the return have not been answered.

3. *Certain Procedural Aspects of Preparing Returns.* Sets forth the applicable standards for members concerning the obligation to examine or verify certain supporting data or to consider information related to another taxpayer when preparing a tax return.

KEY ISSUE 7B Reporting Payment Card and Third-party Network Transactions.

A merchant acquiring entity (i.e., a bank) or a third party settlement organization that has a contractual obligation to make payments to a participating merchant in settlement of payment card transactions is required to file an information statement with the IRS and provide a copy to the merchant. The information statements must be furnished to the merchant by January 31 of the year following the year for which the information is being furnished. The information statement may be provided on Form 1099-K or it may be provided electronically (IRC Sec. 6050W; Reg. 1.6050W-1).

Preparation Pointer: The partnership should receive a Form 1099-K showing the amount of such payments. However, a Form 1099-K may not be received for all such payments, as the payer must file a Form 1099-K only when payments exceed $20,000 and the total number of transactions exceeds 200. Regardless of whether a Form 1099-K is received, all such receipts should be reported on page 1 of Form 1065 on line 1a.

Line 1b of Form 1099-K is used to report sales in which the card was not present at the time of the transaction or the card number was keyed into the terminal. Typically, this relates to online sales, catalog sales, and phone sales.

Preparation Pointer: Businesses are not required to separately report total gross receipts from Forms 1099-K. However, the IRS has indicated that it will use the information to determine if gross receipts reported on the business tax return are accurate for the given tax year. If the amount in box 1 of Form 1099-K is greater than the amount the taxpayer reports in gross receipts on line 1a, Form 1065 (e.g., because it includes tips, sales tax, shipping, or other charges or fees), a statement should be attached to the Form 1065 explaining the difference.

Note: The IRS has released a list of frequently asked questions regarding Form 1099-K and the reporting requirements. This list is periodically updated and can be found at **www.irs.gov** by searching for "payment card transactions."

KEY ISSUE 7C Reporting Farm Income.

If the partnership engages in farming activities, Form 1040 Schedule F (Profit or Loss from Farming) should be attached to Form 1065, and the partnership's net profit (loss) from Schedule F should be reported on line 5 [Net farm profit (loss)] of page 1. Any partnership fishing income is also reported on line 5. However, farm profit or loss from other partnerships should be reported on line 4 [Ordinary income (loss) from other partnerships . . .]. Furthermore, in computing the partnership's net farm profit or loss, the practitioner should not include a Section 179 expense deduction because that deduction should be separately stated.

Since the election to deduct the expenses of raising plants with a preproductive period of more than two years is made by the partner and not the partnership, farm partnerships that are not required to use the accrual method should not capitalize such expenses. Instead, the partnership should report these expenses separately on an attachment to Schedule K, Line 13d, and in box 13 of Schedule K-1, code P.

Identifying Who Is Considered a Farmer or Rancher

According to IRS Pub. 225, *"Farmer's Tax Guide,"* an individual is considered to be a farmer if he or she cultivates, operates, or manages a farm for gain or profit, either as an owner or a tenant. A farm includes grain, cotton, tobacco, livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

Generally, the definition of a farmer, for tax purposes, is based on the raising or growing of an agricultural or horticultural commodity. Thus, to qualify for the beneficial farm tax rules, it is not sufficient to merely sell or process an agricultural product, but rather it is generally necessary to participate in the raising or growing process. However, the Code does not use a single, consistent definition of farming. While traditional grain and livestock operators are normally considered farmers, certain provisions and definitions in the Code may classify industries such as fish raising, horticultural or greenhouse businesses, and sod cultivating as farms.

Proper Determination of Farm Income or Loss

Farmers and ranchers enjoy a number of unique provisions in the Internal Revenue Code. These provisions recognize that agriculture has several attributes not found in other industries:

1. Agricultural producers, as sellers of commodities, face constantly fluctuating sale prices. The market price can increase or decrease significantly from one year to the next.
2. The production quantity can vary substantially from one year to the next, particularly for grain crops. Crop growing incurs the risks of weather and disease, leading to significant fluctuations in output. Livestock producers face similar production risks due to drought and disease.
3. Farmers and ranchers have enjoyed significant political support, often leading to favorable tax legislation, to compensate them for some of the price and production volatility they face.

Some of the more important provisions that might affect the correct determination of farm income or loss are as follows:

1. Choosing the proper accounting method (i.e., cash vs. accrual). There are special rules that apply only to farming income and expenses under either of these accounting methods [IRC Sec. 448(b)(1)]. Note that the Tax Cuts and Jobs Act (TCJA) made changes that will greatly expand the ability for taxpayers to use the cash method of accounting. (See Key Issue 4A.)
2. Correct reporting of income from government provided loans, disaster relief, and crop insurance payments [Reg. 1.451-6; IRC Sec. 451(f)].
3. Correct reporting of income from farmer's cooperative distributions of cash or patronage dividends [IRC Sec. 1388].
4. Special rules for deferring income from sale of livestock as the result of drought and other disasters. (See Key Issue 11G and Election E916.)
5. Correct calculation of tax using the income-averaging rules available for certain farm income [IRC Sec. 1301(a)].
6. The allowance of a special NOL carryback rule for farming losses and other special rules for the handling of NOLs arising from farm disaster losses [IRC Sec. 172(b)(1)(B)].
7. Special rules pertaining to payment of estimated tax by farmers [IRC Sec. 6654(i)].
8. Special rules for charitable gifts of farm commodities and inventory [Reg. 1.170A-4].
9. Rules that apply only to syndicated farming operations [IRC Sec. 448(a)(3)].
10. There are special rules for farm trades or businesses to elect out of the business interest expense limitation established by the TCJA and found under IRC Sec. 163(j). Farmers that make this election are required to use the alternative depreciation system (ADS) method for assets that have a 10-year life or greater [IRC Sec. 168(g)(1)(G)]. (See Chapter 14.)
11. The TCJA removed the rule that required property that is used in farm businesses to be depreciated using the 150% declining balance method [IRC Sec. 168(b)(2)]. In addition, IRC Sec. 168(e)(3)(B)(vii) now applies a five-year MACRS recovery period to items of machinery and equipment used in a farming business.
12. For tax years beginning after 2020 and before 2026, the excess business loss disallowance rule found under IRC Sec. 461(l) replaces the narrower application that disallowed excess farm loss under IRC Sec. 461(j). (See Key Issue 21G.)
13. For tax years beginning after 2017 and before 2026, special rules exist for the calculation of the qualified business income deduction under IRC Sec. 199A for income from cooperatives. See Chapter 18.
14. Sales of property used or produced in the business of farming can be reported on the installment method [IRC Sec. 453(l)(2)].

(1)	Business gross income less deductible expenses (not including items listed below)	$ 57,000
(2)	Loss from rental real estate (a separate activity)	(30,000)
(3)	Loss from other rentals (a separate activity)	(4,000)
(4)	Interest income from investment of working capital	1,000
(5)	Capital gain from sale of land held for investment	23,000
(6)	Section 1231 gain from sale of land used as a parking lot	13,000
(7)	Interest expense—loan to purchase inventory	(5,500)
(8)	Liability coverage on land held for investment	(3,100)
(9)	Interest paid on loan to carry common stock	(2,200)
(10)	Interest paid on loan from Jean used for working capital	(3,300)
(11)	Payment to former partner, deductible as a guaranteed payment	(5,000)

The business net income is nonpassive (and is reported as ordinary income on Form 1065) because both partners materially participate in the partnership operations [IRC Sec. 469(h)(1); Temp. Reg. 1.469-5T]. Nonseparately stated ordinary income is $43,200, consisting of the following items:

(1)	Business income less expenses	$ 57,000
(7)	Business interest expense (loan to purchase inventory)	(5,500)
(10)	Business interest expense (loan used for working capital)	(3,300)
(11)	Retirement payment	(5,000)
		$ 43,200

Note: IRC Sec. 163(j) generally limits business interest expense subject to several exceptions, including one for taxpayers that meet the average annual gross receipts test under IRC Sec. 448(c). See Chapter 14 for a detailed discussion on IRC Sec. 163(j).

Portfolio income for the year totals $24,000, and is comprised of the following items:

- The $1,000 of interest income from the investment of working capital [IRC Sec. 469(e)(1)(B)]. Portfolio income passes through as a separately stated item.
- The $23,000 capital gain from the sale of land held for investment [IRC Sec. 469(e)(1)(A)]. Gain or loss from the sale or other disposition of partnership assets retains the character of the income or loss that was produced by the asset. If the asset is used in business operations and the partners materially participate, gain or loss on the disposition is nonpassive. If the partners do not materially participate, gain or loss on the disposition is passive. If the asset was held for investment, gain or loss on disposition is portfolio income or loss [Temp. Reg. 1.469-2T(c)(3)(i)(C)].

Preparation Pointer: Both the interest income and capital gain from the sale of land held for investment are potentially subject to the NIIT at the partner level. Since these items are separately stated on the partners' Schedules K-1 they should easily be identified as net investment income and included in the partners' NIIT calculation.

Reporting Portfolio Income and Expenses

Partnerships report trade or business income in the "Income" section of the first page of Form 1065. Portfolio income is not trade or business income, and thus is not part of the ordinary (nonseparately stated) income or loss passed through to the partners. Instead, portfolio income passes through to the partners as separately stated income on Schedule K lines 5 (Interest income), 6 (Dividends and dividend equivalents), 7 (Royalties), and 11 [Other income (loss)]. Each partner's share is reported on Schedule K-1 on lines 5, 6, 7, and 11, code A [Other portfolio income (loss)].

Conversely, interest derived in the ordinary course of business, such as interest charged on accounts receivable, is not portfolio income and passes through as a component of nonseparately stated income or loss on line 1 of Schedules K and K-1.

Portfolio expenses are deductible expenses (other than interest) that are clearly and directly allocable to portfolio income [IRC Sec. 469(e)(1)(A)]. Portfolio income is not reduced by deductions allocable to the income. Rather, the partnership reports them on lines 13b (Investment interest expense) or 13d (Other deductions) on Schedule K. The expenses are reported to the partner on Schedule K-1, line 13, code H (Investment interest expense), code I (Deductions-royalty income), and code L [Deductions-portfolio (other)].

Practice Tip: Portfolio income and expenses normally result from investments. Investment income and expenses are shown as portfolio income on Schedules K and K-1 (as discussed in the preceding paragraphs) and are also reported on lines 20a and 20b on Schedule K, and line 20, codes A and B, on Schedule K-1. To calculate the proper amount of investment interest expense that can be deducted by the partner, the investment income and expenses are carried from Schedule K-1 to the partner's Form 4952 *(Investment Interest Expense Deduction).*

For information on reporting foreign-source income, see Key Issue 21H.

KEY ISSUE 9C Reporting Dividend Income.

Common and preferred dividends received by an individual shareholder from domestic corporations and qualified foreign corporations are taxed at the same rates as adjusted net capital gain. For 2019, the maximum tax rate on qualified dividends received by an individual, trust, or estate is 23.8% (20% plus 3.8% net investment income tax). (See Key Issue 9B for a discussion of the NIIT.) Partnerships pass qualified dividend income through to noncorporate partners who are taxed at the favorable capital gains rates [IRC Sec. 702(a)(5)]. Report taxable ordinary dividends, including any qualified dividends (which are also reported on line 6b), on line 6a of Schedules K and K-1.

Dividends are not eligible for the capital gains rates unless the partnership holds the underlying shares for a certain period of time revolving around the stock's ex-dividend date. A stock's ex-dividend date is the day it begins trading without rights to an announced, but as yet unpaid, dividend. To qualify for the reduced rate, the partnership must hold the stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date. For preferred stock dividends attributable to a period or periods aggregating more than 366 days (e.g., cumulative preferred stock with dividends in arrears), the holding period is more than 90 days during the 181-day period beginning 90 days before the stock's ex-dividend date [IRC Sec. 1(h)(11)]. The holding period includes the date of disposition, but not the acquisition date [IRC Sec. 246(c)(3)].

To receive a qualified dividend, the taxpayer must own the stock at least one day before the ex-dividend date. Because the required holding period is more than 60 days during a period beginning 60 days before the ex-dividend date, this means that the holding period must include the ex-dividend date. However, the 61-day (or 91-day) holding period does not have to be consecutive. Also, certain transactions that limit the taxpayer's risk of loss (e.g., short sales and options to sell substantially identical stock or securities) suspend the taxpayer's holding period until the transaction is closed [IRC Sec. 246(c)(4)].

Preparation Pointer: The fact that an amount is reported as a qualified dividend on Form 1099-DIV (Dividends and Distributions) generally means that it satisfies the payer-level requirements. Additional shareholder-level requirements (i.e., required holding period and no transactions limiting the risk of loss) must also be met before an amount is a qualified dividend.

Qualified dividends can include dividends received from qualified foreign corporations—for further discussion, see *PPC's 1040 Deskbook*.

Qualified dividends are not included in the calculation of net capital gain at the individual partner level. This means that qualified dividends do not offset capital losses in excess of capital gains, except to the extent that up to $3,000 ($1,500 for married filing separate returns) of capital loss can be deducted against other income (including dividends) for the tax year.

Partners can elect to treat qualified dividend income as investment income [IRC Sec. 163(d)(4)(B)]. If the election is made, the dividends considered to be investment income are not taxed at the capital gains rates. (A similar rule applies to long-term capital gains.) This gives partners the choice of applying the favorable 0%,15%, and 20% tax rates to dividend income, or using qualified dividend income to offset investment interest expense. See Key Issue 4A of *PPC's 1040 Deskbook* for further discussion on the treatment of dividend income.

Schedule K-1, line 6c, is used to report dividend equivalents. IRC Sec. 871(m) defines a dividend equivalent as—

Treatment of Partnership Liabilities in Deferred Like-kind Exchanges

Because increases and decreases in partnership debt are treated as contributions and distributions of money, an unusual tax problem may arise when a partnership transfers property subject to a liability in one tax year, but does not receive the like-kind property until the next year.

Under Rev. Rul. 2003-56, if a partnership enters into a deferred like-kind exchange in which property subject to a liability is transferred in one tax year and property subject to a liability is received in the following tax year, the liabilities are netted for purposes of determining gain on any deemed contribution or distribution of cash. Any net decrease is treated as a distribution of cash to the partners in the year of the first transfer, while any net increase is treated as a contribution of cash to the partnership in the second tax year.

Like-kind Exchanges Affected by Disasters

The IRS can extend the deadlines for both the identification period and the exchange period in situations involving federally declared disasters, terrorist attacks, military actions, and individuals serving in combat zones or contingency operations (IRC Secs. 7508 and 7508A and Rev. Proc. 2018-58).

Note: Notice 2020-23 provides additional time to perform certain time-sensitive actions listed in Rev. Proc. 2018-58 that are due on or after April 1 2020, and before July 15, 2020. Thus, if either the 45-day identification or 180-day exchange period falls within this time frame, the deadline is automatically extended to July 15, 2020.

Using Installment Reporting for Deferred Like-kind Exchanges

Because deferred like-kind exchanges include a 180-day replacement period, it is not unusual for these exchanges to span two tax years. If the qualified intermediary (QI) (see the following discussion regarding using QIs) does not locate replacement property or does so for less than the amount held for that purpose, the taxpayer will receive cash at the termination of the 180-day replacement period. If this payment falls in the year subsequent to the year the taxpayer relinquished his property, gain allocable to the cash payment can be reported in the year received using the installment method rules [Reg. 1.1031(k)-1(j)(2)]. Likewise, if the QI gives the taxpayer an installment note of the person to whom the QI transferred the property, such receipt is deemed to be directly from the other party. However, it appears that the recognition of depreciation recapture cannot be deferred.

Preparation Pointer: Taxpayers must strictly follow the 45-day identification and 180-day exchange requirements previously discussed and outlined in Reg. 1.1031(k)-1(b) to qualify for installment reporting for transactions consummated in the subsequent tax year.

In a 2008 private letter ruling, the IRS allowed an LLC to revoke an election out of the installment method when the election resulted from a failed like-kind exchange (Ltr. Rul. 200813019). The LLC received the cash proceeds from the sale of a rental property from a QI in the year after the year the LLC entered into an exchange agreement and the QI sold the property. The LLC's accountant failed to recognize that the sale qualified for installment reporting and reported the entire gain on sale in the year of the sale.

Using a Qualified Intermediary

Using a QI is a safe harbor approach to accomplishing a nontaxable exchange. A QI is a person who is not the taxpayer or a disqualified person and who expressly agrees under the terms of an exchange agreement to acquire the taxpayer's relinquished property, transfer the relinquished property to another taxpayer, acquire the replacement property, and transfer the replacement property to the taxpayer [Reg. 1.1031(k)-1(g)(4)]. The IRS has privately ruled that an exchange facilitator operating electronically through an internet site in a so-called virtual capacity was an approved QI (Ltr. Rul. 200236026).

A *disqualified person* is generally either related to the taxpayer or someone that has acted as the taxpayer's agent, such as an attorney, accountant, broker, or real estate agent, any time during the previous two-year period. However, routine financial services provided to the taxpayer during this period by a financial institution (i.e., a bank), title insurance company, or escrow company are not taken into account [Reg. 1.1031(k)-1(k)(4)]. Thus, the taxpayer's bank can be a QI. See Ltr. Rul. 200338001 for a particular structure that professionals may use to serve as intermediaries for their clients.

Practice Tip: Although a taxpayer to a multi-party exchange may have momentary ownership of a property, the IRS has ruled that the deeding of property can bypass this party without invalidating the tax-free exchange treatment

(Rev. Rul. 90-34). Direct deeding of properties should reduce the costs of transferring the properties and reduce any legal liability that momentary ownership may create.

Relief Available When a QI Goes Bankrupt. Rev. Proc. 2010-14 provides relief for taxpayers who initiated like-kind exchanges by transferring relinquished property to a QI but were unable to complete the exchanges within the statutory time period solely due to the failure of the QI to acquire and transfer replacement property to the taxpayer. Qualifying taxpayers recognize gain on the disposition of the relinquished property under the safe harbor gross profit ratio method, and gain is only recognized as the taxpayer receives payments attributable to that property.

Reporting Deferred Like-kind Exchanges

Deferred exchanges are reported in Form 8824 (Like-Kind Exchanges). Information pertaining to the dates the properties are identified, transferred, and received are reported in Part I of Form 8824. The gains realized and recognized, as well as the basis of the replacement property, are computed in Part III of Form 8824.

A special rule applies when a partnership disposes of a Section 197 intangible but retains other Section 197 intangibles acquired in the same transaction. No loss can be claimed; instead, the unrecognized loss is added to the bases of the remaining Section 197 intangibles acquired in the same transaction and taken into account in future amortization deductions [IRC Sec. 197(f)(1); Reg. 1.197-2(g)(1)]. The basis of the remaining Section 197 intangibles would then be available to reduce any gain recognized on a subsequent disposition of the intangibles. The same type of rule applies if a Section 197 intangible becomes worthless or is abandoned.

Example 11D-2: Disposing of Section 197 intangibles at a loss.

Assume the same facts as in Example 11D-1, except Arendahl also sells the patent on September 1, 2019, for $18,000, realizing a loss on the sale of $2,000 [$30,000 cost – $18,000 sales price – $10,000 accumulated amortization ($30,000 ÷ 15 years × 5.0 years)]. The loss is not recognized; instead, $2,000 is added to the amortizable basis of the franchise rights acquired in the same transaction in 2014.

The special rule does not state that a loss can never be claimed on the disposition or worthlessness of a Section 197 intangible. If the intangible was acquired separately, a loss may be recognized on its disposition or worthlessness, although no loss can be recognized due to a partial worthlessness [Reg. 1.197-2(g)(1)(ii)].

KEY ISSUE 11E Nonrecaptured Section 1231 Loss Carryovers.

Property used in a trade or business (real property or property subject to the allowance for depreciation) or for the production of rental income and held more than one year is Section 1231 property. Net gains from Section 1231 property are treated as long-term capital gains while net losses are treated as ordinary losses.

However, net Section 1231 gain for the year is recaptured (that is, treated as ordinary gain rather than Section 1231 gain) if the taxpayer has nonrecaptured Section 1231 losses from prior years. This rule prevents taxpayers from manipulating the timing of sales to achieve long-term capital gain treatment for net Section 1231 gains in some years and ordinary loss treatment for net Section 1231 losses in other years. Nonrecaptured Section 1231 losses equal the excess of net Section 1231 losses deducted in the five tax years prior to the current year, over the amount of such losses recaptured (applied against net Section 1231 gains) during the same period [IRC Sec. 1231(c)].

Reporting Nonrecaptured Section 1231 Losses

Partnerships do not track or compute nonrecaptured Section 1231 losses. Instead, net Section 1231 gain or loss is passed through to the partners as a separately stated item on line 10 of Schedule K-1. The partners then combine the net Section 1231 gains passed through from the partnership with their own Section 1231 gains and losses. Any nonrecaptured Section 1231 losses are recaptured on the partner's personal tax return.

KEY ISSUE 11F Investing in a Qualified Opportunity (QO) Fund

Qualified opportunity zones (QO zones) offer unique planning opportunities for investors who have gains to defer. The two major tax benefits of investing in QO zones are the ability for eligible taxpayers to elect to—

1. temporarily defer certain eligible gains from the sale of property if such gain is reinvested in a qualified opportunity fund (QO fund), or
2. permanently exclude from income post-acquisition capital gains on the disposition of QO fund investments held for 10 years.

Taxpayer's can rely upon proposed regulations (REG-115420-18 and REG-120186-18) Prop. Regs. 1.1400Z2(a)-1 through 1.1400Z2(g)-1, except for Prop. Reg. 1.1400Z2(c)-1, if applied in a consistent manner for all tax years. As an alternative, final regulations found in TD 9889, can be applied to tax years beginning after December 21, 2017, and on or before 60 days after January 13, 2020, (when the final regulations will be applicable) to provide guidance under IRC Sec. 1400Z-2 with regard to investing in QO funds.

Definition of Qualified Opportunity Zone

A *QO zone* is a population census tract that is a low-income community. The IRS must certify and designate the community as a QO zone [IRC Sec. 1400Z-1(a)]. The term *low-income community* is borrowed from the Section 45D new markets tax credit [IRC Sec. 1400Z-1(c)(1)]. It includes any population census tract with a poverty rate of at least

20%. It also includes a tract whose median family income does not exceed 80% of statewide median family income. For tracts located within a metropolitan area, the standard is 80% of the greater of (a) statewide median family income or (b) the metropolitan area median family income.

In general, a state may not designate more than 25% of its low-income communities as QO zones [IRC Sec. 1400Z-1(d)(1)]. If a state has less than 100 total low-income communities, it can designate 25 tracts as QO zones. Also, a tract that is not a low-income community may be designated as a QO zone if (a) it is contiguous with a low-income community that is designated as a QO zone and (b) its median family income is not more than 125% of the median family income of the contiguous tract [IRC Sec. 1400Z-1(e)(1)]. However, no more than 5% of a state's QO zones can be designated under this exception [IRC Sec. 1400Z-1(e)(2)]. Once a tract has been designated as a QO zone, it will retain that status for a period of ten years [IRC Sec. 1400Z-1(f)].

Eligible Taxpayers

Eligible taxpayers include individuals, C corporations including regulated investment companies (RICs) and real estate investment trusts (REITs), partnerships, S corporations, trusts, and estates.

If partnerships elect to defer eligible gains, the deferred gain is not recognized at the partnership level and, thus, not included in the partners' distributive shares of income nor does it impact the partners' basis.

If the partnership does not elect to defer eligible gain, the gain is included in the partners' distributive shares of income and impacts the partners' basis in their partnership interests. The partners may then elect to defer some or all of the gain under IRC Sec. 1400Z-2(a)(1)(A).

Note: Notice 2020-23 provides additional time to perform certain time-sensitive actions for taxpayers that have been affected by the COVID-19 pandemic. This includes an investment at the election of the taxpayer due to be made during the 180-day period described in IRC Sec. 1400Z-2(a)(1)(A), which is due to be performed on or after April 1, 2020, and before July 15, 2020. The due date has been automatically postponed to July 15, 2020.

Observation: The flexibility for each partner to elect the deferral is not available with a Section 1031 exchange.

Eligible Gain

An *eligible gain* is any gain treated as a capital gain for federal income tax purposes or is a qualified Section 1231 gain. Thus, eligible gains include long- and short-term capital gain, IRC Sec. 1231 gain (not taking into account any losses) and unrecaptured IRC Sec. 1250 gain. Gains treated as ordinary income, such as depreciation recapture, are not eligible gains. In addition, the gain must not arise from a sale or exchange with a related person [as defined in IRC Sec. 1400Z-2(e)(2)].

Definition of a QO Fund

A QO fund is any investment vehicle that (1) is organized as a corporation or partnership for investing in QO zone property and (2) holds at least 90% of its assets in QO zone property [IRC Sec. 1400Z-2(d)]. The 90% test looks to the average percentage of QO zone property held by the fund on the last day of the first half of the tax year and the last day of the tax year. Note that a QO fund cannot be organized for the purpose of investing in other QO funds.

Caution: A QO fund that fails the 90% test is subject to a penalty for each month of noncompliance [IRC Sec. 1400Z-2(f)]. The penalty amount is calculated under the following formula: (90% of aggregate assets − aggregate amount of QO zone property) × Section 6621(a)(2) underpayment rate for the month. No penalty is imposed if the failure is due to reasonable cause [IRC Sec. 1400Z-2(f)(3)].

Note: The IRS has issued a series of frequently asked questions (FAQs) on opportunity zones. Go to **irs.gov** and type "opportunity zone" in the search box. In these FAQs, the IRS has indicated that taxpayers can self-certify to become a QO fund. No approval or action by the IRS will be required. A partnership self-certifies to become a QO fund by completing Form 8996 *(Qualified Opportunity Fund)* and attaching it to a timely filed (including extensions) Form 1065. In addition, the partnership should answer "yes" to the question on Form 1065, schedule B, line 26, and provide the amount from line 14 of Form 8996. This represents the penalty, if any, for failure to meet the 90% test.

Definition of QO Zone Property

QO zone property includes the following [IRC Sec. 1400Z-2(d)(2)]:

1. QO zone stock is any stock that meets all of the following requirements and [IRC Sec. 1400Z-2(d)(2)(B)(i)]:
   a. The stock is acquired by the QO fund after 2017, at its original issue from a domestic corporation solely for cash.

5. Partnership floor plan financing interest expense that is allocable to the partner is not taken into account in the partner's ATI calculation.

Example 14G-1: 30% business interest limitation at the partnership and partner levels.

ABC Partnership is owned 50-50 by XYZ Corporation and an individual. ABC generates $200 of noninterest income, and the only expense is $60 of business interest expense.

ABC's deduction for business interest expense in 2019 is limited to 30% of ATI, or $60 ($200 × 30% = $60). The partnership then deducts the $60 of interest and reports ordinary income of $140. XYZ's distributive share of partnership taxable income is $70.

XYZ has no income from operations but has $25 of its own business interest expense.

The double counting rule provides that XYZ's ATI does not take into account the $70 distributive share of nonseparately stated items from ABC. As a result, XYZ's ATI is zero, and none of the $25 of its own business interest expense can be deducted in the current year due to the Section 163(j) limit.

Definition of Trade or Business

When calculating ATI, items other than interest expense and interest income are allocated to a particular trade or business according to Prop. Reg. 1.163(j)-10(b). The term *trade or business* means a trade or business within the meaning of IRC Sec. 162 [Prop. Reg. 1.163(j)-1(b)(38)]. For purposes of the Section 163(j) limitation, the term *trade or business* does not include the following excepted trades or businesses [IRC Sec. 163(j)(7); Prop. Reg. 1.163(j)-1(b)(38)]:

1. The trade or business of performing services as an employee.
2. Any electing real property trade or business. An electing real property trade or business is a trade or business described in IRC Sec. 469(c)(7)(C) and Reg. 1.469-9(b)(2) for purposes of qualifying as a real estate professional under the passive activity loss rules or Prop. Reg. 1.163(j)-9(g) and that makes an election under IRC Sec. 163(j)(7)(B). A real property trade or business that makes the irrevocable election under IRC Sec. 163(j)(7)(B) to be excepted from the Section 163(j) limitation is required to use the alternative depreciation system (ADS) to depreciate any of its non-residential real property, residential rental property, and qualified improvement property.
3. Any electing farming business. An electing farming business means a trade or business that makes an election under Prop. Reg. 1.163(j)-9 and that is a farming business as defined in IRC Sec. 263A(e)(4) or Reg. 1.263A-4(a)(4) or any trade or business of a specified agricultural or horticultural cooperative as defined in IRC Sec. 199A(g)(4) [Prop. Reg. 1.163(j)-1(b)(11)]. IRC Sec. 163(j)(10), which cross-references to IRC Sec. 168(g)(1)(G), requires that an electing farming business must use the ADS method for any property with a recovery period of 10 years or more.

   A real property trade or business cannot elect out of IRC Sec. 163(j) if it leases at least 80% of its real property (determined by fair market value) to a commonly controlled business [Prop. Reg. 1.163(j)-9(h)(1)]. Two trades or businesses are under common control if 50% of the direct and indirect ownership of both businesses are held by related parties within the meaning of IRC Secs. 267(b) and 707(b). Absence of a written lease or describing the arrangement in a service contract or other agreement that is not called a lease will not prevent this rule from applying.
4. Any excepted regulated utility trade or business.

Prop. Reg. 1.163(j)-9 provides guidance for making an election under IRC Secs. 163(j)(7)(B) and (C) to be an excepted trade or business for electing real property trades or businesses or electing farming businesses. See Election E503 for a sample election.

Law Change Alert: The Coronavirus Aid, Relief, and Economic Security (CARES) Act retroactively made QIP eligible for bonus depreciation for tax years beginning after 2018. For taxpayers with significant amounts of QIP, the loss of bonus depreciation for such property could make the election out of the Section 163(j) limit unattractive, especially since the CARES Act also temporarily increased the limit on business interest expense. Due to the retroactive change that makes QIP eligible for bonus depreciation, Rev. Proc. 2020-22 provides guidance for taxpayers to retroactively withdraw the election under IRC Sec. 163(j)(7) to be an electing real property trade or business or an electing farming business. In addition, Rev. Proc. 2020-22 also provides guidance for businesses that would like to make a late Section 163(j)(7) election for a 2018, 2019, or 2020 tax year. See Election E503 for information on how to make these elections under Rev. Proc. 2020-22.

<u>Safe Harbor for Certain Infrastructure Trades or Businesses</u>. Rev. Proc. 2018-59 provides a safe harbor that allows certain taxpayers to elect to be treated as a qualifying real property trade or business under IRC Sec. 163(j)(7)(B). The election applies to taxpayers with a trade or business that—

1. is conducted by a party contractually obligated to fulfill the terms of a specified infrastructure arrangement (as defined in the revenue procedure),
2. is conducted in connection with fulfilling the terms of a specified infrastructure arrangement, and
3. would not otherwise be treated as a real property trade or business under IRC Sec. 163(j)(7)(B) or IRC Sec. 469(c)(7)(C).

If a taxpayer makes this election, the taxpayer is not subject to the business interest expense limitation under IRC Sec. 163(j), but must use the alternative depreciation system (ADS) of IRC Sec. 168(g) to depreciate the property described in IRC Sec. 168(g)(8). Rev. Proc. 2018-59 is effective on December 10, 2018, and may be applied to tax years beginning after 2017.

Special Rules Applicable to Partnerships

If a deduction for business interest expense of a partnership is subject to the Section 163(j) limit, IRC Sec. 163(j)(4) provides that the limitation applies at the partnership level and any deduction for business interest expense within the meaning of IRC Sec. 163(j) is taken into account in determining the nonseparately stated taxable income or loss of the partnership. Once a partnership determines its business interest expense, business interest income, ATI, and floor plan financing interest expense, the entity calculates its Section 163(j) limit [Prop. Reg. 1.163(j)-6(a)].

Business interest expense that is deductible at the partnership level is not subject to any additional Section 163(j) limit at the partner level.

The deductible business interest expense and any excess business interest expense retain their character at the partner level. For example, the interest expense retains its character as either passive or non-passive at the partner level [Prop. Reg. 1.163(j)-6(c)].

Any excess business income, that is, the amount of unused ATI from the partnership is passed on to the partner and can be used to increase their respective ATI amount [IRC Sec. 163(j)(4)(C)].

Allocation of Excess Section 163(j) Items to Partners

Excess business interest expense is one of the *Section 163(j) excess items* that must be allocated to partners. The other Section 163(j) excess items are the partnership's excess taxable income and excess business interest income [Prop. Reg. 1.163(j)-6(b)(6)].

Excess Business Interest Expense. Any business interest expense that is disallowed by a partnership for any tax year because of the Section 163(j) limitation is *excess business interest expense* [Prop. Reg. 1.163(j)-1(b)(14)] and is allocated to each partner in the same manner as the partnership's nonseparately stated taxable income or loss [IRC Sec. 163(j)(4)(B); Prop. Reg. 1.163(j)-6(g)(1)]. This allocated amount is treated as paid or incurred by the partner in the next tax year, but only to the extent that the partner is also allocated excess taxable income or excess business interest income from that partnership in that year [IRC Sec. 163(j)(4)(B)(ii)(I); Prop. Reg. 1.163(j)-6(g)(2)]. The partner can deduct its share of the partnership's *excess business interest expense* but only against future excess taxable income or excess business interest income attributed to the partner by the partnership whose business gave rise to the excess business interest expense. Any such deduction requires a corresponding reduction of excess taxable income. For this purpose, excess taxable income allocated to a partner from a partnership for any tax year is not taken into account for any business interest other than excess business interest expense from the partnership until all of the excess business interest for that tax year and all preceding tax years has been treated as paid or accrued [IRC Sec. 163(j)(4)(B)(ii); Prop. Reg. 1.163(j)-6(g)(3)].

Note: The CARES Act provides special rules for the treatment of excess business interest expense that is passed through to partners from partnership tax years that begin in 2019. Fifty percent of the excess business interest from 2019 is treated as accrued or paid in the partner's first tax year beginning in 2020, and is not subject to any limits. The remaining excess business interest expense is treated under the normal rules that apply to excess business interest expense; that is, its deduction is suspended until the partnership passes through excess taxable income or excess interest income.

Excess Taxable Income. Partners are allowed to increase their ATI by their share of the partnership's *excess taxable income*, if any [IRC Sec. 163(j)(4)(A)(ii)(II)]. A partnership's excess taxable income is computed by multiplying its adjusted taxable income by the following fraction [IRC Sec. 163(j)(4)(C)]:

$$\frac{30\% \times \text{adjusted taxable income} - (\text{business interest expense, exclusive of floor plan financing interest} - \text{business income})}{30\% \times \text{adjusted taxable income}}$$

If the numerator is negative, there is no excess taxable income.

This rule allows partners to increase their limit on business interest expense to the extent the partnership could have deducted more business interest (i.e., the partnership's net business interest expense was less than its limit).

Key Issue 14G

4. Asset basis information for corporations or partnerships if the taxpayer looks through to the corporation's or partnership's basis in the corporation's or partnership's assets under Prop. Reg. 1.163(j)-10(c)(5)(ii).
5. A summary of the method used to determine asset basis in property used in both excepted and nonexcepted businesses, as well as information regarding any deemed sale under Prop. Reg. 1.163(j)-10(c)(5)(iv).

Computing the Deductible Amount of Business Interest Expense for Partnerships

The deduction is computed as follows:

Step 1 Compute business interest income and expense for the taxpayer's trades and businesses. Compute any floor plan financing interest expense separately.

Step 2 Compute adjustments to taxable income for the net interest income limitation. Adjusted taxable income for the limit on business interest expense is taxable income computed without regard to IRC Sec. 163(j)(8)(A).

Step 3 Compute adjusted taxable income. To the extent any items listed in Step 2 are included in taxable income, they should be reversed to compute adjusted taxable income. Adjustments in Step 2 that are deductions or losses will increase taxable income for the interest limitation. The amount determined cannot be less than zero [IRC Sec. 163(j)(1)].

Step 4 Apply the percentage limit. The amount computed at Step 3 is limited to 30% for partnership tax years beginning in 2019 [IRC Sec. 163(j)(1)(A)].

Step 5 Compute the annual limitation. The deduction for interest expense is limited to the sum of the following amounts for the tax year [IRC Sec. 163(j)(1)]:

(i) Business interest income.

(ii) 30% of adjusted taxable income.

(iii) Floor plan financing interest.

Step 6 Compute the disallowed interest carryforward. The difference between the taxpayer's total interest expense and the deductible portion in Step 5 is carried forward indefinitely [IRC Sec. 163(j)(2)].

Note: For taxpayers other than partnerships, the percentage limitation is 50% for tax years beginning in 2019 and 2020. Partnerships obtain the benefit of the 50% limit for tax years beginning in 2020. Taxpayers can make an irrevocable election to forgo the increased percentage limitation in which case 30% is used to compute the ATI limit [IRC Sec. 163(j)(10)(A)(iii)].

See Worksheet W137 to calculate the business interest expense deduction.

Filing Form 8990

The business interest expense limitation is determined and reported on Form 8990 [Limitation on Business Interest Expense Under Section 163(j)].

Partnerships with business interest expense must file Form 8990. Also, partnerships with excess business interest income or excess taxable income to be allocated to its partners must file Form 8990, even if the partnership has no interest expense.

Exclusions from Filing. The following partnerships are excluded from filing Form 8990:

1. Partnerships that meet the small business gross receipts test under IRC Sec. 448(c) if the partnership does not have excess business interest expense from a lower tier partnership.
2. A real property trade or business as defined in IRC Sec. 469(c)(7) can elect out of the Section 163(j) limitation.
3. Farming businesses, as defined in IRC Sec. 263A(e)(4), can elect out of the business interest expense limitation.
4. Certain utility businesses are exempted from the Section 163(j) limitation, without the need for an election.

Flow-through of Business Interest Expense Items to Partners. Form 1065, Schedule B (Other Information), questions 23 and 24 relate to the business interest expense limitation. Question 23 is answered yes by partnerships that are real property trades or businesses or farming businesses that have elected out of the application of IRC Sec. 163(j). Question 24 is answered no by partnerships that meet the small business gross receipts limitation under IRC Sec. 448(c), or partnerships that only have business interest expense from items (2) through (4) as listed above. Form 8990 must be filed by partnerships that answer yes to this question.

Note: A lower tier entity must report information on excess business interest expense, excess taxable income, and excess business interest income on Schedules K-1 for upper tier partners.

Once the partnership has calculated and taken its business interest limitation into account on page one of Form 1065, certain information is required to be reported to the partners. To the extent that the partnership has excess business interest expense, it is reported to each partner on Schedule K-1, line 13 (other deductions), code K. Excess taxable income, if any, is reported on Schedule K-1, line 20 (other information), code AE. Finally, any excess business interest income is reported on Schedule K-1, line 20, code AF.

Example 14G-2: Calculating the limit on business interest expense.

For 2019, WhollyBananas Partnership (Bananas) has $10,000 of adjusted taxable income, $2,000 of business interest income, and $12,000 of business interest expense. Bananas does not qualify under the small business exemption, nor does it have floor plan financing interest. Bananas can only deduct $5,000 of its business interest expense. The limitation is the sum of $2,000 of business interest income plus $3,000 (30% × $10,000 ATI). The $5,000 of business interest expense allowed is deducted as a nonseparately stated item on page one of Banana's Form 1065.

The $7,000 of excess business interest expense is allocated to Banana's partners. See Illustration 14-2 for a filled in Form 8990 based on the facts of this example.

Prop. Reg. 1.163(j)-6(f) provides an 11-step process that allows a partnership to allocate deductible interest expense and any Section 163(j) excess items in the same manner as nonseparately stated income or loss to preserve both the entity-level calculation requirement and the requirement that the allocation at the partner level has substantial economic effect. Prop. Reg. 1.163(j)-6(o)(11) provides a detailed example to illustrate the 11-step process. In addition, the instructions to Form 8990 provide worksheets that can be used to allocate its deductible business interest expense and Section 163(j) excess items, if any, among its partners using the 11-step process which follows the guidance provided in Prop. Reg. 1.163(j)-6(f)(2).

KEY ISSUE 14H Deducting Real Property Taxes Incurred by Accrual-basis Partnerships.

Economic Performance Rule

Historically, accrual-basis taxpayers, including partnerships, could accrue real property taxes when the liability became a lien on the property or when personal liability arose (referred to as the "accrual date"), as set by the state legislature. This presented the opportunity for income tax deferral, since the accrual date often is the first day of the real property tax year.

Example 14H-1: Accrual of tax under general rules.

Bayco Associates is a calendar-year, accrual-basis partnership. Essco purchased an office building and warehouse on April 1, 2019. Annual property taxes on the building and warehouse are $30,000. The accrual date for property taxes in the state in which Bayco's property is located is April 1, and the property tax year ends March 31. Under the general rules, the full $30,000 would be deductible in 2019, representing taxes for the property tax year ending March 31, 2020, and reported on page 1 of its 2019 Form 1065.

However, Reg. 1.461-4(g) requires *economic performance* to occur before taxes (and certain other types of expenses) can be deducted.

Example 14H-2: Accrual of tax under economic performance regulations.

Assume the same facts as in Example 14H-1. Under the economic performance rules, Bayco would have to *pay* the tax by December 31, 2019, to be able to deduct the tax on its 2019 Form 1065. As a practical matter,

Guidance on the TCJA Changes Made to Bonus Depreciation

Reg. 1.168(k)-1 provided guidance for bonus depreciation on qualified property placed in service before 2005. Rev. Proc. 2017-33 generally applied the rules under Reg. 1.168(k)-1 to property that qualified for 50% bonus depreciation under the rules in effect before 2018.

Regulations proposed in August 2018 and finalized in September 2019 are consistent with IRC Sec. 168(k) in that the property must meet the following four requirements to be eligible for 100% bonus depreciation [Prop. Reg. 1.168(k)-2(b); Reg. 1.168(k)-2(b)]:

1. it must be of a specified type;
2. the original use must begin with the taxpayer or used property must meet the IRC Sec. 168(k)(2)(E)(ii) acquisition requirements;
3. it must be placed in service within a specified time period or must be planted or grafted before a specified date; and
4. it must be acquired by the taxpayer after September 27, 2017.

The proposed regulations can be applied to qualified property placed in service by the taxpayer during or after the taxpayer's tax year that includes the date on which they are finalized. However, taxpayers may choose to apply the proposed regulations to qualified property acquired and placed in service after September 27, 2017, during tax years ending on or after September 28, 2017 [Prop. Reg. 1.168(k)-2(g)]. The final regulations apply to qualified property placed in service by the taxpayer during or after the taxpayer's tax year that includes September 24, 2019 [Reg. 1.168(k)-2(h)(1)]. However a taxpayer may choose to apply the final regulations to qualified property acquired and placed in service after September 27, 2017, by the taxpayer during the taxpayer's tax year ending on or after September 28, 2017 [Reg. 1.168(k)-2(h)(2)]. Additional proposed regulations were issued in September 2019 (REG-106808-19) along with the final regulations. These proposed regulations amend some of the August 2018 proposed regulations and provide additional clarification.

Qualified Property for Bonus Depreciation

For property acquired and placed in service after September 27, 2017, and before 2027, *qualified property* for bonus depreciation must be one of the following [IRC Sec. 168(k)(2); Prop. Reg. 1.168(k)-2(b)(2); Reg. 1.168(k)-2(b)(2)]:

1. Eligible Section 168 recovery property.
2. Depreciable computer software that is not amortizable over 15 years under IRC Sec. 197.
3. Water utility property, as defined in IRC Sec. 168(e)(5).
4. A qualified film or television production under IRC Sec. 181(d) and Reg. 1.181-3.
5. A qualified theatrical production under IRC Sec. 181(e).
6. A specified plant, as defined in IRC Sec. 168(k)(5)(B).

Note that items 4. and 5. are qualified property only if they would have been deductible under IRC Sec. 181 without regard to IRC Secs. 181(a)(2) and (g) or Regs. 1.181-1(b)(1)(i) (ii), and (b)(2)(i).

Qualified property does not include any asset subject to the alternative depreciation system (ADS) under IRC Sec. 168(g) unless the taxpayer voluntarily elects to use ADS for the asset, in which case it can still be eligible property [IRC Sec. 168(k)(2)(C)(i)]. ADS is generally required for property (1) used predominately outside of the United States, (2) used by a tax-exempt entity, or (3) financed by tax-exempt bonds. Therefore, such property is ineligible for bonus depreciation. Also, farmers who elect out of the uniform capitalization (UNICAP) rules under IRC Sec. 263A(d)(3) are required to use ADS, which makes them ineligible for bonus depreciation.

<u>Eligible Section 168 Recovery Property</u>. This is depreciable property with a MACRS recovery period of 20 years or less. Most real estate fails to meet this definition. However, some real property (such as land improvements, general-purpose buildings used in agriculture, and retail motor fuels outlets) has a recovery period of 20 years or less and,

thus, is eligible Section 168 recovery property. Property that falls within this definition includes the following MACRS property [IRC Sec. 168(k)(2)(A); Prop. Reg. 1.168(k)-2(b)(2)(i)(A); Reg. 1.168(k)-2(b)(2)(i)(A)]:

1. Qualified leasehold improvement property as defined by former IRC Sec. 168(e)(6).
2. Qualified restaurant property as defined by former IRC Sec. 168(e)(7), that is qualified improvement property as defined in (a) Prop. Reg. 1.168(b)-1(a)(5)(i)(C) and 1.168(b)-1(a)(5)(ii) or (b) Reg. 1.168(b)-1(a)(5)(i)(C) and (ii).

   Note: Restaurant buildings do not meet the definition of qualified improvement property and, as a result, do not qualify for bonus depreciation.
3. Qualified retail improvement property as defined by former IRC Sec. 168(e)(8).
4. Qualified improvement property.

Law Change Alert: The Coronavirus Aid, Relief, and Economic Security (CARES) Act retroactively assigns qualified improvement property (QIP) a 15-year recovery period, meaning that it qualifies for bonus depreciation. See the discussion later in this key issue for details.

The normal MACRS recovery period is used to determine if an asset has a recovery period of 20 years or less, even if the taxpayer elects to depreciate the asset over the longer ADS period [Reg. 1.168(k)-1(b)(2)(i)(A)].

<u>Property Not Eligible for Bonus Depreciation</u>. The following property does not qualify for bonus depreciation [Prop. Reg. 1.168(k)-2(b)(2)(ii); Reg. 1.168(k)-2(b)(2)(ii)]:

1. Property described in IRC Sec. 168(f) for which MACRS is not available (for example, property subject to the unit-of-production method of depreciation).
2. Property required to be depreciated under the alternative depreciation system (ADS).

   Observation: MACRS nonresidential real property, residential rental property, and qualified improvement property held by a real property trade or business that elects out of the IRC Sec. 163(j) limit on business interest expense [see IRC Sec. 163(j)(7)(B)] and property with a recovery period of 10 years or more held by a farming business that elects out of the limit on business interest expense [see IRC Sec. 163(j)(7)(C)] are not eligible for bonus depreciation for tax years beginning after 2017.
3. Property included in a class for which the taxpayer elected not to take bonus depreciation.
4. A specified plant placed in service during the tax year for which the taxpayer made an election under IRC Sec. 168(k)(5) for a prior tax year.
5. Any class of property placed in service before 2018 for which a corporate taxpayer elected to forego bonus depreciation and instead be allowed minimum tax credits.
6. Property placed in service after 2017 and used in a regulated public utility trade or business described in IRC Sec. 163(j)(7)(A)(iv).
7. Property placed in service after 2017 and used in a trade or business that has floor plan financing indebtedness, if the interest on that debt was taken into account to compute the business interest expense limit under IRC Sec. 163(j)(9).

   Note: Floor plan financing interest is not taken into account for a tax year if the sum of the amounts calculated as business interest income and 30% of adjusted taxable income for the tax year equals or

allowed a 100% first-year write off and depreciation on vehicles costing more than $18,100 are limited by the first-year Section 280F limit of $18,100.

Heavy SUVs pickups, and vans are treated for tax purposes as transportation equipment, and that means they qualify for 100% bonus depreciation. 100% bonus depreciation is available when an SUV, pickup, or van has a manufacturer's gross vehicle weight rating (GVWR) above 6,000 pounds. The GVWR of a vehicle can be verified by looking at the manufacturer's label, which is usually found on the inside edge of the driver's side door where the door hinges meet the frame.

For bonus depreciation vehicles that qualify for 100% bonus depreciation, there is a technical glitch in the law that causes the depreciation limits for years two–five (years subsequent to the placed-in-service year) to be zero. This is because when applying the first year 100% bonus depreciation rules, all the allowable depreciation is taken in year one, which leaves nothing for years two–five, and then depreciating the remaining basis beginning in year six under the catch-up rule of IRC Sec. 280F(a)(1)(B). In order to provide a solution to this problem, the IRS has provided a safe harbor calculation in Rev. Proc. 2019-13 wherein the taxpayer deducts the lesser of the Section 280F limitation for that year or the remaining adjusted depreciable basis (original basis of the vehicle less first-year depreciation claimed, including bonus depreciation) multiplied by the standard annual depreciation rate for the year. For less expensive vehicles, the maximum allowable deductions for year two and beyond under the safe harbor calculation will be lower than the normal Section 280F limits for those years. For more expensive vehicles, the maximum allowable deductions for year two and beyond under the safe harbor calculation will be limited to the normal Section 280F amounts. See Rev. Proc. 2019-13, Section 4.03, for the details of these calculations. This safe harbor may not be used for any auto for which the Section 179 deduction is elected.

Example 15B-2: Computing luxury auto depreciation under the safe harbor.

PP Partnership, purchased and placed in service an automobile in 2018 for $60,000. PP used the automobile exclusively for business. In 2018, PP claimed the full $18,000 deduction allowed under Section 280F on the vehicle. Beginning in 2019, PP will begin depreciating the remaining adjusted depreciation basis of $42,000 ($60,000 original cost less $18,000 first-year depreciation) using the standard MACRS tables covering automobiles, subject to the Section 280F limitation. As such, the depreciation deduction for 2019 will be $13,440 [the lesser of $13,440 ($42,000 × 32%) or $16,000 (the Section 280F limitation for year 2 for vehicles placed in service in 2018)].

Variation: The purchase price of the automobile was $80,000. In this case, the 2019 depreciation deduction will be $16,000 [the lesser of $19,840 ($62,000 × 32%) or $16,000 (the Section 280F limitation for year 2 for vehicles placed in service in 2018)].

Impact of Bonus Depreciation on AMT

Property for which bonus depreciation has been claimed is not subject to any AMT adjustment on the bonus depreciation amount or the remaining regular MACRS depreciation deduction over the duration of the recovery period except as provided in Prop. Reg. 1.168(k)-2(d)(1)(iv)(A)(2) with regard to specified plants [IRC Secs. 168(k)(2)(G) and 168(n)(2)(D); Prop. Reg. 1.168(k)-2(d)(1)(iv)]. If the partnership elected out of (i.e., did not claim) bonus depreciation for a class of property placed in service in tax years ending prior to 2016, it also effectively made an election out of the exemption from being subject to AMT adjustments for that class of property.

Bonus Depreciation for Qualified Improvement Property

Qualified improvement property is any improvement that is Section 1250 property made to an interior portion of a nonresidential building that is placed in service after the date the building is first placed in service. However, expenditures attributable to the enlargement of a building, any elevator or escalator, or the building's internal structural framework are not qualified improvement property. [IRC Sec. 168(e)(6) and Prop. Reg. 1.168(b)-1(a)(5)].

Law Change Alert: The Coronavirus Aid, Relief, and Economic Security (CARES) Act provided a long-awaited technical correction to assign QIP a 15-year (20-year for ADS) recovery period, as if such provision had been included in the TCJA [IRC Sec. 168(e)(3)(E)(vii)]. Therefore, QIP placed in service after 2017 can qualify for bonus depreciation. If the taxpayer elects out of bonus depreciation for QIP, it is depreciated straight-line over a 15-year recovery period [IRC Sec. 168(b)(3)(G)]. The CARES act also made a technical correction to the definition of QIP to

clarify that it only includes improvements to a building that are made by the taxpayer. Therefore, taxpayers cannot acquire a building and treat any cost assigned to improvements made by a previous owner as QIP.

In Rev. Proc. 2020-25 the IRS issued guidance on how taxpayers who placed QIP in service in prior years (when such property was assigned a 39-year recovery period) can take advantage of this provision. Also, recognizing that this retroactive reclassification of QIP may affect elections that taxpayers made (or failed to make), the IRS is allowing taxpayers to make certain late elections regarding depreciation and/or to revoke elections they previously made.

Special rule for partnerships. Partnerships subject to the centralized audit regime generally cannot file amended returns. However, Rev. Proc. 2020-23 allows certain partnerships to file amended returns for their tax years beginning in 2018 and 2019 to take tax law changes under the CARES Act into consideration. Partnerships that choose not to file amended returns as permitted under Rev. Proc. 2020-23 or that cannot file amended returns because the placed in service year for the QIP is not within the scope of Rev. Proc. 2020-23 can file an administrative adjustment request (AAR) for the QIP's placed in service year and any affected succeeding years that are filed on or before October 15, 2021 (or, if earlier, the date the statute of limitations expires).

Claiming bonus depreciation on QIP. Rev. Proc. 2020-25, Section 3 provides that taxpayers who placed QIP in service after 2017 in tax years ending in 2018, 2019, or 2020 (their 2018, 2019 or 2020 tax years) can depreciate such property straight-line over a 15-year recovery period and, provided all requirements are met, claim bonus deprecation. A change to using a 15-year recovery period or claiming bonus depreciation is a change from an impermissible accounting method to a permissible method.

The change to a permissible method can be made by filing an amended return for the placed in service year and any affected succeeding years on or before October 15, 2021 (or if sooner before the statute of limitations for that year expires). Alternatively, the taxpayer can file a Form 3115 (Application for Change in Accounting Method) to request an automatic accounting method change under Rev. Proc. 2015-13. Form 3115 is filed with a timely filed income tax return for the year of change. See Section 6.03(1) of Rev. Proc. 2020-25 for details on this accounting method change, including relaxation of the prohibition against making an accounting method change more than once in a five-year period, a reduced filing requirement, and rules for making concurrent method changes. The negative Section 481(a) adjustment resulting from claiming more depreciation in the affected years than claimed under the impermissible method is taken into account in the year of change.

Generally, an accounting method is not adopted until a taxpayer has used it for at least two years. However, taxpayers who only claimed impermissible depreciation on QIP for a single year can include such depreciation in their accounting method change. Or, they can correct the depreciation for such "one-year property" by filing an amended return.

Caution: Rev. Proc. 2020-25 does not apply to QIP if the taxpayer deducted the cost of the property as an expense. Also, any changes to depreciation of QIP due to a late election out, or revocation of, the Section 163(j) limit on business interest expense are made under Rev. Proc. 2020-22.

Observation: Requesting an accounting method change on a Form 3115 may be less time-consuming than filing amended returns for several years. Even if QIP was only placed in service during one prior year, amended returns must be filed for the placed in service year as well as any succeeding years, to take into account the change in depreciation for each of those years. But, a request for an accounting method change filed on Form 3115 must be attached to the taxpayer's timely filed original return for the year the change is requested [Rev. Proc. 2015-13, Sec. 6.03(1)]. For taxpayers that have already filed their 2019 returns, a Form 3115 to change the depreciation method for QIP cannot be filed until the 2020 return is filed, which means that the tax benefit will not be realized until after that. For these taxpayers, filing amended returns for prior years will generally allow the tax benefit to be received much sooner.

Making late depreciation elections. In general, taxpayers must make the following depreciation-related elections on a timely filed return for the year the property is placed in service:

a. Election to use the alternate depreciation system (ADS) [IRC Sec. 168(g)(7)].

b. Election to treat certain plants as placed in service (for bonus depreciation) in the year they are planted or grafted (rather than in the later year that they become productive) [IRC Sec. 168(k)(5)].

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c. Election out of bonus depreciation [IRC Sec. 168(k)(7)].

d. Election to apply 50% (rather than 100%) bonus depreciation rate to certain property placed in service in the taxpayer's first year ending after September 27, 2017 [IRC Sec. 168(k)(10)].

Rev. Proc. 2020-25, Sec. 4.02 extends the deadline for taxpayers who place depreciable property in service in their 2018, 2019 or 2020 tax years, timely filed their returns for the placed in service year, and want to make an election described in items a., b., or c of the preceding paragraph. Likewise, taxpayers that timely filed their return for their tax year that includes September 27, 2017 and who want to make the election described in item d. in the preceding paragraph can make a late election. Late elections are made by filing amended returns for the placed in service year and any affected succeeding tax years by October 15, 2021 (or if earlier, before the statute of limitations expires). Alternatively, the election can be made by filing a Form 3115 with the taxpayer's timely filed original return for either (a) the first or second tax year after the year the property is placed in service or (b) that is filed after April 17, 2020 and on or before October 15, 2021. See Rev. Proc. 2020-25, Section 6.03(2) for details on requesting this automatic accounting method change.

Note: The Section 168(k)(7) election out of bonus depreciation is made with respect to a class (or classes) of assets and applies to all assets in that class placed in service during the year for which the election is made. QIP placed in service after 2017 is in the 15-year property class and is not a separate class of property, unlike QIP placed in service before 2018, which is a separate class of property [Reg. 1.168(k)-2(f)(1)(ii)(D)].

Observation: Rev. Proc. 2019-33 allowed taxpayers to make late elections under IRC Sec. 168(k)(5), 168(k)(7) and 168(k)(10). Rev. Proc. 2020-25 extends the time for making such elections even further.

Revoking or withdrawing certain elections. Rev. Proc. 2020-25, Sec. 5.02(2) allows taxpayers that placed depreciable property in service during their 2018, 2019, or 2020 tax years and who made the Section 168(k)(5) election for specified plants or the election out of bonus depreciation under IRC Sec. 168(k)(7) and taxpayers that made a Section 168(k)(10) election to use the 50% bonus deprecation rate for certain assets for their year including September 28, 2017 on a timely filed original return filed on or before April 17, 2020 (or who made a late election under Rev. Proc. 2019-33 before that date) to revoke those elections, by filing amended returns for the placed in service year and any affected succeeding years on or before October 15, 2021 (or if earlier, before the statute of limitations expires). Or, the elections can be revoked by filing a Form 3115 to request an automatic accounting method change. See Section 6.03(2) for details on filing Form 3115.

Likewise, under Rev. Proc. 2020-25, Sec. 5.02(3), taxpayers that elected to use the ADS depreciation method for assets placed in service during their 2018, 2019, or 2020 tax years can revoke that election by filing amended returns for the placed in service year and any affected succeeding years.

Bonus Depreciation for Partnership Basis Adjustments

A positive Section 743(b) adjustment to the basis of partnership property pursuant to a Section 754 elections can potentially qualify for bonus depreciation [Prop. Reg. 1.168(k)-2(b)(3)(iv); Reg. 1.168(k)-2(b)(3)(iv)(D)]. As explained in Chapter 32, these basis adjustments can arise when a partnership interest is transferred. Bonus depreciation for a positive Section 743(b) basis adjustment is allowed when: (1) the basis adjustment relates to partnership bonus-depreciation eligible property and (2) the bonus depreciation used property acquisition requirements are met. See Key Issue 15H for additional discussion of this issue.

Impact of Bonus Depreciation on Mid-quarter Convention

The depreciable basis of property for which bonus depreciation is claimed is taken into account when determining if the taxpayer is required to use the mid-quarter convention to calculate MACRS depreciation deductions for the year [Prop. Reg. 1.168(k)-2(g)(11)]. (See Key Issue 15E.) Therefore, claiming bonus depreciation (or not) has no impact on the need to use the mid-quarter convention. [See Section 3.03(4) of Rev. Proc. 2011-26.]

Bonus Depreciation in Carryover Basis Situations

When qualified property is transferred in a carryover basis transaction described in IRC Sec. 168(i)(7) (including a contribution to partnership under IRC Sec. 721 or a distribution from a partnership under IRC Sec. 731) in the same tax year the transferor (the contributing partner or distributing partnership) places the qualified property in service, the property is treated as originally placed in service on the date the transferor places it in service.

If there are multiple transfers in multiple transactions described in IRC Sec. 168(i)(7) in the same tax year, the placed-in-service date is deemed to be the date on which the first transferor placed the property in service. Bonus depreciation is allowed, with the deduction allocated between the transferor and the transferee on a monthly basis in accordance with Reg. 1.168(d)-1(b)(7)(ii). [See Reg. 1.168(k)-1(f)(1)(iii).]

However, if a taxpayer places qualified property in service and in the same year contributes that property to a partnership in a tax-free IRC Sec. 721 transaction, and one of the partnership's other partners previously had a depreciable interest in the property, any bonus depreciation is allocated entirely to the contributing partner. Also, if qualified property is placed in service and transferred in an IRC Sec. 168(i)(7) transfer in the same year and in the same year the transferee disposes of the property [other than in another Section 168(i)(7) transfer], no bonus depreciation is allowed for either party [Prop. Reg. 1.168(k)-2(f)(1)(iii); Reg. 1.168(k)-2(g)(1)(iii)].

Example 15B-3: Claiming bonus depreciation when property is placed in service and contributed to partnership in same year.

On January 5, 2019, Barb purchased and placed in service a $9,000 machine that qualified for bonus depreciation. On August 20, 2019, Barb contributed the machine to the Rainy Day Partnership. The contribution was tax-free under IRC Sec. 721.

None of the partners in Rainy Day (other than Barb) had ever had a depreciable interest in the machine. Barb and Rainy Day are calendar-year taxpayers.

The 100% bonus depreciation deduction for the machine is allocated between Barb and Rainy Day based on the number of months they had the machine in service during 2019. Barb had the machine in service for seven of 12 months, which included the month she placed it in service but did not include the month she contributed it to Rainy Day. For 2019, Barb is allocated $5,250 ($9,000 × 7/12) of bonus depreciation from the machine and Rainy Day is allocated $3,750 ($9,000 × 5/12).

Bonus Depreciation in Short Tax Years

For a short tax year of less than 12 months, the amount of allowable bonus depreciation is generally not reduced or prorated [Reg. 1.168(k)-1(d)(1)(i)].

Acquisition and Disposition in Same Year

Bonus depreciation is not allowed for an asset that is placed in service and disposed of in the same tax year [Reg. 1.168(k)-1(f)(1)(i)]. Of course, *regular* MACRS depreciation is not allowed in this circumstance either.

Electing Out of Bonus Depreciation

Taxpayers can elect out of (forego) bonus depreciation by following the instructions to Form 4562. For qualified property owned by a partnership, the election out is made at the partnership level rather than at the partner level. [See Reg. 1.168(k)-1(e) and Election E306.]

A taxpayer can elect out of bonus depreciation for any class of qualified property that is placed in service during the tax year. If the election is made, bonus depreciation is not allowed for any property in that class that is placed in service during that year. For these purposes, the term *class of property* means (1) all MACRS property with the same recovery period (e.g., all five-year property is one class and all seven-year property is another class), (2) water utility property defined in IRC Sec. 168(e)(5) and depreciated under IRC Sec. 168, (3) computer software defined in and depreciated under IRC Sec. 167(f)(1), and (4) qualified improvement property depreciated under IRC Sec. 168. [See Reg. 1.168(k)-1(e)(2).]

Practice Tip: Electing out could be advisable for partnerships with (1) partners that have expiring NOLs, (2) partners that expect to pay higher tax rates in future years, or (3) individual partners who want to preserve a certain level of self-employment income to make larger contributions to their tax-deferred retirement accounts.

In general, the election out must be made by the due date (including extensions) of the partnership's Form 1065 for the tax year in which the qualified property is placed in service by the partnership. [See Reg. 1.168(k)-1(e)(3).] If the partnership fails to properly elect out of bonus depreciation, the amount of depreciation allowable under IRC Sec. 167(f)(1) (for computer software) or IRC Sec. 168 (for other depreciable assets) must be determined for the placed-in-service tax year and all subsequent years by including the bonus depreciation deduction.

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Note: The election out of bonus depreciation under IRC Sec. 168(k)(7) is similar to the prior election out under former IRC Sec. 168(k)(2)(D)(iii) with one exception. Under IRC Sec. 168(k)(7), *qualified property* retains its character when a taxpayer chooses to elect out of bonus depreciation. Rev. Proc. 2017-33 clarifies that this means qualified property is not subject to AMT adjustments under IRC Sec. 56, even if the taxpayer elects out of bonus depreciation.

In Rev. Proc. 2019-33, the IRS issued guidance that allows taxpayers to make late bonus depreciation elections or revoke an election for certain property acquired after September 28, 2017, and placed in service during the tax year that includes September 28, 2017. Taxpayers can: (1) elect entirely out of 100% bonus depreciation, (2) elect to claim 50% bonus depreciation (instead of 100% bonus depreciation) for qualified property acquired after September 27, 2017, and placed in service during the tax year that includes September, 28, 2017, or (3) elect bonus depreciation for any specified plant that is planted or grafted after September 27, 2017, and before 2027. Taxpayers that failed to make these elections for tax years that include September 28, 2017, can make late elections by filing an amended return or a Form 3115 for a limited period of time. If bonus depreciation elections were made, taxpayers can revoke the elections by filing an amended return or a Form 3115 for a limited period of time.

No Bonus Depreciation for Electing Real Property and Farming Businesses. A partnership that is a real property trade or business or a farm business that elects out of the TCJA business interest expense deduction limitation rules imposed by IRC Sec. 163(j) must use the ADS deprecation method for specified assets. Assets that are depreciated under ADS do not qualify for bonus depreciation. So an election out of the business interest expense deduction limitation rules is also effectively an election out of bonus depreciation for specified assets.

Coordination with Other Depreciation Deductions

When bonus depreciation is claimed for a qualifying new asset, the Section 179 expense deduction and regular MACRS depreciation can also be claimed. The basis of the asset is first reduced by the Section 179 expense deduction, then by the bonus depreciation deduction, and then by the regular MACRS depreciation deduction.

KEY ISSUE 15C ACE Depreciation Adjustments.

Before the Tax Cuts and Jobs Act (TCJA) the adjusted current earnings (ACE) adjustment potentially applied to C corporation taxpayers. One of the most burdensome aspects of the ACE calculations is the requirement to recompute depreciation.

The TCJA repealed the corporate AMT for tax years beginning after 2017 and beyond (IRC Sec. 55). Therefore, ACE depreciation adjustments are no longer required for those years.

KEY ISSUE 15D Form 4562 and Tax Return Presentation Rules.

Form 4562 (Depreciation and Amortization) is used to report the calculation of the tax depreciation expense shown on the tax return.

Depreciation or Amortization of Basis Adjustments Due to Section 754 Elections

When depreciation or amortization expense attributable to a Section 743(b) basis adjustment due to a Section 754 election (see Chapter 32) is allocable to a specific transferee partner, the depreciable or amortizable basis and the depreciation or amortization expense attributable to a basis adjustment should not be included on Form 4562. These amounts should be reflected on a schedule attached to the transferee partner's Schedule K-1. (Chapter 32 and Key Issue 15H discuss Section 743(b) basis adjustments and depreciation or amortization of basis adjustments, respectively.) Depreciation or amortization expense related to basis adjustments made according to IRC Sec. 743(b) should be reported to affected partners on Schedule K-1, line 13, code V, Section 743(b) negative adjustments along with a supporting statement or note, and then reported as an expense item on the partner's Schedule E. The Section 754 regulations specify that the partnership is responsible for calculating and reporting depreciation or amortization attributable to Section 743(b) basis adjustments to the transferee partner [Reg. 1.743-1(j)]. See Illustration 15-3 for a sample Schedule K-1 reporting format.

Section 179 Expense Deduction

Section 179 expense deductions must be separately stated because of the limitations that apply at the partner level (i.e., the taxable income limitation and dollar value limitation). Accordingly, the Form 4562 instructions state a partnership's Section 179 expense deduction should *not* be included in the total depreciation expense reported on Form 4562 (and carried to the depreciation expense line of page 1 of Form 1065). Instead, Section 179 expense deductions should be carried to line 12 of Schedules K and K-1. The amount from Schedule K-1, line 12 should be carried to the partner's Form 4562 and ultimately to Schedule E. See Key Issue 15F for more on Section 179 expense deduction issues.

The Section 179 expense election is made by completing Part I of Form 4562 and filing the form with the return for the tax year the eligible property is placed in service. The election can be made with an original return, whether or not it is timely filed. The Section 179 expense election can be made (or revoked) on an original return or an amended return [IRC Sec. 179(c)(2); Reg. 1.179-5(c)].

Bonus Depreciation

A partnership should report bonus depreciation (Key Issue 15B) on Form 4562 *[Depreciation and Amortization (Including Information on Listed Property)]* using line 14 or line 25 for listed property such as vehicles. From there, the bonus depreciation generally becomes part of the depreciation deducted on the first page of Form 1065.

What If the Partnership Has Multiple Trade or Business Activities?

If the partnership is engaged in several trade or business, rental, or investment activities, using a single Form 4562 to report total depreciation expense could cause confusion. For example, trade or business depreciation should generally be carried from Form 4562 to the depreciation expense line on the first page of Form 1065. Rental real estate depreciation should be carried to Form 8825 and, ultimately, to line 2 of Schedules K and K-1. Depreciation of rental property other than real estate should be carried to a white paper schedule that supports line 3 of Schedules K and K-1. Depreciation of property used to generate portfolio income should be carried to line 13 of Schedules K and K-1.

The Form 4562 instructions direct taxpayers to prepare a separate Form 4562 for each business or activity shown in the return.

Amounts Capitalized as Depreciable Property under IRC Sec. 263A

Form 4562 asks taxpayers to indicate on line 23 the amount of basis capitalized for uniform capitalization (UNICAP) purposes under IRC Sec. 263A and placed in service during the current year. Partnerships subject to IRC Sec. 263A and having depreciable basis additions should be sure to complete line 23 of Form 4562 to demonstrate compliance.

KEY ISSUE 15E MACRS Half-year and Midquarter Conventions.

Under MACRS, most property (other than real estate) is depreciated using a half-year convention—half a full year's depreciation is taken in the year the property is placed in service and also in the year of disposition. However, if more than 40% of the aggregate basis of property (excluding most real property) is placed in service during the last three months of the tax year, "all property placed in service during the year" must be depreciated as if it were placed in service at the midpoint of the quarter in which it was actually placed in service. If the midquarter convention applies, property placed in service in the first half of the year receives more than a half year's depreciation, and property placed in service in the fourth quarter receives only 12½% of a full year's depreciation.

Midquarter Convention

For the midquarter convention to apply, the aggregate basis of property placed in service during the last three months of the tax year must exceed 40% of the aggregate basis of property placed in service during the full year. In some cases, applying the mid-quarter convention can result in a lower total depreciation deduction than if the half-year convention applied. The term *aggregate basis of property* means the total depreciable basis of all property placed-in-service during the year except for (1) nonresidential real property; (2) residential rental property; (3) railroad grading and tunnel bores; (4) property acquired and disposed of in the same tax year; (5) Section 168(f) property not depreciated under MACRS. This includes, for example, property depreciated under a units of

production method. Included, however, is *listed property* (autos, televisions, etc.) as defined under IRC Sec. 280F(d)(4).

Depreciable basis means the property's basis considered when determining gain or loss upon the property's disposition. Thus, the property's basis must be reduced by any Section 179 expense deduction, any reduction for investment tax credit claimed, and any basis allocated to personal use [Reg. 1.168(d)-1(b)]. For example, if a widgetmaker machine is acquired for $45,000, and Section 179 expense deduction of $25,000 is elected, the widgetmaker machine would have basis of $20,000 for purposes of the 40% test to determine whether the midquarter convention applies. The basis of property for which bonus depreciation is claimed is included in the aggregate basis of property for purposes of determining if the mid-quarter convention applies [IRC Sec. 168(d)(3)].

Preparation Pointer: Making the Section 179 election for depreciable assets placed in service during the fourth quarter (as opposed to assets placed in service in earlier quarters) may get the partnership out of the mid-quarter convention when getting out would result in a larger overall depreciation deduction for the year.

Property Acquired and Sold in Same Year

When determining if the 40% test is met, property acquired and disposed of in the same year is not counted as property placed in service during the year. In addition, no depreciation expense is computed for such property.

Example 15E-1: Property bought and sold in same year.

During 20X1, the Sierra Partnership, a calendar year taxpayer, acquired the following depreciable property with the placed-in-service dates indicated:

Property	Cost	In Service
Used Truck	$8,000	1/11/X1
Office Desk	500	8/2/X1
Safe	1,000	8/27/X1
Computer	3,000	11/13/X1

These are the only items placed in service during 20X1. In September, Sierra sells the truck and the desk. Since these items were placed in service and disposed of in the same tax year, their depreciable bases are not considered in determining whether the midquarter convention applies. Because the computer was placed in service during the last three months of the tax year and its basis ($3,000) exceeds 40% of the aggregate basis of depreciable property placed in service during the tax year (the safe and computer together have a $4,000 aggregate basis), the midquarter convention applies to the safe and the computer. No depreciation is allowed for the truck and desk because they were placed in service and disposed of in the same tax year.

Convention in Year of Disposition

If property subject to the half-year convention is sold, the half-year convention also applies in the year of sale—i.e., the sale is treated as occurring at the midpoint of the year in which the property is sold (unless the property is acquired and disposed of in the same tax year—see previous discussion). If the midquarter convention applied to property in the year it was placed in service, the property is treated as sold at the midpoint of the applicable quarter in the year of sale.

Example 15E-2: Disposition of property to which midquarter convention applies.

YoBar Partners buys a pickup truck for $7,500 in Year 1. Assume the midquarter convention applies to all property placed in service in Year 1. In April of Year 3, YoBar sells the pickup. It is treated as sold at the midpoint of the quarter in which the sale occurs (i.e., the second quarter). Therefore, for Year 3, the partnership should take $^{4.5}/_{12}$ times the full Year 3 amount of depreciation for the truck.

Warning: The 40% test generally is applied at the partnership level. However, if a pass-through entity is formed or availed of for the principal purpose of avoiding the midquarter convention or causing the midquarter convention to apply, the 40% test is applied at the partner or other appropriate level [Reg. 1.168(d)-1(b)(6)].

Allocations in Year of Nonrecognition Transaction

If depreciable property is transferred in a tax-free transaction (for example, a tax-free contribution to a partnership under IRC Sec. 721) in the same year the property is first placed in service, the 40% test is applied by treating the transferred property as placed in service by the transferee entity on the transfer date. Additionally, the property's depreciable basis is not considered in determining whether the transferor must use the midquarter convention.

This means the transferee determines whether the midquarter or half-year convention applies to the transferred property. Then, both the transferor and transferee must use the same convention to determine their shares of the first-year depreciation, which is allocated between the transferor and transferee based on the number of months each holds the property. The transferor counts the month the property was placed in service as a full month for this purpose. The transferee counts the month in which the transfer occurs.

Example 15E-3: First-year depreciation for property contributed to partnership.

Assume Barry Bonilla placed new computer equipment costing $15,000 in service in his sole proprietorship on February 15 of Year 1. On October 1, Barry contributes the equipment to an existing calendar year partnership, Big Bucks Limited Partnership, in exchange for a partnership interest. Big Bucks did not acquire any other depreciable property in Year 1.

Big Bucks (the transferee) must consider the computer equipment in applying the 40% test. Big Bucks had no other depreciable property acquisitions, so the midquarter convention applies to the computer equipment for both the transferee (Big Bucks) and the transferor (Barry). Barry does not count the computer equipment in applying the 40% test to his Year 1 property acquisitions.

Since the computer equipment is treated as placed in service at the first quarter's midpoint, the Year 1 depreciation is equal to $^{10.5}/_{12}$ of the full year's amount. For five-year MACRS property, this translates to a 35% depreciation rate or $5,250 ($^{10.5}/_{12} \times 40\% \times \$15{,}000$). This amount is allocated between Barry and Big Bucks based on months held (February–September by Barry and October–December by Big Bucks). Barry is allocated $3,818 of depreciation ($^{8}/_{11} \times \$5{,}250$) for Year 1, and Big Bucks is allocated $1,432 ($^{3}/_{11} \times \$5{,}250$).

If the transferee cannot determine which convention will be used by the due date of the transferor's tax return (because, for example, the transferee's tax year has not yet ended), the transferor can choose to use either the midquarter or half-year convention. However, the transferor must specify on its tax return the proper applicable convention has not yet been determined for that property. If the transferor guesses wrong, he should file an amended tax return to correct the depreciation deduction.

KEY ISSUE 15F Section 179 Expense Deduction.

IRC Sec. 179 allows eligible taxpayers to elect to expense the cost of certain depreciable property in the tax year in which the property is placed in service. See Election E301 for a sample election to claim the Section 179 expense deduction. Property that is eligible for the Section 179 expense deduction includes most depreciable tangible personal property and software used in an active trade or business [IRC Sec. 179(d)]. However, certain types of depreciable tangible personal property are ineligible, as explained later in this key issue.

Interactive decision tools are available and can be used to guide the user through the following topics:

- *Determining Eligibility for Section 179 Expensing and Bonus.*
- *Maximizing the First-year Cost Recovery Deduction for a Business Vehicle.*

For qualifying property placed in service in tax years beginning after 2017, the Tax Cuts and Jobs Act (TCJA) increases the maximum Section 179 deduction to $1 million with annual inflation adjustments (up from $510,000 for tax years beginning in 2017). For tax years beginning in 2019, the inflation-adjusted maximum is $1.02 million. In addition to the dollar limit, the Section 179 expense deduction is subject to the following two limits:

1. *Property-placed-in-service Limit.* The allowable Section 179 expense deduction is reduced dollar-for-dollar to the extent eligible Section 179 property placed in service for the year exceeds $2.55 million in 2019 ($2.5

million in 2018). Thus, no Section 179 expense deduction is allowed if eligible property additions exceed $3.57 million in 2019 ($3.5 million in 2018).

2. *Taxable Income Limit.* The Section 179 expense deduction is limited to the taxable income for the year.

For partnerships, these limits apply to both the entity and to each owner [Reg. 1.179-2(b)(3)]. Each partner must separately apply the property-placed-in-service limit on their individual tax return. However, a partner's allocable share of the partnership's investment in eligible property is not included by the owner when computing this limitation [Reg. 1.179-2(b)(3)]. Each partner must also separately compute a taxable income limit on their individual income tax return, and must for this purpose, include their share of company taxable income.

Qualifying Property for Section 179 Expensing

Qualifying property is any tangible property or off-the-shelf computer software that is subject to depreciation, amortization, or other reasonable allowance for wear and tear that is Section 1245 property as defined in IRC Sec. 1245(a)(3) and, at the election of the taxpayer, qualifying real property as defined in IRC Sec. 179(f). In addition, the property must be acquired by purchase from an unrelated party and used more than 50% in the active conduct of a trade or business. [IRC Sec. 179(d)(1)].

Section 179 expensing is not available for any tangible property that is:

1. used outside of the U.S. as described in IRC Sec. 50(b)(1),
2. used by tax-exempt organizations as described in IRC Sec. 50(b)(3),
3. used by certain government units, or foreign persons, or entities, as described in IRC Sec. 50(b)(4), or
4. placed in service by an estate or trust [IRC Sec. 179(d)(4)].

Qualifying Real Property Definition for Section 179 Purposes

Qualified real property is [IRC Sec. 179(f)]:

1. qualified improvement property described in IRC Sec. 168(e)(6),
2. any of the following improvements added to nonresidential real property placed in service by the taxpayer after the date the nonresidential real property was first placed in service by any person and that is Section 1250 property: (a) roofs, (b) heating ventilation and air-conditioning property, (c) fire protection and alarm systems, or (d) security systems.

For property placed in service in a year beginning before 2018, qualified real property was either:

1. qualified leasehold improvements described in IRC Sec. 168(e)(6) as in effect before 2018,
2. qualified restaurant improvements described in IRC Sec. 168(e)(6) as in effect before 2018 (which included both building and improvement costs), or
3. qualified retail improvements described in IRC Sec. 168(e)(8) as in effect before 2018.

Note: Generally, the post-2017 definition of qualified real property that can qualify for Section 179 expensing is more expansive than the pre-2018 definition, since improvements to any nonresidential building qualify, not just those to leased property or property used in a retail or restaurant business. Rev. Proc. 2019-8 explains how taxpayers elect to treat qualified real property as Section 179 property. Taxpayers can elect to expense under IRC Sec. 179(a) the cost (or a portion of the cost) of qualified real property placed in service in a tax year beginning after 2017 on the originally filed return, or an amended return. If the taxpayer expenses only a portion of the cost of qualified real property on the originally filed return, they can increase that portion by filing an amended return.

No Proration of Section 179 Expense Deduction Required

If Section 179 property is placed in service part way through a tax year, no proration of the Section 179 expense deduction is required. Similarly, if Section 179 property is placed in service in a short tax year, no proration of the Section 179 expense deduction is required [Reg. 1.179-1(c)].

Example 15F-1: Section 179 expense deduction in a short year.

The Loser Partnership started business on December 1, 2019, and has a December 31 year-end. On December 10, 2019, Loser placed in service a machine acquired that day for $25,000. No other depreciable assets were placed in service during the current year. If Loser so desires, $25,000 can be expensed in the 2019 tax year under IRC Sec. 179 (subject to the other Section 179 expense limitations explained in this key issue), even though Loser's initial tax year consisted of only one month.

Section 179 Expense Deduction Is Not Subject to UNICAP

Amounts allowed as a deduction under IRC Sec. 179 are not subject to the Section 263A uniform capitalization (UNICAP) rules [Reg. 1.179-1(j)].

Computing the Section 179 Deduction for Vehicles

Vehicles that are not classified as passenger autos also qualify for the Section 179 deduction (up to $1.02 million for qualifying assets placed in service in tax years beginning 2019) when used over 50% for business.

However, heavy SUVs (those with gross vehicle weight ratings between 6,001 and 14,000 pounds) are subject to a reduced Section 179 allowance of only $25,500 (for 2019) [IRC Sec. 179(b)(5)]. It is important to understand that the reduced Section 179 deduction rule only applies to vehicles that are classified as SUVs for tax purposes.

Note: The $25,000 Section 179 allowance for heavy SUVs is adjusted annually for inflation [IRC Sec. 179(b)(6)(A)].

The reduced $25,500 (for 2019) Section 179 deduction rule does not affect vehicles that are not considered to be SUVs under the tax law. For this purpose, non-SUVs are defined to include the following [IRC Sec. 179(b)(5)(B)(ii)]:

1. Vehicles designed to seat more than nine passengers behind the driver's seat. Many shuttle vans qualify for this exception.

2. Vehicles equipped with a cargo area that is not readily accessible directly from the passenger compartment and that is at least six feet in interior length. Many pickups with full-size cargo beds qualify for this exception.

3. Vehicles with: (a) an integral enclosure that fully encloses the driver's compartment and load carrying device, (b) no seating behind the driver's seat, and (c) no body section protruding more than 30 inches ahead of the leading edge of the windshield. Many delivery vans qualify for this exception.

Taxable Income from Active Conduct of Trade or Business

A partnership's net income from actively conducted trades or businesses is calculated by considering the aggregate amount of items described in IRC Sec. 702(a) other than credits, tax-exempt income, and guaranteed payments under IRC Sec. 707(c). With these exceptions, virtually all profit and loss items are included in the partnership's taxable income [Reg. 1.179-2(c)(2)(iv)]. Specifically included in the definition of taxable income from an active trade or business are Section 1231 gains from such businesses and interest income earned from working capital used in such businesses [Reg. 1.179-2(c)(1)].

A partner's taxable income from active trade or business activities includes his pass-through share of all partnership taxable income from the active conduct of any of the partnership's trades or businesses—as long as the partner is engaged in the active conduct of at least one of the trades or businesses [Reg. 1.179-2(c)(2)(v)].

At the individual partner level, Reg. 1.179-2(c)(6)(iv) provides that wages, salaries, tips, and other employee compensation are considered taxable income from the active conduct of a trade or business. An employee's income is not reduced by unreimbursed employee business expenses in arriving at the taxable income limit. And, if a joint return is filed, the taxable incomes of both spouses are aggregated—even though the Section 179 expense deduction may be related to the activities of only one spouse [Reg. 1.179-2(c)(7)].

Note: The determination of *active conduct* is based on facts and circumstances and requires meaningful participation in the trade or business's management or operations. However, the active conduct standard used in determining a taxpayer's taxable income from the active conduct of a trade or business is not the same as the material participation standard used under the passive activity loss (PAL) rules. Property held for income production

or used in an activity not engaged in for profit (e.g., a hobby) does not qualify as Section 179 property; and the taxable income from such activities does not count as income from an active trade or business. For these purposes, the definition of a trade or business also includes rental activities. It seems reasonable that a taxpayer who meets the Section 469(i) *active participation* test should include the taxable income (or loss) from rental activities for purposes of the Section 179 taxable income limitation [Reg. 1.179-2(c)(6)].

Application of Taxable Income Limitation to Partnerships and Partners

The taxable income limitation applies at both the partnership and partner levels. Thus, a partnership cannot allocate a Section 179 expense deduction that exceeds its taxable income limitation for that year. Similarly, a partner cannot deduct Section 179 expense (including the amount passed through by the partnership) in excess of his taxable income from all active trade or business activities.

The taxable income limit at the partnership level is computed without regard to deductions suspended at the partner level (for example, suspended PALs or at-risk losses). At the partner level, suspended losses are not considered in computing the partner's taxable income limitation until they become deductible.

In calculating the partnership-level taxable income limitation, all of the partnership's trade or business income and deduction items are counted, including amounts required to be separately stated under IRC Sec. 702(a). However, the partnership-level taxable income limitation is to be calculated without regard to guaranteed payment deductions. At the partner level, the taxable income from the partnership is the partner's allocable share of the partnership's taxable income from trades or businesses as previously defined.

Carryover of Section 179 Expense Deductions Limited by the Taxable Income Limitation

If, because of the taxable income limitation, the taxpayer cannot fully deduct the cost of property for which the Section 179 election is made, the disallowed deduction is carried forward indefinitely—until the taxpayer has sufficient taxable income from the active conduct of a trade or business. However, the limit on deducting the disallowed Section 179 expense in a carryover year is the lesser of—

1. the aggregate amount disallowed under the taxable income limitation for all prior tax years (to the extent not previously allowed as a deduction), or

2. the amount of any "unused Section 179 expense allowance" for the tax year.

The "unused Section 179 expense allowance" for a tax year equals the excess (if any) of—

1. the maximum cost of Section 179 property the taxpayer can deduct for the tax year after applying the dollar limitation and the taxable income limitation, minus

2. the Section 179 property the taxpayer actually elects to expense under IRC Sec. 179 for the tax year.

Special Carryover Rules for Partnerships and Partners

The taxable income limitation applies at both the partnership and the partner levels. Accordingly, there can potentially be Section 179 expense carryovers at the partnership level and at the partner level with respect to Section 179 property for which the expensing election was made by the partnership. When the taxable income limitation applies at the partnership level, the partnership must still reduce the Section 179 property's basis by the full amount expensed under the Section 179 election. The disallowed deduction is carried forward by the partnership and has no immediate impact on the partners.

In *Hayden*, the taxpayer challenged the validity of the partnership's taxable income limitation as set forth in Reg. 1.179-2(c)(2). The Tax Court concluded the regulation is valid and the decision was upheld by the Seventh Circuit. The LLC in question (treated as a partnership for federal tax purposes) had a tax loss in 1994 before taking into account the attempted pass-through to its members (treated as partners) of the Section 179 expense deduction.

Example 15F-2: Taxable income limitation causes carryover at partnership level.

ABC (a calendar-year partnership) owns and operates a restaurant. In the current year, ABC purchases and places in service two items of Section 179 property—a cash register costing $3,000 and office furniture costing $8,000. ABC elects to expense under IRC Sec. 179 the full $11,000 cost of both items.

ABC has $6,000 of taxable income for the year (before any Section 179 expense deduction) derived from the active conduct of its restaurant business. Therefore, ABC can deduct only $6,000 of Section 179 expense and must carry forward the remaining $5,000 at the partnership level. ABC must reduce the Section 179 property's adjusted basis by the full amount elected to be expensed—i.e., by $11,000. However, ABC cannot allocate to its partners any portion of the $5,000 carryover until ABC is able to deduct it under the carryover deduction rules explained earlier. (The carryover amount apparently does not reduce the tax bases of partners' interests until it is allowed as a deduction at the partnership level.)

Claiming Section 179 Expense Deductions in Excess of What Partners Can Use. A partnership that claims large Section 179 expense deductions can potentially cause a problem at the partner level, because the annual Section 179 expense deduction limitation also applies at the partner level. This issue is most likely to arise when a partner has Section 179 expense deductions coming from other sources (such as interests in other partnerships or S corporations). What happens to the excess Section 179 expense deduction (the amount that exceeds the annual limitation)? There does not appear to be any provision that allows an affected partner to carry the excess amount forward to future tax years. In other words, the excess Section 179 expense deduction amount apparently goes up in smoke. This problem can be corrected by having the partnership amend its Form 1065 to claim a smaller Section 179 expense deduction. However, it is better to avoid the whole problem on the front end by claiming a smaller Section 179 expense deduction on the partnership's original return.

Effect of Property Dispositions on Section 179 Expense Deduction Carryovers

If there is a disposition of property to which an unused Section 179 expense carryover applies, the partnership can adjust the property's basis upward by the unused Section 179 expense carryover.

As stated earlier, the taxable income limitation can also come into play at the partner level. If Section 179 expense is passed through by the partnership, the partner's basis in his interest is reduced—even if he gets no current deduction because of the taxable income limitation at his level. However, if the partner disposes of his partnership interest while Section 179 expense deduction carryovers are still allocable to that interest, the partner can increase the basis in his interest immediately prior to the disposition by the unused Section 179 expense deduction carryover allocable to the partnership interest.

Example 15F-3 illustrates the carryover rules when a taxable income limitation applies at the partner level, and the disallowed Section 179 expense deduction is allocable to partner assets other than the partnership interest.

Example 15F-3: Taxable income limitation causes carryover at partner level.

Gordon is a general partner in GeeDee, a calendar year partnership. Gordon (a calendar year taxpayer) is active in the partnership's business. In the current year, GeeDee allocates $3,000 of Section 179 expense and $15,000 of taxable income (determined without regard to the Section 179 expense deduction) to Gordon. The income was derived from GeeDee's active conduct of a trade or business.

In addition to being a partner in GeeDee, Gordon conducts a business as a sole proprietor. In the current year, he purchases and places in service office equipment costing $32,000 for his sole proprietorship. Gordon elects under IRC Sec. 179 to expense $22,000 of these costs. Assume that Gordon has a $12,500 taxable loss (determined without regard to the Section 179 expense deduction), derived from the active conduct of this sole proprietorship business.

Gordon's taxable income limitation for the year is $2,500 ($15,000 taxable income from GeeDee less $12,500 taxable loss from his sole proprietorship). Therefore, Gordon can deduct only $2,500 of the elected $25,000 of Section 179 expense. Gordon notes in the appropriate books and records that he chooses to deduct $2,500 of the Section 179 expense allocated from GeeDee, and he carries forward the $22,000 of Section 179 expense allocable to the office equipment purchased for his sole proprietorship plus the remaining $500 from GeeDee (for a total carryforward of $22,500).

On January 1 of the following year, Gordon sells the office equipment used by the sole proprietorship. Immediately before the sale, Gordon increases the office equipment's adjusted basis by $22,000—the amount of the unused carryover of Section 179 expense deduction allocable to the office equipment.

Example 15F-4 illustrates the carryover rules when the taxable income limitation applies at the partner level, and the disallowed Section 179 expense deduction is allocable to the partnership interest.

Example 15F-4: Partner's taxable income limitation causes carryover of Section 179 expense from partnership.

Assume the same facts as in Example 15F-3, except Gordon notes in the appropriate books and records he chooses to deduct $2,500 of the Section 179 expense relating to his sole proprietorship. He decides to carry forward the remaining $19,500 of Section 179 expense relating to the sole proprietorship plus the $3,000 of Section 179 expense from GeeDee (for a total carryforward of $22,500).

On January 1 of the following year, Gordon sells his partnership interest to Alvin. Immediately before the sale, Gordon increases the adjusted basis of his partnership interest by $3,000—the unused carryover of Section 179 expense deduction allocable to the partnership interest.

Noncorporate Lessors Are Generally Ineligible for Section 179 Deductions

Noncorporate lessors, which would include partnerships, are generally prohibited from claiming Section 179 expense deductions for the cost of property that is leased to other parties [IRC Sec. 179(d)(5)]. However this restriction does not apply in the following two circumstances:

- The noncorporate lessor manufactured or produced the leased property in question.
- Under a two-pronged test (1) the term of the lease (counting options to renew) is *less* than 50% of the class life of the leased property as defined by IRC Sec. 168(i), and (2) for the first 12 months after the property is transferred to the lessee, the lessor's deductions allowed solely by IRC Sec. 162 with respect to the leased property *exceed* 15% of the rental income produced by the leased property. Since depreciation under IRC Sec. 167, taxes under IRC Sec. 164, and interest expense under IRC Sec. 163 are not Section 162 expenses, they are ineligible for purposes of the more-than-15%-of-rental-income test.

Example 15F-5: Noncorporate lessor restriction does not apply.

The Lessor Partnership (LP) is in the equipment leasing business. All of LP's equipment is leased under short-term and medium-term leases, the terms of which are less than 50% of the Section 168(i) class lives of the property. Therefore, the first prong of the preceding test is passed.

In the first 12 months after the equipment is transferred to lessees, the Section 162 expenses allocable to leased equipment typically exceed 15% of the rental income. LP's Section 162 expenses include commissions paid to leasing agents, allocable marketing expenses, and allocable general and administrative expenses. For such equipment, the second prong of the preceding test is also passed. Since both prongs of the test are passed for such equipment, the noncorporate lessor restriction on Section 179 expense deductions does not apply to such equipment.

Trusts and Estates Are Ineligible for Section 179 Deductions

While the Section 179 election is made at the partnership level, the tax benefits are reaped at the partner level. Unfortunately, trust and estate partners are ineligible for the Section 179 expensing privilege [IRC Sec. 179(d)(4)]. Nevertheless, the partnership should make the election when other partners will benefit.

Depreciable personal property additions allocable to trust and estate partners that otherwise would be immediately deducted under IRC Sec. 179 must be capitalized and depreciated using any allowable depreciation method with the depreciation expense allocated to the trust and estate partners. (Allowable methods are summarized in Key Issue 15A.) This will create temporary outside basis imbalances between the trust and estate partners and the other partners until the affected property is fully depreciated, sold, or otherwise disposed of.

Observation: Alternatively, the partnership agreement could call for Section 179 expense deductions to be specially allocated *away* from any trust and estate partners. Then, they could be specially allocated additional *regular* depreciation deductions or other deductions to make up for the difference. There is some risk that the IRS could view this approach as creating insubstantial allocations (Chapter 26 explains insubstantial allocations). In the authors' opinion, it is doubtful that the insubstantial allocation concept was meant to prohibit allocations that are

primarily intended to compensate for outside basis discrepancies between trust and estate partners and other partners that would otherwise be caused by the ineligibility of trust and estate partners for Section 179 expense deductions. That said, another alternative to avoid such outside basis discrepancies is to simply avoid claiming Section 179 expense deductions for partnerships that have trust or estate partners.

Disposition of Section 179 Property and Recapture of the Section 179 Expense Deduction

Asset Sold. If Section 179 property is sold by a partnership, the amount of the Section 179 expense previously taken is treated as depreciation and must be recaptured under IRC Sec. 1245 to the extent of any gain realized on the disposition [IRC Sec. 1245(a) and Reg. 1.179-1(e)(3)].

According to the instructions to Schedule K-1, line 20, code L, and the instructions to Form 4797, a partnership that sells or otherwise disposes of property for which a Section 179 expense deduction was previously claimed and passed through to the partners does not report the sale transaction on Forms 4797 *(Sales of Business Property)*, 4684 *(Casualties and Thefts)*, 6252 *(Installment Sales)*, or 8824 *(Like-Kind Exchanges)*. Instead, the information to calculate Section 179 expense recapture must be provided to the affected partners on Schedule K-1 attachments so the partners can fill out these forms with their own returns. See Example 15F-6. Recapture does not apply when Section 179 expense deductions are carried over as opposed to actually deducted.

Decline in Business Use. If property for which a Section 179 expense deduction was claimed ceases to be used more than 50% in business at any time before the end of the property's recovery period, partial recapture of the deduction is required [IRC Sec. 179(d)(10) and Reg. 1.179-1(e)]. Recapture does not apply when Section 179 expense deductions are carried over as opposed to actually deducted.

According to the instructions to Schedule K-1, line 20, code M, the partnership must provide the following information when the business use of any property declines to 50% or less:

1. The partner's distributive share of the original basis and depreciation allowed or allowable (not including the Section 179 expense deduction).

2. The partner's distributive share of the Section 179 expense deduction (if any) passed through for the property and the partnership's tax years in which the deduction was passed through. See Example 15F-6.

Observation: According to the instructions for Form 1040, Schedule SE, the recapture income resulting from the decline in the business use of the Section 179 property is subject to self-employment (SE) tax. See Example 15F-6.

Example 15F-6: Disposition of Section 179 property and recapture of Section 179 expense deduction.

Susan Simpson owns a 50% general partnership interest in the SOS Partnership (a calendar-year taxpayer), and she materially participates in the partnership's business activity. The remainder of this example relates only to Susan's portion of SOS's transactions.

On January 15, 2017, SOS placed in service Asset #1, which cost $25,000 and is five-year MACRS recovery property. SOS claimed a $25,000 Section 179 expense deduction in 2017 for the entire cost of Asset #1. On July 1, 2019, SOS sells Asset #1 for $52,000, which triggers $25,000 of Section 1245 recapture and requires that certain information be provided to the partners.

On January 8, 2018, SOS placed in service Asset #2, which cost $35,000 and is five-year MACRS recovery property. SOS used Asset #2 100% for business and claimed a $35,000 Section 179 expense deduction for Asset #2 on its 2018 return. On July 1, 2019, the business-use percentage for Asset #2 drops to 0%, which triggers the Section 179 expense deduction recapture rule and requires that certain information be provided to the partners.

The MACRS depreciation deductions that would have been allowed to SOS for Asset #2 without the Section 179 expense deduction are as follows:

For 2018 (20% × $35,000)	$ 7,000
For 2019 (.5 × 32% × $35,000)	5,600
Total	$ 12,600

Therefore, SOS has $22,400 of Section 179 expense recapture in 2019 with respect to Asset #2 ($35,000 Section 179 expense deduction minus $12,600 of depreciation that would have been allowed without the Section 179 expense deduction). SOS increases its basis in Asset #2 by $22,400 to account for the Section 179 expense recapture.

Susan deducted her 50% share of Section 179 deductions from Asset #1 and Asset #2. Her share of the total gain from selling Asset #1 is $26,000, which consists of $12,500 of Section 1245 recapture and $13,500 of Section 1231 gain. Susan's share of the Section 179 expense recapture from Asset #2 is $11,200. Therefore, Susan's total gain is $37,200 ($12,500 + $13,500 + $11,200).

Illustration 15-2 shows the recapture information required to be provided by SOS to Susan with her 2019 Schedule K-1.

KEY ISSUE 15G Short Year Depreciation.

Special rules apply when a partnership has a short year. Generally, under Rev. Proc. 89-15, the depreciation deduction for a short year is prorated, depending on the number of months in the short year. (All information in this key issue is based on Rev. Proc. 89-15.) A partnership may choose between two alternate methods for computing the depreciation in subsequent years.

Depreciation for Property Placed in Service or Disposed of during a Short Year

The first step in computing short year depreciation is to determine whether the half-year or midquarter convention applies. The midquarter convention applies if the aggregate basis of property placed in service during the last three months of the tax year exceeds 40% of the aggregate basis of property placed in service for the entire year. Thus, if the short year consists of three months or less, the midquarter convention automatically applies, since it is the last three months of the short year that is used as the test, irrespective of how long the short year is.

Example 15G-1: Midquarter convention required.

The Gogetum Partnership has a short year of two and one-half months. On the first day of the short year, Gogetum purchased new equipment for $200,000. On the last day of the short year, it purchased $100,000 of new equipment. Since the short year is three months or less, the midquarter convention applies to all new equipment, because 100% of the basis of property was placed in service during the last three months.

Example 15G-2: Midquarter convention not required.

Assume the same facts as in Example 15G-1, except Gogetum has a short year of four months. Now the midquarter convention would not apply, since only 33⅓% ($100,000 ÷ $300,000) of the purchased properties were placed in service during the last three months of the short year.

Computing the Midpoint of the Short Year under the Half-year Convention

When using the half-year convention, the midpoint is determined by dividing the number of months in the short year by two. Partial months are treated as an entire month in computing the number of months in the short year.

Example 15G-3: Determining the midpoint of a short year.

The Newdeal Partnership has a short year that started on August 11 and ended on December 31. Since each partial month is treated as a full month, the short year will consist of five months (August–December) and the midpoint will be the middle of October. Thus, all property will be treated as placed in service on October 15th.

No month may be counted more than once. Thus, if there are two successive short years, with the first year ending and the second year beginning in the same month, the first short year cannot include the month in which the first short year terminates.

Example 15G-4: Two successive short years.

The Crazy Partnership's first short year begins March 21 and ends September 22. The second short year begins September 23 and ends December 31. The first short year consists of six months (March–August), since the final month is not included in the first short year when there is a second, successive short year. The second short year has four months (September–December).

If a partnership's short year begins *and* ends on other than the first or last day of the month, the length of the tax year is expressed as the number of days in the short year. The midpoint is then computed by dividing the number of days by two. If the midpoint is any day other than the first day or midpoint of the month, the deemed midpoint is the nearest preceding first day or midpoint of the month.

Example 15G-5: Determining the midpoint when the short year begins and ends on a day other than the first or last of a month.

The Righton Partnership has a short tax year that begins April 12 and ends September 23. There are 164 days in the short year. The short year's midpoint is the 82nd day, which is July 3. The midpoint for the year is therefore deemed to be July 1, the nearest preceding first day or midpoint of a month.

Computing the Midpoint of a Short Year Using the Midquarter Convention

If a partnership is required to use the midquarter convention, the short year is divided into quarters. If the short year consists of four or eight full calendar months, this is easy to do and each quarter's midpoint is either the midpoint of the month (four-month year) or the first of the month (eight-month year).

Example 15G-6: Computing the midquarter convention midpoint in an eight-month short year.

The Getrich Partnership has a short year beginning May 1 and ending December 31. Each quarter consists of two months, and the midpoint of each quarter is the first day of the second month of each quarter.

If the short year consists of anything other than four or eight full months, the quarters are determined by dividing the number of days in the short year by four. The midpoint is then determined by dividing the number of days in each quarter by two. If the midpoint is anything other than the first day or midpoint of a month, the deemed midpoint is the nearest preceding first day or midpoint.

Example 15G-7: Computing the midquarter convention midpoint in a short year that does not consist of four or eight months.

The Growfast Partnership has a short year beginning June 7 and ending December 31. There are 208 days in the short year, and 52 (208 ÷ 4) days in each quarter. The arithmetic midpoint for each quarter is the 26th day. Growfast makes its depreciation calculations based on the following:

Quarters	Arithmetic Midpoint	Deemed Midpoint
June 7–July 28	July 2	July 1
July 29–Sept 18	August 23	August 15
Sept 19–Nov 9	October 14	October 1
Nov 10–Dec 31	December 5	December 1

No Short Year Adjustment under Midmonth Convention

Property placed in service under the midmonth convention is treated as placed in service or disposed of on the midpoint of the calendar month the property is placed in service. Thus, there is no adjustment for short years.

Computing First-year Depreciation in a Short Year

First-year depreciation for property placed in service in a short year is calculated by first computing the depreciation as though there were no short year and then multiplying that amount by the number of months the property was in service during the short year divided by 12. The number of months the property is deemed to be in service is computed as discussed earlier in this key issue.

Example 15G-8: Computing first-year depreciation in a short year.

The Wahoo Partnership has a short year that begins September 10 and ends December 31. Wahoo depreciates one asset using the midyear convention. For a 12-month year the depreciation would be $12,000. The depreciation for the short year is $4,000 ($12,000 × 4⁄12) since Wahoo has a four-month short year.

Computing Subsequent Years' Depreciation

Depreciation taken in a short year impacts the depreciation calculation in all subsequent years. A partnership can choose between two different methods of computing the depreciation in subsequent years, but once chosen, the method must be used consistently until the year of change to the straight-line method.

Under the *allocation method*, each tax year contains part of two different 12-month recovery years for depreciation. Depreciation is calculated for each recovery year and then each recovery year's depreciation is prorated by the number of months of the recovery year included in the tax year.

Example 15G-9: Using the allocation method in years subsequent to a short year.

The Confused Partnership had a five-month short year in 2018 resulting from starting up a business. Confused placed one asset in service during 2018. Under the allocation method, the 2019 depreciation amount includes seven months of depreciation from the first recovery year and five months of depreciation from the second recovery year. If the depreciation for the first recovery year is $12,000 and the depreciation for the second recovery year is $24,000, the 2019 depreciation amount is $17,000, computed as follows:

First recovery year ($12,000 × 7⁄12)	$ 7,000
Second recovery year ($24,000 × 5⁄12)	10,000
2019 depreciation	$ 17,000

Under the *simplified method*, the depreciation in any subsequent year is computed by multiplying the adjusted basis of the property on the first day of the year by the appropriate depreciation rate under the method and life used to depreciate the property.

Example 15G-10: Using the simplified method in years subsequent to a short year.

The Laidback Partnership started business in 2018 and had a short year of five months. It purchased a computer (MACRS five-year property with a 200% DB annual depreciation rate of 40%) for $30,000 in 2018 and deducted $5,000 of depreciation expense in that year ($30,000 × 40% × 5⁄12). Using the simplified method, the 2019 depreciation deduction is $10,000 [($30,000 – $5,000) × 40%]. For 2020 (the third recovery year), the depreciation deduction is $6,000 [($30,000 – $5,000 – $10,000) × 40%]. See Example 1 in section 5.04 of Rev. Proc. 89-15.

KEY ISSUE 15H Depreciating or Amortizing Basis Adjustments Due to Section 754 Elections.

Pursuant to a Section 754 election, a partnership can elect to adjust the basis of its assets under IRC Sec. 743(b) when there is a transfer of a partnership interest. (See Chapter 32.) Basis adjustments can also arise under IRC Sec. 734(b) due to certain partnership distributions. (See Chapter 33.)When a positive basis adjustment (step-up) is

assigned to depreciable or amortizable partnership property, the step-up is generally treated as a depreciable or amortizable property addition (i.e., newly acquired property). Accordingly, it must be depreciated or amortized, with the resulting additional deductions allocated to the transferee partner. Key Issue 15D explains how to report depreciation/amortization from basis adjustments. The method used to depreciate/amortize the step-up depends on the depreciation/amortization rules that apply to the underlying property.

The general rule is that a basis step-up is treated as newly-purchased property placed in service on the date the triggering partnership interest transfer takes place. The step-up can then be depreciated using the current-law MACRS rules—*regardless* of whether the underlying property is pre-ACRS, ACRS, or MACRS property. There is no effect on the underlying property—it continues to be depreciated as before.

A special rule applies to basis step-ups when the underlying property has Section 704(c) built-in gain, and the partnership uses the remedial allocation method to allocate depreciation. (See Chapter 27.) In such case, any basis step-up equal to the amount of Section 704(c) built-in gain is depreciated over the underlying property's remaining recovery period (i.e., that portion of the step-up is not treated as newly acquired property). Any basis step-up over and above the amount of Section 704(c) built-in gain is depreciated under the current-law MACRS rules (i.e., that portion of the step-up is treated as newly acquired property) [Reg. 1.743-1(j)(4)(i)(B)(2)]. (See Chapter 27 for a full discussion of Section 704(c) built-in gains.

Example 15H-1: Depreciating a positive basis adjustment.

Alvin, Betty, and Chuck are equal partners in the ABC Partnership. The partnership has a Section 754 election in effect. Chuck sells his interest to Clarice. The partnership has one depreciable asset, that is allocated a positive basis adjustment (step-up) of $2,500 with respect to Clarice. The $2,500 is treated as the cost of newly acquired MACRS property of the same nature as the underlying asset and is treated as being placed in service by the partnership on the date of the triggering partnership interest transfer.

Assume the underlying asset is five-year MACRS property and that the mid-year convention applies. Therefore, the first-year depreciation from the basis step-up is $500 (20% of $2,500). As a result, Clarice is allocated depreciation equal to the $500 plus her one-third share of the regular depreciation attributable to the common basis of the partnership asset in question (i.e. the depreciation computed based on the asset's historical adjusted basis). The depreciation deductions allocated to Alvin and Betty are unaffected by all this. [This example is based on Reg. 1.743-1(j)(4)(i)(C), Example 1.]

If there is a basis step-down allocable to depreciable property, the transferee partner is in effect allocated *negative depreciation* each year. The amount of negative depreciation is taken into account over the remaining depreciable life of the property. Each year's negative depreciation amount equals the negative basis adjustment multiplied by a fraction. The numerator of the fraction is the portion of the property's adjusted basis recovered that year (i.e., the amount of regular depreciation). The denominator is the property's remaining adjusted basis at the time of the partnership interest transfer that gave rise to the negative adjustment.

As long as the negative depreciation is less than or equal to the transferee partner's share of depreciation from the partnership's common basis, the effect is simply a reduced depreciation deduction. See Example 15H-2. However, if the negative depreciation exceeds the depreciation from the partnership's common basis, the transferee partner must report ordinary income equal to the excess. See Example 15H-3.

Example 15H-2: Negative depreciation from basis step-down.

Donna, Earl, and Frank are equal partners in the DEF Partnership. The partnership has a Section 754 election in effect. On December 31st, Frank sells his interest to Francie. The partnership has one depreciable asset that is allocated a negative basis adjustment (step-down) of $2,500. As of December 31st, the remaining adjusted basis of the asset in question was $15,000. During the following year, the depreciation attributable to the asset's common basis is $3,000. Of this Francie is allocated $1,000.

Francie is also allocated $500 of negative depreciation computed as follows: $2,500 × ($3,000 ÷ $15,000). Thus, her net depreciation deduction is $500 ($1,000 from common basis less $500 of negative depreciation). The depreciation deductions allocated to Donna and Earl are unaffected by all this. [This example is based on Reg. 1.743-1(j)(4)(ii)(C), Example 1.]

Example 15H-3: Too much negative depreciation.

Assume the same facts as in Example 15H-2, except the remaining adjusted basis of the asset on December 31 is only $6,000. During the following year, the depreciation attributable to the asset's common basis is $1,200, of this Francie is allocated $400.

Francie is also allocated $500 of negative depreciation computed as follows: $2,500 × ($1,200 ÷ $6,000). Thus, her net depreciation deduction is zero ($400 from common basis less $400 of negative depreciation). In addition, Francie must report $100 of ordinary income, to reflect the remaining $100 worth of negative depreciation. As in Example 15H-2, Donna and Earl are unaffected by all this. [This example is based on Reg. 1.743-1(j)(4)(ii)(C), Example 3.]

Bonus Depreciation on Section 743 Basis Adjustments

Positive Section 743(b) adjustments to the basis of partnership property pursuant to Section 754 elections can potentially qualify for bonus depreciation [Prop. Reg. 1.168(k)-2(b)(3)(iv)(D); Reg. 1.168(k)-2(b)(3)(iv)(D)]. A Section 743 basis increase meets the acquisition test if the following tests are met:

1. The partner acquiring the partnership interest did not have any depreciable interest in the property to which the basis adjustment is allocated before the transfer of the partnership interest.
2. The partnership interest is not acquired from a related person described in IRC Sec. 179(d)(2)(A) (which includes the acquiror's spouse, ancestors, and lineal descendents and controlled entities) or from a member of the same controlled group. For this test, whether parties are related is determined by comparing the transferor and the transferee of the partnership interest.
3. The partner acquiring the partnership interest does not determine his basis in the interest, in whole or in part, with reference to its basis in the hand of the transferor [such as when an interest is contributed to a corporation in a Section 351 exchange or to a partnership (or LLC classified as a partnership) under IRC Sec. 721] or under IRC Sec. 1014(a) or former IRC Sec. 1022 (related to property acquired from a decedent).

   Observation: This means that a basis adjustment made due to a transfer of the partnership interest at a partner's death does not qualify for bonus depreciation.

Specifically, bonus depreciation for a positive Section 743(b) basis adjustment is allowed when: (1) the basis adjustment relates to partnership bonus-depreciation eligible property and (2) the bonus depreciation used property acquisition requirements set forth in Prop. Reg. 1.168(k)-2(b)(3)(iii)(A) or Regs. 1.168(k)-2(b)(3)(iii)(A)(2) and (3) are met.

A positive basis adjustment generally is treated as newly purchased property placed in service when the transfer occurs. Any appropriate recovery period or method may be chosen by the transferee member to compute the depreciation for the basis increase [Reg. 1.743-1(j)(4)(i)(B)(1)].

Note: Reg. 1.743-1(j)(4)(i)(B)(2) indicates that when a partnership uses the remedial allocation method under Reg. 1.704-3(d) with respect to a built-in gain on an item of depreciable property (see Key Issue 27C), any portion of a positive basis adjustment under IRC Sec. 743(b) that is attributable to the Section 704(c) built-in gain must be recovered over the remaining recovery period for the partnership's excess book basis in the property (as determined under the remedial allocation method in Reg. 1.704-3(d)(2)). However, under final regulations issued in September 2019, that rule does not apply with respect to any Section 743 basis adjustment that is recovered using bonus depreciation, unless the property is held by a publicly traded partnership described at IRC Sec. 7704(b). In other words, the entire basis adjustment, regardless of whether any of it is attributable to Section 704(c) built-in gain, can qualify for bonus depreciation.

An election out of bonus depreciation for a certain class of property does not affect the ability to claim bonus depreciation for a Section 743 basis adjustment made to property in that class, and vice versa. So, bonus depreciation can be claimed with respect to a Section 743 basis adjustment (provided all other requirements are met), even if the partnership elected out of claiming bonus depreciation for all of its other qualified property in the same class placed in service in the same year. Likewise, the partnership can elect not to claim bonus depreciation for a Section 743 basis adjustment made to qualified property even if it did not make that election for all other qualified

property in the same class placed in service that year [Reg. 1.743-1(j)(4)(i)(B)(1)]. In this case, the basis adjustment must be recovered under a reasonable method.

Example 15H-4: Claiming bonus depreciation on a Section 743 basis adjustment.

Quinn, Robyn, and Sam form QRS Partnership in 2019. Each partner contributes $100,000 and shares equally in the partnership's results. QRS purchases a retail motor fuels outlet for $300,000. Assume the retail motor fuels outlet qualifies for bonus depreciation, but QRS elects not to deduct bonus depreciation for all qualified property placed in service during 2019. QRS has a Section 754 election in effect. QRS claimed depreciation of $15,000 for the retail motor fuels outlet for 2019. During 2020, when the retail motor fuels outlet's FMV is $600,000, Quinn sells his partnership interest to Thomas (who is unrelated to Quinn) in a fully taxable transaction for $200,000. Thomas did not have any depreciable interest in the retail motor fuels outlet before acquiring Quinn's interest in QRS. Thomas' outside basis in his QRS interest is $200,000. His share of the partnership's previously taxed capital is $95,000 [($300,000 – $15,000) ÷ 3]. Assuming all other requirements are met, Thomas's Section 743 basis adjustment is $105,000 and is allocated entirely to the retail motor fuels outlet. Thomas' Section 743 basis adjustment qualifies for bonus depreciation.

<u>Variation 1:</u> Now assume that instead of selling his interest to Thomas, Quinn sells his partnership interest to Ursula, his daughter. Because she is a person related to Quinn under IRC Sec. 179(d)(2)(A), Ursula's Section 743 basis adjustment does not qualify for bonus depreciation.

<u>Variation 2:</u> Now assume that QRS purchased the retail motor fuels outlet from Thomas before Thomas purchased Quinn's interest in QRS. Because he had a depreciable interest in the retail motor fuels outlet before he acquired Quinn's interest in QRS, Thomas's Section 743 basis adjustment does not qualify for bonus depreciation.

<u>Used Property Acquisition Requirements</u>. A Section 743(b) basis adjustment with respect to partnership bonus-depreciation-eligible property can meet the bonus depreciation used property acquisition requirements set forth in Prop. Reg. 1.168(k)-2(b)(3)(iii)(A) and Reg. 1.168(k)-2(b)(3)(iii)(A). See Key Issue 15B for a detailed discussion of the acquisition requirements.

The Preamble to Prop. Reg. 1.168(k)-(2) (found in REG-104397-18) notes that because a Section 743(b) basis adjustment is a partner-specific basis adjustment to partnership property, each partner is treated as having owned and used the partner's proportionate share of partnership property. The Section 743(b) basis adjustment with respect to partnership bonus-depreciation-eligible property can meet the bonus depreciation used property acquisition requirements as long as the transferee partner has not used the portion of the partnership property to which the basis adjustment relates at any time prior to the acquisition (that is, the transferee partner has not used the transferor partner's portion of partnership property prior to the acquisition).

Similarly, the transferee partner is treated as acquiring a portion of partnership property, and the transferor partner is treated as the person from whom the property is acquired.

However, the relationship between the transferor partner and the transferee partner cannot be a prohibited relationship under IRC Sec. 179(d)(2)(A). The transferor partner and transferee partner cannot be members of the same controlled group of corporations under IRC Sec. 179(d)(2)(B), and the transferee partner's basis in the partnership interest cannot be determined in whole or in part by reference to the transferor partner's adjusted basis or determined under IRC Sec. 1014(a).

The preceding considerations apply equally whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another partner. Assuming that the transferor partner's specific interest in partnership property has not previously been used by the transferee partner, the corresponding Section 743(b) basis adjustment will be eligible for bonus depreciation in the hands of the transferee partner, as long as all other requirements of IRC Sec. 168(k) are met.

<u>No Bonus Depreciation for Section 734(b) Basis Adjustments</u>. Positive Section 734(b) adjustments to the basis of partnership property pursuant to Section 754 elections cannot qualify for bonus depreciation because the used property acquisition requirements are not met [Prop. Reg. 1.168(k)-2(b)(3)(iv)(C); Reg. 1.168(k)-2(b)(3)(iv)(C)]. As

explained in Chapter 33, Section 734(b) basis adjustments can arise when partnership property is distributed to partners.

Step-up or Step-down Relates to Section 197 Intangible Asset

If the transferred asset was an amortizable Section 197 asset in the hands of the transferor, the transferee continues to amortize the basis of the asset (to the extent it does not exceed the transferor's basis) over the remainder of the transferor's 15-year amortization period. If the transferred asset was not amortizable to the transferor, it cannot be amortized (to the extent it does not exceed the transferor's basis) by the transferee. Any basis adjustment allocable to an amortizable Section 197 intangible is amortized as a new Section 197 intangible acquired at the time of the transaction that caused the basis increase [IRC Sec. 197(f)(2) and Reg. 1.197-2(g)(3)].

However, if the transferor and transferee partners are related parties, an antichurning rule explained later in this key issue may prevent the transferee partner from amortizing the step-up. This would occur if the underlying asset is not amortizable under the Section 197 rules—for example because it predates the August 11, 1993, effective date for the Section 197 provisions and was not eligible for amortization under pre-Section 197 law [IRC Sec. 197(f)(9) and Regs. 1.197-2(g)(3), (h)(1), and (h)(5)].

Presumably, a negative basis adjustment with respect to an amortizable Section 197 asset is handled in the same fashion as a negative basis adjustment with respect to a depreciable asset. As long as the negative amortization is less than or equal to the transferee partner's share of amortization from the partnership's common basis, the effect is simply a reduced deduction. However, if the negative amortization exceeds the amortization from the partnership's common basis, the transferee partner must report ordinary income equal to the excess.

Example 15H-5: Negative amortization from basis step-down.

Glenn, Honor, and Indigo are equal partners in the GHI Partnership. The partnership has a Section 754 election in effect. On December 31st, Indigo sells her interest to Ignacio. The partnership has one amortizable Section 197 asset that is allocated a negative basis adjustment (step-down) of $2,500. As of December 31st, the remaining adjusted basis of the asset was $48,000. During the following year, the amortization attributable to the asset's common basis is $4,000, of this Ignacio is allocated $1,333.

Ignacio is also allocated $208 of negative amortization computed as follows: $2,500 × ($4,000 ÷ $48,000). Thus, his net amortization deduction is $1,125 ($1,333 from common basis less $208 of negative amortization). The amortization deductions allocated to Glenn and Honor are unaffected by this.

Example 15H-6: Too much negative amortization.

Assume the same facts as in Example 15H-5, except the remaining adjusted basis of the amortizable Section 197 asset on December 31st was only $6,000. During the following year, the amortization attributable to the asset's common basis is $1,000, of this Ignacio is allocated $333.

Ignacio is also allocated $417 of negative amortization computed as follows: $2,500 × ($1,000 ÷ $6,000). Thus, his net amortization deduction is zero ($333 from common basis less $333 of negative amortization). In addition, Ignacio must report $84 of ordinary income, to reflect the remaining $84 worth of negative amortization. As in Example 15H-5, Glenn and Honor are unaffected by this.

Impact of Anti-churning Rules on Basis Adjustments Allocable to Intangibles

Business intangibles acquired after August 10, 1993, generally are eligible for 15-year amortization under the Section 197 rules. However, IRC Sec. 197 also includes *anti-churning rules* intended to prevent *related taxpayers* from buying and selling intangible assets among themselves (*churning*) to create *new* intangibles eligible for the 15-year amortization privilege [IRC Sec. 197(f)(9)]. When an intangible asset is acquired from an unrelated taxpayer [within the meaning of IRC Sec. 197(f)(9)], the anti-churning rules will *never* apply. Note also that the anti-churning rules only apply to intangibles that were *not* eligible for amortization or depreciation under pre-Section 197 law. The two classic examples are goodwill and going concern value.

Finally, note that the anti-churning rules apply *only* to intangible assets that existed as of August 10, 1993 (the day before the general effective date of the Section 197 rules) or as of July 25, 1991 (the day before the earlier effective date for taxpayers that elected earlier application of the Section 197 rules). In summary, the Section 197 anti-

churning rules will *never* apply to intangible assets that were not in existence as of August 10, 1993. However, lots of valuable intangibles that are still around did exist as of August 10, 1993, so the anti-churning rules continue to be important even at this late date.

When applying the Section 197 anti-churning rules in the context of the partnership basis adjustment provisions, determinations are to be made at the partner level [IRC Sec. 197(f)(9)(E); Reg. 1.197-2(h)(12)(i)]. For instance, when a partner acquires a partnership interest from another partner, it can trigger a positive adjustment (step-up) to the basis of the transferee (acquiring) partner's share of an intangible partnership asset under IRC Sec. 743(b) (Chapter 32). Under the Section 197 anti-churning rules, the transferee partner is effectively treated as directly acquiring an interest in the intangible from the transferor partner. Note that under IRC Sec. 732(d), similar step-ups can occur with respect to distributee partners for property distributed by partnerships without Section 754 elections in place (Chapter 33).

When a partnership distributes cash in excess of a distributee partner's basis in his partnership interest, a step-up to the basis of a partnership intangible asset can be triggered under IRC Sec. 734(b) if the partnership has a Section 754 election in force (Chapter 33). Under the Section 197 anti-churning rules, the other partners are effectively treated as directly acquiring increased interests in the intangible from the distributee partner. (See Example 15H-9.)

When a partner receives a partnership intangible asset as part of a liquidating distribution, it can trigger a step-up to the distributee partner's basis in the intangible under IRC Sec. 732(b) (Chapter 33). For purposes of the Section 197 anti-churning rules, the distributee partner is effectively treated as acquiring the intangible directly from the continuing partners (Examples 15H-10 and 15H-11).

The general rule is that the step-up amount is treated as the cost of a new Section 197 intangible asset, with 15-year amortization allowed [Reg. 1.197-2(g)(4)]. However, if the intangible asset receiving the basis step-up is potentially covered by the anti-churning rules (i.e., the intangible asset existed on August 10, 1993, and was *not* amortizable or depreciable under pre-Section 197 law), *amortization of the basis step-up may be disallowed.*

More specifically, an intangible may be ineligible for 15-year amortization when acquired from a related party, as defined by IRC Secs. 267(b) and 707(b)(1) after substituting 20% for 50% in those Code Sections [IRC Sec. 197(f)(9)(C)(i)]. For example, a partial list of related parties for Section 197 anti-churning purposes includes—

- spouses, brothers, sisters, ancestors, and lineal descendants;
- a corporation and a partnership if the same person owns over 20% (by value) of the corporation's stock and over 20% of the capital or profits interests in the partnership (constructive ownership rules may apply here);
- a partnership and a person owning (directly or indirectly) over 20% of the capital or profits interests in the partnership; and
- two partnerships if the same persons own (directly or indirectly) over 20% of the capital or profits interests in both partnerships.

Example 15H-7: Section 754 basis step-up for intangible.

On January 1, 2019, Arnie and Beth formed the AB Partnership. Arnie is a 40% partner, and Beth owns the remaining 60%. Beth contributed $120,000 cash for her interest in AB. In exchange for his interest in AB, Arnie contributed an intangible asset that is not amortizable under IRC Sec. 197 because he owned it as of August 10, 1993, and it was not amortizable or depreciable under pre-Section 197 law. The intangible had an $80,000 FMV and a $20,000 tax basis (the same as Arnie's pre-contribution basis). The intangible is not amortizable by AB because the partnership "steps into the shoes" of Arnie with respect to the intangible [Reg. 1.197-2(g)(2)(ii)].

On February 1, 2019, Arnie sells his AB interest to Alma—a person unrelated to Arnie—for $80,000. Assume AB has a Section 754 election in effect and that essentially nothing has happened since formation. Alma is entitled to a $60,000 step-up in basis under IRC Sec. 743(b). Assume that under the applicable basis adjustment rules the entire step-up is properly allocated to Alma's share of the intangible asset.

The anti-churning rules for step-ups attributable to Section 743(b) basis adjustments are found in Reg. 1.197-2(h)(12)(v). Under those provisions, the anti-churning rules do not apply as long as the person acquiring the partnership interest (Alma) is unrelated to the person transferring the interest (Arnie).

AB should treat the $60,000 step-up as the cost of a new Section 197 intangible asset and begin amortizing it over 180 months. The resulting amortization deductions must be reported to Alma because the entire $60,000 step-up belongs to her. [Adapted from Example 27 in Reg. 1.197-2(k).]

Example 15H-8: Anti-churning partner retains use of contributed intangible.

Assume the same facts as in Example 15H-7, except at the same time AB was formed, AB licensed the use of the intangible back to Arnie. Under the licensing agreement, Arnie continues to directly use the intangible for designated business purposes. Further assume that the sale of Arnie's interest in AB to Alma was part of a series of related transactions that were contemplated at the time AB was formed.

Arnie is considered an *anti-churning partner* under Reg. 1.197-2(h)(12)(vi)(B)(2)(i). This is because, under his licensing agreement with AB, Arnie remains a direct user of the intangible even after selling his AB interest to Alma. Under Reg. 1.197-2(h)(12)(vi)(A), this means the anti-churning rules apply to Alma's entire step-up amount because she acquired her AB interest from someone tainted by the anti-churning partner status. [Adapted from Example 27 in Reg. 1.197-2(k).]

Example 15H-9: Distribution causes partnership step-up in basis for non-amortizable intangible.

On January 3, 2016, Angie, Bill, and Chuck formed the ABC Partnership. Each of the three partners shares equally in profits, losses, and capital. In exchange for her partnership interest, Angie contributed a non-amortizable intangible asset that she developed before August 11, 1993. The intangible has a $150,000 FMV and a zero tax basis to Angie. Bill and Chuck each contributed $150,000 cash for their interests. Assume Angie and Bill are related parties under the Section 197 anti-churning rules, but neither is related to Chuck.

The intangible is not amortizable in the hands of ABC because the partnership "steps into the shoes" of Angie with respect to the asset [Reg. 1.197-2(g)(2)(ii)].

As of January 1, 2019, the value of the intangible has increased to $600,000. On that date, ABC distributes $300,000 cash to Bill in complete liquidation of his ABC interest. Assume ABC has a Section 754 election in effect. For simplicity, further assume Angie's basis in her interest immediately before the distribution to Bill is still the original zero and that Bill's and Chuck's bases in their interests are still the original $150,000 each.

Upon receiving the distribution, Bill recognizes a $150,000 tax gain under IRC Sec. 731(a)(1). This is the excess of the $300,000 cash received over his pre-distribution tax basis of $150,000. Since ABC has a Section 754 election in effect, Bill's tax gain triggers an offsetting $150,000 step-up to the basis of ABC's assets under IRC Sec. 734(b). Assume the entire step-up is allocated to the partnership's intangible asset. So, ABC's tax basis in the intangible is increased from zero to $150,000.

The anti-churning rules for step-ups attributable to Section 734(b) basis adjustments are found in Reg. 1.197-2(h)(12)(iv). Under these rules, Angie is ineligible to amortize her $75,000 share of the step-up because she is related to the distributee partner (Bill). However, since Chuck is unrelated to Bill, he is eligible to amortize his $75,000 share of the step-up under Reg. 1.197-2(h)(12)(iv)(B)(1). [This example is adapted from Example 31 in Reg. 1.197-2(k).]

Example 15H-10: Distribution of non-amortizable intangible to partner causes basis step-up.

Andy, Bob, and Claudia formed the ABC Partnership in 1990 and share partnership profits, losses, and capital equally. In 2019, the partnership distributes a non-amortizable intangible it developed before August 11, 1993, to Andy in liquidation of his ABC interest. The intangible has a $180,000 FMV and a tax basis of zero. At the time of the distribution, Andy's tax basis in his ABC interest is $150,000. Andy is unrelated to Bob and Claudia.

Under IRC Sec. 732(b), Andy's basis in the intangible asset distributed by the partnership becomes $150,000, which is a $150,000 step-up over ABC's basis in the asset. Andy is treated as having owned and used his ⅓ share of partnership assets, including the intangible.

Reg. 1.197-2(h)(12)(ii) indicates the anti-churning provisions apply only to the extent the Section 732(b) step-up exceeds the total unrealized appreciation in the value of the intangible allocable to partners unrelated to the distributee partner (Andy). Remember, Bob and Claudia are unrelated to Andy. Their combined share of the unrealized appreciation in the value of the intangible is $120,000 (⅔ of $180,000).

Therefore, $120,000 of the step-up is *not* subject to the anti-churning rules, and Andy can therefore amortize that amount over 15 years. The remaining step-up of $30,000 is subject to the anti-churning rules and cannot be amortized by Andy. In effect, Andy has two intangibles. The first one has a tax basis of $120,000 and is amortizable. The second one has a tax basis of $30,000 and is non-amortizable under the anti-churning rules. [Adapted from Example 28 in Reg. 1.197-2(k).]

Example 15H-11: Distribution of partnership's non-amortizable intangible to partner who acquired interest after effective date.

Assume the same facts as Example 15H-10, except only Bob and Claudia form the ABC Partnership. Andy acquires his one-third interest in ABC on January 1, 2004, for $150,000 cash. Assume Andy's tax basis in his ABC interest is still $150,000 when he receives the liquidating distribution of the partnership intangible in 2019.

The anti-churning rules do not apply to the resulting Section 732(b) step-up in the basis of the intangible distributed to Andy to the extent the step-up does not exceed the unrealized appreciation in the value of the intangible allocable to unrelated partners Bob and Claudia. Andy can amortize $120,000, just as he could in Example 15H-10.

Under Reg. 1.197-2(h)(12)(ii)(E), the anti-churning provisions do not apply to the step-up to the extent of Andy's share of the unrealized appreciation. His share is $60,000 (one-third of the total unrealized appreciation of $180,000), which actually exceeds the $30,000 remaining amount of the step-up. This favorable outcome is because (1) Andy is deemed to have acquired his ABC interest from an unrelated person after August 10, 1993, and (2) the intangible in question was acquired by ABC before Andy acquired his interest in the partnership. Andy is deemed to have acquired his ABC interest from an unrelated person because, at the time of his entry into the partnership, no ABC partner was related to him.

None of the $150,000 step-up is subject to the anti-churning rules. So Andy can treat the entire $150,000 as a new Section 197 asset and amortize it over 15 years. [Adapted from Example 29 in Reg. 1.197-2(k).]

KEY ISSUE 15I Allocating Depreciation Recapture Income.

Before Reg. 1.1245-1(e)(2), partnerships often allocated recapture among the partners in proportion to the allocation of gain from sale of the recapture property. Under that procedure, the allocation of recapture income could have been inconsistent with the allocation of the depreciation that created the recapture income. Under the regulation, a partner's distributive share of recapture income is the *lesser* of—

1. the partner's share of the total gain from sale, or
2. the partner's share of prior depreciation or amortization deductions (allowed or allowable) with respect to the property.

Any remaining recapture income is allocated among the partners in proportion to (but not in excess of) their shares of the total gain. This allocation of recapture income will not necessarily follow how the related depreciation deductions were allocated. For instance, when a partnership interest is transferred, the depreciation recapture "potential" is transferred to the new partner even though that partner did not benefit from the related depreciation deductions.

When a partner contributes built-in gain property covered by the Section 704(c) rules discussed in Chapter 27, the contributing partner's share of prior depreciation or amortization deductions includes the allowed or allowable

deductions before the contribution. Therefore, the allocation of recapture income will "follow" the allocation of gain under the Section 704(c) rules. (See Chapter 27 for more on recapture allocations for contributed property.)

While the recapture allocation regulations are under IRC Sec. 1245, they also apply to Section 1250 depreciation recapture—because Reg. 1.1250-1(f) requires the use of Section 1245 principles in allocating Section 1250 recapture income among partners.

Example 15I-1: Allocating recapture when depreciation has been specially allocated.

Hub and Bub make equal contributions to form the Hubba Bubba Partnership (HBP). The partnership agreement "specially allocates" depreciation deductions 90% to Hub and 10% to Bub. Gains from property sales are allocated first in the amount necessary to equalize the partner's book capital accounts and then 50/50 thereafter.

After several years of operations, HBP sells a depreciable asset that originally cost $10,000. The partnership claimed $2,000 of depreciation deductions with respect to the asset, and the deductions were allocated 90% to Hub and 10% to Bub. The asset is sold for $10,400, which results in a $2,400 gain—$2,000 of which represents Section 1245 depreciation recapture. Under the partnership's gain allocation procedure, the first $2,000 of gain is allocated 90% to Hub and 10% to Bub to equalize their capital accounts. The remaining $400 of gain is allocated 50/50. Thus, under the partnership agreement, Hub will be allocated total gain of $2,000 (90% of the first $2,000 and 50% of the remaining $400) and Bub will be allocated total gain of $400.

Under the regulations, $1,800 of Section 1245 depreciation recapture income is allocated to Hub [the lesser of his share of the total gain ($2,000) or his share of prior depreciation deductions ($1,800)]. The remaining $200 of Section 1245 recapture income is allocated to Bub.

Variation: Assume the facts remain the same, except the asset is sold for only $9,500—resulting in a $1,500 gain, all of which is Section 1245 recapture income. Since Hub was allocated $1,600 more in prior depreciation deductions than Bub ($1,800 versus $200), the entire gain is allocated to Hub under the partnership agreement (because this allocation comes as close as possible to equalizing the partners' capital accounts). Under the regulations, the $1,500 of Section 1245 recapture income is allocated to Hub [the lesser of the total gain allocated to him ($1,500) or his share of the prior depreciation deductions ($1,600)].

Note: Intangible assets amortizable under IRC Sec. 197 are Section 1245 property and are thus subject to the Section 1245 recapture income allocation issue [IRC Secs. 197(f)(7) and 1245(a)(3)].

Allocations of Unrecaptured Section 1250 Gain

Unrecaptured Section 1250 gain is subject to a 25% maximum federal income tax rate. When depreciable real property held over one year is sold for a taxable gain, the unrecaptured Section 1250 gain component is the part that: (1) is attributable to depreciation deductions and (2) would otherwise be treated as Section 1231 gain eligible for the favorable long-term capital gain tax rates. In other words, it is the amount of long-term gain attributable to depreciation that is *not* required to be treated as ordinary income pursuant to the Section 1250 recapture rule.

Currently, there is no guidance on how unrecaptured Section 1250 gain should be allocated among partners when a partnership sells appreciated real estate. Pending such guidance, it is presumably permissible to follow the guidelines for allocating Section 1245 recapture, as explained earlier in this key issue. Reg. 1.1250-1(f) mandates that Section 1245 recapture allocation principles be followed in making allocations of Section 1250 ordinary income recapture, so this concept presumably applies to allocations of unrecaptured Section 1250 gains as well.

Note: Line 20, other information on the 2019 Schedule K-1, has added a code (code AD) for Section 1250 unrecaptured gain. Presumably, this will be for providing the information previously referenced. Practitioners should monitor the instruction to Schedule K-1 to confirm the reporting requirements for code AD.

KEY ISSUE 15J Depreciating Assets Acquired in Like-kind Exchange and Involuntary Conversion Transactions.

For exchanges where both the relinquished and the replacement property are transferred after 2017, only *real* property held for use in a trade or business or for investment qualifies for a tax-deferred like-kind exchange [IRC Sec.

1031(a)(1)]. Real property held for sale does not qualify for like-kind treatment [IRC Sec. 1031(a)(2)]. Before this law change, both real and personal property were eligible for like-kind treatment, as were intangibles such as patents or intellectual property.

Replacement property is MACRS property that is acquired in exchange for other MACRS property in Section 1031 like-kind exchanges or Section 1033 involuntary conversion transactions [Reg. 1.168(i)-6(b)(1)].

Relinquished property is the MACRS property given up by the taxpayer in exchange for the replacement MACRS property [Reg. 1.168(i)-6(b)(2)].

MACRS property generally means depreciable tangible property placed in service after 1986 that is depreciated under IRC Sec. 168 [Reg. 1.168(b)-1(a)(2)].

This key issue explains how to depreciate the exchanged basis amount and the excess basis amount:

- *Exchanged basis* is the taxpayer's depreciable basis in the replacement property after calculating year-of-disposition depreciation for the relinquished property. This usually equals the adjusted basis of the relinquished property after subtracting year-of-disposition depreciation [Regs. 1.168(i)-6(b)(7) and (9)].

- *Excess basis* is the taxpayer's additional depreciable basis (if any) in the replacement property over the exchanged basis. The excess basis usually equals any additional consideration paid (above the relinquished property) to acquire the replacement property. The excess basis is reduced by the amount of replacement property basis that is expensed under IRC Sec. 179 (if any) [Regs. 1.168(i)-6(b)(8) and (10)].

The depreciation method used by the previous owner of the replacement property (assuming that property is pre-owned) has no effect on the new owner. For example, if a partnership relinquishes MACRS property in exchange for replacement property that the previous owner depreciated under ACRS, the partnership (the new owner) can follow the regulations in calculating depreciation for the replacement property, because it's MACRS property in the partnership's hands. Similarly, depreciation elections made by the previous owner of the replacement property have no effect on the new owner's depreciation calculations. For example, if a partnership relinquishes MACRS property in exchange for other property that the previous owner depreciated using the alternative depreciation system (ADS) [pursuant to IRC Sec. 168(g)(7)], the partnership (the new owner) can depreciate the replacement property using the general MACRS system. The partnership is not required to continue using ADS to depreciate the replacement property [Reg. 1.168(i)-6(c)(2)].

Depreciating the Exchanged Basis Amount

The rules for determining the applicable recovery period (5 years, 10 years, 39 years, etc.), depreciation method [200% declining balance (DB), straight-line (SL), etc.], and convention (half-year, mid-quarter, mid-month) for depreciating the replacement property's exchanged basis amount are summarized below.

General Rule. The exchanged basis amount is depreciated over the remaining recovery period of the relinquished property using the same depreciation method (200% DB, SL, etc.) and the same depreciation convention (half-year, mid-quarter, etc). However, this general rule only applies when the replacement property has: (1) the same or shorter recovery period compared to the relinquished property and (2) the same or faster depreciation method compared to the relinquished property [Regs. 1.168(i)-6(c)(3)(ii), (4)(ii), and (4)(iv)].

Example 15J-1: General rule applies.

FlipCo Partnership, a calendar-year taxpayer, relinquishes Building O (an office building) in exchange for Building N (a warehouse) in a Section 1031 like-kind exchange. Building O is relinquished in July 2019, and Building N is acquired and placed in service three months later in October. Assume the unadjusted depreciable basis (original cost) of relinquished Building O was $4,680,000 when FlipCo placed it in service in July 2012. Under IRC Sec. 168, the prescribed recovery period for replacement Building N (39 years) and the prescribed depreciation method (straight-line) are the same as the prescribed period and method for relinquished Building O. Therefore, the general rule applies here.

This means FlipCo depreciates replacement Building N's exchanged basis amount over the remaining recovery period of relinquished Building O, using the same depreciation method and convention. Beginning in

October 2019, Building N is therefore depreciated using the SL method over 32 years (Building O's remaining recovery period was 32 years as of its disposition in July 2019).

FlipCo's 2019 depreciation deduction for relinquished Building O is $65,000 [($4,680,000 ÷ 39) × (6.5/12)]. Depreciation for Building O equals $10,000 per month. This makes sense because Building O cost $4,680,000 and was being depreciated over 468 months (39 × 12).

FlipCo's monthly depreciation deduction for replacement Building N's exchanged basis amount is also $10,000 because the exchanged basis equals $3,840,000 ($4,680,000 original cost for relinquished Building O minus $840,000 cumulative depreciation through July 2019) and the remaining recovery period is 384 months (32 × 12). For the subsequent years, the monthly depreciation deduction for Building N's exchanged basis amount will also be $10,000. Under the facts in this particular example, the results would be identical if FlipCo simply continued to follow the existing depreciation schedule (for relinquished Building O) after restarting the depreciation clock in October 2019 [Reg. 1.168(i)-6(c)(6), Example 1].

Electing Out of the General Rule. Sometimes, following the general rule can be disadvantageous. For instance, the taxpayer may be forced to depreciate the exchanged basis amount for replacement property that would otherwise have a shorter recovery period over the longer recovery period that applied to the relinquished property. Or, the taxpayer may be forced to depreciate the exchanged basis amount of the replacement property that would otherwise have a faster depreciation method using the slower method that applied to the relinquished property, or both. In such cases, the taxpayer would get faster depreciation write-offs if the replacement property were treated as newly acquired property. Fortunately, taxpayers are permitted to elect out of the general rule and, instead, treat the replacement property as newly acquired property placed in service at the time of replacement.

Example 15J-2: When electing out is beneficial.

RobinCo Partnership, a calendar-year taxpayer, placed Building R (a retail building) in service in January 2009. In January 2019, RobinCo exchanges Building R for Tower S (a radio transmitting tower) in a Section 1031 exchange. Since IRC Sec. 168 prescribes a shorter recovery period for replacement Tower S (15 years) than for relinquished Building R (39 years), the general rule says Tower S's exchanged basis amount must be depreciated over the longer remaining recovery period for Building R. Also, since the prescribed depreciation method for replacement Tower S (150% DB) is faster than the prescribed method for relinquished Building R (SL), the general rule says depreciation for Tower S must be calculated using the slower method for Building R. So following the general rule would require RobinCo to depreciate replacement Tower S's exchanged basis amount over 31 years (the remaining recovery period for relinquished Building R) using the SL method and the mid-month convention.

Alternatively, RobinCo could elect out of the general rule and treat Tower S as newly acquired property placed in service in January 2019. RobinCo could then depreciate Tower S's exchanged basis amount over 15 years using the 150% DB method. Electing out would generally make sense in this situation [Reg. 1.168(i)-6(c)(6), Example 3].

Replacement Property Has Longer Recovery Period or Slower Method. The general rule previously explained does not apply when the replacement property has either: (1) a longer recovery period compared to the relinquished property or (2) a slower depreciation method compared to the relinquished property.

When the replacement property's recovery period is longer, the replacement property's exchanged basis amount must be depreciated over the remainder of the longer period that would have applied if the replacement property had originally been placed in service back when the relinquished property was placed in service.

Similarly when the replacement property's depreciation method is slower, the replacement property's exchanged basis amount must be depreciated using the slower method that would have applied if the replacement property had originally been placed in service back when the relinquished property was placed in service.

Example 15J-3: Longer recovery period and/or slower method applies.

BillCo Partnership, a calendar-year taxpayer, placed Bridge P in service in January 2013 and depreciates it using the half-year convention. In January 2019, BillCo relinquishes Bridge P by exchanging it for Building Q

(an apartment building) in a Section 1031 exchange. The prescribed recovery period for replacement Building Q is 27.5 years, which is longer than the prescribed 15-year period for relinquished Bridge P. Therefore, replacement Building Q must be depreciated as if it had been placed in service back in July of 2013 (under the half-year convention that applied to relinquished Bridge P) using the longer 27.5 year recovery period.

Also, since the prescribed depreciation method for replacement Building Q (straight-line) is slower than the prescribed method for relinquished Bridge P (150% declining balance), depreciation for Building Q must be calculated using the slower straight-line method.

Therefore, replacement Building Q's exchanged basis amount is treated as placed in service in July 2019 (under the half-year convention that applied to relinquished Bridge P). Depreciation of Building Q's exchanged basis amount is then calculated using the remaining 21.5 year recovery period (27.5 years less six years worth of depreciation allowed for Bridge P under the half-year convention) using the straight-line method and the mid-month convention starting in July 2019 [Reg. 1.168(i)-6(c)(6), Example 2].

Deferred Exchanges. If the relinquished property is disposed of prior to the acquisition of the replacement property, the taxpayer cannot depreciate the relinquished property's exchanged basis amount during the period between the disposition of the relinquished property and the acquisition of the replacement property. During this intervening period, the depreciation recovery period for the replacement property's exchanged basis amount is suspended [Reg. 1.168(i)-6(c)(5)(iv)].

Depreciating the Excess Basis Amount

Generally, a replacement property's excess basis amount (if any) is treated as newly acquired property placed in service by the acquiring taxpayer in the year of replacement. This is the later of: (1) the tax year in which the replacement property is placed in service by the acquiring taxpayer or (2) the tax year in which the relinquished property is disposed of [Regs. 1.168(i)-6(b)(4) and (b)(6) and (d)(1)].

Depreciation of the excess basis amount is then calculated using the recovery period, depreciation method, and convention prescribed by IRC Sec. 168 for the replacement property at the time of replacement. In addition, the excess basis can be taken into account for purposes of the Section 179 expense deduction and additional first-year bonus depreciation when allowed.

When the replacement property is disposed of during the same tax year the relinquished property is placed in service, no depreciation is allowed for the replacement or the relinquished property [Reg. 1.168(i)-6(d)(1)].

Example 15J-4: Depreciating excess basis.

GreatCo Partnership, a calendar-year taxpayer, placed a retail building in service in 2004. On January 16, 2019, GreatCo relinquishes the building plus $2 million cash for an office building in a Section 1031 exchange. At that time, the relinquished building had an adjusted depreciable basis of $1.5 million. This becomes the exchanged basis amount for the replacement office building. After the exchange, the total depreciable basis of the replacement office building in GreatCo's hands is $3.5 million, which consists of $1.5 million of exchanged basis plus $2 million of excess basis.

The replacement office building's $1.5 million exchanged basis is depreciated according to the rules explained earlier in this key issue. The replacement office building's excess basis of $2 million is treated as newly acquired property placed in service on January 16, 2019, and is depreciated using the recovery period, depreciation method (including bonus depreciation and Section 179 expense deductions to the extent allowed), and convention prescribed by IRC Sec. 168 for the office building as of January 16, 2019 (the time of replacement in this example) [Reg. 1.168(i)-6(d)(1)].

Involuntary Conversion Replacement Property Acquired before Disposition of Relinquished Property

When Section 1033 involuntary conversion replacement property is acquired and placed in service before disposition of the relinquished property (for example, under a threat of condemnation), the taxpayer can depreciate the unadjusted depreciable basis of the replacement property until the relinquished property is disposed.

When the relinquished property is disposed, the taxpayer must determine the replacement property's exchanged basis and depreciate that amount under the rules explained earlier in this key issue. The taxpayer continues depreciating the replacement property's excess basis (if any) using the placed-in-service date for the replacement property and the depreciation recovery period, method, and convention prescribed at that time by IRC Sec. 168.

In the tax year the relinquished property is disposed, the taxpayer must "true things up" by including the following amount in taxable income: the excess of depreciation that was allowed for the replacement property's unadjusted depreciable basis over depreciation that would have been allowed for the replacement property's excess basis from the date the replacement property was placed in service (under the applicable convention) until the time the relinquished property was disposed [Reg. 1.168(i)-6(d)(4)].

Transactions Involving Nondepreciable Property

In a Section 1033 involuntary conversion, land and/or other nondepreciable property may be acquired to replace relinquished MACRS property. The nondepreciable replacement property cannot be depreciated. Therefore, it falls outside the scope of the rules explained in this key issue. However, when replacement property consists of a mixture of MACRS property and nondepreciable property, the rules explained here apply when calculating depreciation for the amount of basis allocable to the replacement MACRS property. Such basis is determined under IRC Sec. 1033 and the related regulations [Reg. 1.168(i)-6(d)(2)].

Depreciating Passenger Automobiles

The regulations include special and very complicated rules explaining how to calculate depreciation for passenger automobiles disposed of and acquired in Section 1033 involuntary conversions [Reg. 1.168(i)-6(d)(3)]. These rules generally are not beneficial. Therefore, taxpayers should consider electing out as explained later in this key issue.

Using Optional Depreciation Tables

The regulations also include a special set of complicated rules for taxpayers that choose to use the optional IRS-provided tables to determine depreciation for MACRS replacement property (as opposed to calculating amounts by hand using the applicable recovery period, depreciation method, and convention) [Reg. 1.168(i)-6(e)].

Just because an optional depreciation table was used for the relinquished MACRS property does not mean the taxpayer must also use an optional table to depreciate the replacement property's exchanged basis. (Conversely, when a table was not used for the relinquished property, the taxpayer can still choose to use a table to depreciate the replacement property's exchanged basis.) When the taxpayer decides against using an optional table, depreciation deductions for the replacement property are calculated according to the simpler rules explained earlier in this key issue.

Taking Advantage of the Election out Privilege

The regulations impose a general rule for depreciating replacement property exchanged basis amounts. This general rule can be disadvantageous in certain circumstances. (See Example 15J-2.) In addition, some taxpayers may simply wish to avoid complexities imposed by the regulations. As a rule of thumb, the guidelines in the regulations may become excessively complicated when the replacement property has excess basis or the taxpayer uses the optional IRS-provided depreciation tables.

The IRS gives taxpayers the option of electing out of the rules in the regulations. When this election out is made, the taxpayer simply depreciates the entire basis of the MACRS replacement property (both the exchanged basis amount and the excess basis amount, if any) as the cost of newly acquired property.

The election out must be made for each or involuntary conversion transaction for which an election out is desired. The election out must be made by the due date (including extensions) of the return for the year of replacement. When considering the election out, the following key points should be kept in mind.

1. Even when the taxpayer elects out, the year-of-disposition depreciation for relinquished property must still be calculated according to the rules in the regulations [Reg. 1.168(i)-6(i)].

2. For deferred exchanges, the depreciation deduction timing rules in the regulations still apply even when the taxpayer elects out [Reg. 1.168(i)-6(c)(5)(iii)].

3. When the taxpayer wants to make a Section 179 election for the replacement property, the regulations must be used to determine the excess basis amount. (Section 179 expense deductions are only allowed for excess basis amounts, not for exchanged basis amounts.) If the replacement property is eligible for bonus depreciation, it is allowed for both the excess basis amount and the exchanged basis amount [Reg. 1.168(k)-1(f)(5)(iii)(A)].

4. For partnerships, the election out must be made at the entity level and not at the owner level.

See Election E307 for how to make this election. The election out is made in the manner provided for on Form 4562 (Depreciation and Amortization) and its instructions [Reg. 1.168(i)-6(j)].

KEY ISSUE 15K Depreciating MACRS Property after Changes in Use.

After the placed-in-service year, MACRS property may continue to be MACRS property owned by the same taxpayer. However, a change in the property's use may result in a different recovery period, a different depreciation method, or both. For instance, this can happen when the property—

1. is reclassified under IRC Sec. 168(e) due to a change in use;

2. begins or ceases to be used predominantly outside the U.S.; or

3. begins or ceases to be tax-exempt use property, as defined in IRC Sec. 168(h).

Generally, a change in use is deemed to occur when the primary use of the property in the current tax year is different from its primary use in the immediately preceding year. The primary use of property can be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property. If a change in use occurs under this rule, depreciation for the year of change is calculated as though the change occurred on the first day of that year [Regs. 1.168(i)-4(d)(1) and (2)].

Shorter Period and/or Faster Method after Change in Use

In general, if a change in use results in changing to a shorter recovery period and/or faster depreciation method, depreciation deductions beginning in the year of change are calculated as though the property was placed in service in the year of change.

Depreciation deductions for any 12-month tax year beginning with the year of change are then calculated by multiplying the adjusted depreciable basis of the property as of the first day of each year by the applicable depreciation rate for each year. In calculating depreciation for the year of change and subsequent years, the taxpayer can use any applicable depreciation method and recovery period allowed under IRC Sec. 168 for the property in the year of change. The applicable convention is the same as the convention that applied before the change. However, the depreciation allowance for the year of change itself is determined without applying the applicable convention, unless the property is disposed of during the year of change. If the year of change or any subsequent year is less than 12 months, depreciation must be adjusted for the short tax year. (For further guidance, see for example Rev. Proc. 89-15.) (More complicated rules apply if the taxpayer calculates depreciation using the optional IRS-provided tables for MACRS property; this is a good reason to *not* use the tables.)

Assets affected by the preceding rule are not considered for purposes of determining whether the mid-quarter convention is mandatory for other MACRS property placed in service during the year in question. Assets affected by the preceding rule are ineligible in the year of change for elections under IRC Secs. 168(f)(1), 179, and 1400L(f).

The taxpayer also has the option of continuing to calculate depreciation as though the change in use had not occurred. The taxpayer elects this treatment by calculating depreciation (on the timely filed, including extensions, federal income tax return for the year of change) as though the change had not occurred. In other words, the election is made by continuing with the existing depreciation schedule as if nothing had happened. In many cases, the election will be disadvantageous if the taxpayer wants to maximize depreciation deductions. However in certain situations, it can be advantageous, as illustrated by Example 15K-1 [Reg. 1.168(i)-4(d)(3)].

Example 15K-1: Shorter recovery period after change.

X Partnership, a calendar-year partnership, placed in service during 2014 equipment costing $100,000. The partnership used the equipment through 2018 in its Alpha line of business. The equipment was properly depreciated under the MACRS rules using a seven-year recovery period, the 200% DB method (switching to SL in 2018), and the half-year convention.

Beginning in 2019, X starts using the equipment in its Beta line of business. As a result, the equipment's classification under IRC Sec. 168(e) changes from seven-year property to five-year property. The depreciation method stays the same. Depreciation deductions for 2019 and subsequent years are determined as though X placed the equipment in service in 2019 in its Beta line of business. Assume that for 2019, the partnership depreciates new five-year recovery property using the 200% DB method and the half-year convention.

On January 1, 2019, the equipment's adjusted depreciable basis is $22,311. The depreciation deduction for 2019 (the deemed placed-in-service year) is computed without considering the half-year convention. Therefore, the partnership's 2019 deduction is $8,924 [(January 1, 2019, basis of $22,311 ÷ 5 years) × 200%]. The 2020 deduction will be $5,355 [(January 1, 2020, basis of $13,387 ÷ 5 years) × 200%]. (See Illustration 15-1 for a completed Form 4562 based on the facts of this example.)

Alternatively, X can elect to disregard the change in use and continue to treat the equipment as though it is used in the Alpha line of business. If this election is made, the partnership's depreciation for 2019 is $8,924 (January 1, 2019, basis of $22,311 ÷ 2.5 years remaining after switching to SL method). The 2020 deduction will be $8,925 (January 1, 2020, basis of $13,387 ÷ 1.5 years remaining after switch to SL method). [This example is based on Reg. 1.168(i)-4(d)(6), Example 1.]

Note: Under these particular facts, X Partnership is better off making the election to disregard the change in use, assuming the objective is to maximize depreciation deductions.

Longer Period and/or Slower Method after Change in Use

If the change in use results in a longer recovery period and/or slower depreciation method, the adjusted basis of the affected property as of the beginning of the year of change is depreciated using the longer period and/or slower method. This rule applies, beginning with the year of change, as though the taxpayer had originally placed the affected property in service with the longer period and/or slower method [Reg. 1.168(i)-4(d)(4)]. Assets affected by this rule are ineligible in the year of change for the elections under IRC Secs. 168(f)(1), 179, and 1400L(f).

Depreciation deductions for any 12-month tax year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the affected property as of the first day of each year by the applicable depreciation rate for each year. The applicable convention that applies to the affected property is the same as the convention that applied before the change in use. If the year of change or any subsequent year is less than 12 months, the depreciation deduction determined under this rule must be adjusted for the short tax year. (For further guidance, see for example Rev. Proc. 89-15.)

The applicable depreciation method for the year of change and any subsequent year is the method that would apply if the taxpayer had used the longer recovery period and/or slower depreciation method in the placed-in-service year. If the 200% DB or 150% DB method would have applied in the placed-in-service year, but the DB method would have been switched to SL for the year of change or any prior year, the applicable recovery method beginning with the year of change is the SL method.

If the applicable depreciation method is 200% DB or 150% DB, the applicable recovery period is the longer period resulting from the change in use. If the recovery period does not change, the applicable recovery period is the same as before.

If the applicable depreciation method is the SL method, the applicable recovery period is the number of years remaining as of the beginning of each year (taking into account the applicable convention), determined as if the taxpayer had used the longer recovery period in the placed-in-service year. If the recovery period does not change, the applicable recovery period is the number of years remaining as of the beginning of each year (taking into account the applicable convention) based on the existing recovery period.

Observation: More complicated rules apply if the taxpayer calculates deprecation using the optional IRS-provided MACRS tables.

Example 15K-2: Longer period and slower method after change.

Y Partnership, a calendar-year partnership, placed in service equipment costing $100,000 in January 2017. For 2017 and 2018, the equipment was used only within the U.S. Under the MACRS rules, Y properly depreciated the equipment in those years using a five-year recovery period, the 200% DB method, and the half-year convention. Starting in 2019, Y begins using the equipment predominantly outside the U.S. As a result of this change in use, the equipment becomes subject to the ADS rules beginning in 2019. Under ADS, the equipment must be depreciated over nine years using the SL method. As of January 1, 2019, the equipment's adjusted depreciable basis is $48,000.

Y's depreciation deductions for 2019 and subsequent years are determined as though the equipment had been placed in service in January 2017 as property used predominantly outside the U.S. Therefore, the applicable depreciation method is SL, and the applicable recovery period is 7.5 years (the number of years remaining as of January 1, 2019, for nine-year property placed in service in 2017, taking into account the half-year convention). Therefore, Y's 2019 depreciation deduction is $6,400 (January 1, 2019, basis of $48,000 ÷ 7.5 years). The 2020 amount will also be $6,400 (January 1, 2020, basis of $41,600 ÷ 6.5 years). [This example is based on Reg. 1.168(i)-4(d)(6), Example 3.]

Miscellaneous Rules

The discussion in this key issue only covers what the authors consider to be the most important points.

- For the more complicated rules applicable to taxpayers that choose to use the optional IRS-provided MACRS depreciation tables, see Reg. 1.168(i)-4(d)(5) and Examples 2 and 4 in Reg. 1.168(i)-4(d)(6). As mentioned earlier, not using the tables will make calculating depreciation easier.
- For special rules on changes of use that occur during the placed-in-service year, see Reg. 1.168(i)-4(e).

KEY ISSUE 15L Depreciating (or Deducting) Expenditures for Tangible Property.

Expenditures for tangible property can be treated in several different ways. The expenditures must be capitalized and recovered through depreciation if they are for permanent improvements or betterments that increase the value of the property, restore its value or use, substantially prolong its useful life, or adapt it to a new or different use [IRC Secs. 168 and 263(a)]. Expenses, such as materials and supplies that are incidental and do not materially add to the value of the property or appreciably prolong its useful life are deductible as ordinary and necessary business expenses under IRC Sec. 162. Finally, costs incurred to produce, purchase, or improve goods held for sale to customers are treated as inventory costs. Although the result is clear, the proper categorization of expenditures has long been a source of controversy between businesses and the IRS.

The tangible property regulations clarify the proper categorization of expenditures and provide rules for determining gain or loss upon the disposition of MACRS property, determining the asset disposed of and accounting for partial dispositions of MACRS property, and also amend the general asset account regulations and the accounting for MACRS property regulations (TD 9689). Answers to frequently asked questions about the tangible property regulations can be found on the IRS website at **www.irs.gov** by entering the words "tangible property regulations" in the search feature.

The tangible property regulations include a number of taxpayer-favorable elections. These elections are claimed on the tax return and do not require IRS approval or consent to be effective. Information on these elections, including sample election statements, can be found at—

- E801—Election to capitalize rotable, temporary, and standby emergency spare parts.
- E802—Election to treat a partial disposition as a disposition.
- E803—*De minimis* safe harbor expensing election.

- E804—Election to capitalize employee compensation and overhead costs.
- E805—Safe harbor for deducting costs of improving eligible building property.
- E806—Election to capitalize repairs and maintenance costs consistent with books.

Capital Expenditure Defined

Capital expenditures must be capitalized and recovered through depreciation (or amortization/depletion) or disposition (if the property is not subject to depreciation).

1. Capital expenditures are (a) costs for new buildings or permanent improvements or betterments made to increase the value of property or (b) amounts expended in restoring property or making good the exhaustion from depreciation [IRC Sec. 263(a); Reg. 1.263(a)-1]. Capital expenditures include amounts paid or incurred to add to the value or prolong the useful life of property or to adapt property to a new use.
2. Incidental repairs are deductible under IRC Sec. 162 as ordinary and necessary business expenses, provided the property's cost or basis is not increased by the expenditure. These costs do not materially add to the value of property or appreciably prolong its life. Rather they keep the property in an ordinarily efficient operating condition [Reg. 1.162-1(a) and Reg. 1.162-4].

The regulations provide an election to capitalize repair and maintenance expenses consistent with the taxpayer's presentation on its financial records [Reg. 1.263(a)-3(n)(1)]. The election is made by attaching a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year in which the taxpayer pays eligible amounts. The statement must be titled "Section 1.263(a)-3(n) Election" and must include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under Reg. 1.263(a)-3(n). The election is made by the partnership, not the partners. A taxpayer making this election must treat amounts paid for repairs and maintenance during the tax year that are capitalized on its books and records as improvements to a unit of tangible property (basically all components of real or personal property that are functionally interdependent). The taxpayer must begin depreciating the cost of the improvements when they are placed in service under the applicable provisions of the Code and regulations. See Election E806 for a sample election.

Deducting Materials and Supplies

Materials and supplies are tangible items used or consumed in the taxpayer's operations that are not inventory and [Reg. 1.162-3(c)]—

1. are a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that are not acquired as part of any single unit of tangible property;
2. consist of fuel, lubricants, water, and similar items, that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations;
3. are a unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;
4. are a unit of property that has an acquisition cost or production cost (as determined under IRC Sec. 263A) of $200 or less (or other amount as identified in published IRS guidance); or
5. are identified in published IRS guidance as materials and supplies eligible for treatment under this section.

Except as provided in Reg. 1.162-3(d) (election to capitalize the cost of rotable spare parts, temporary spare parts, or standby emergency spare parts), Reg. 1.162-3(e) (election to use an optional method of accounting for rotable and temporary spare parts), or Reg. 1.263(a)-1(f) (*de minimis* safe harbor election), amounts paid to acquire or produce nonincidental materials and supplies are deductible when used or consumed in the taxpayer's operations [Reg. 1.162-3(a)]. Incidental materials and supplies are deductible in the tax year paid, provided taxable income is clearly reflected. Materials and supplies are incidental if no record of their consumption is kept and no physical inventory of them is taken at the beginning and end of the year. Two common examples are a unit of property that has an economic useful life of 12 months or less, or an acquisition or production cost of $200 or less.

Example 15L-1: Deducting nonincidental materials and supplies.

Easy Beez Partnership purchases 40 office chairs for $80 each and 100 custom briefcases costing $250 each. Because of heavy usage, the briefcases have a useful life of less than one year. Assume that the chairs and briefcases are nonincidental materials and supplies. All of the chairs are used by employees during the year, but only 40 briefcases are used, with the remainder stored for future use.

Both the chairs and the briefcases are *materials and supplies* because each chair is a unit of property costing $200 or less, and each briefcase is a unit of property with an economic life of 12 months or less in the year of purchase. Easy Beez can deduct $3,200 ($80 × 40) for the chairs and $10,000 ($250 × 40) for the briefcases. The remaining briefcases will be deductible when used (consumed) by the employees.

According to Reg. 1.162-3(f), taxpayers electing the *de minimis* safe harbor under Reg. 1.263(a)-1(f) for amounts paid for the production or acquisition of tangible property must apply the safe harbor to amounts paid for all materials and supplies that meet the requirements of Reg. 1.263(a)-1(f), unless the taxpayer elects to capitalize and depreciate rotable, temporary, and standby emergency spare parts [as described under Reg. 1.162-3(d)] or uses the optional method of accounting for rotable, temporary, and standby emergency spare parts [as described under Reg. 1.162-3(e)].

Handling Rotable, Temporary, and Standby Emergency Spare Parts. Rotable and temporary spare parts generally are materials and supplies acquired for installation on a unit of property or temporarily used until a new or repaired part can be installed, and then removed and reinstalled on other property or stored for later installation. Costs for rotable and temporary spare parts are treated as first used or consumed in the taxpayer's operations in the year the taxpayer permanently disposes of the parts [Reg. 1.162-3(a)(3)].

Standby emergency spare parts are parts that are [Reg. 1.162-3(c)(3)]—

- acquired when particular machinery or equipment is acquired, or later acquired and set aside for use in that particular machinery or equipment,
- set aside for use as replacements to avoid lost time due to equipment emergencies or failures,
- located at or near the installed related machinery or equipment to be readily available when needed,
- directly related to a particular piece of machinery it serves,
- normally expensive,
- only available on special order and not readily available from a vendor or manufacturer,
- not subject to normal periodic replacement,
- not interchangeable in other machines or equipment,
- not acquired in quantity (generally only one is on hand for each piece of machinery or equipment), and
- not repaired and reused.

Businesses can elect to capitalize and depreciate the cost of rotable spare parts, temporary spare parts, or standby emergency spare parts [Reg. 1.162-3(d)]. See Election E801. The election is not available for rotable, temporary, or standby emergency spare parts intended to be used as a component of a unit of property where the taxpayer did not elect to capitalize and depreciate that unit of property. In the case of a partnership, the election is made by partnership and not by the partners. A taxpayer makes the election on a timely filed original tax return (including extensions) by capitalizing the amount paid to acquire or produce the rotable, temporary, or standby emergency spare part in the tax year the amounts are paid and beginning to depreciate the costs when the asset is placed in service under the applicable provisions of the Code and regulations. The election does not apply to an asset or a portion thereof placed in service and disposed of in the same tax year. A taxpayer can make an election for each rotable, temporary, or standby emergency spare part that qualifies for the election [Reg. 1.162-3(d)].

Rotable and Temporary Spare Parts Optional Method. Taxpayers using the spare parts optional accounting method (1) deduct the amount paid to acquire or produce the part in the tax year it is first installed on a unit of property for use in the taxpayer's business; and (2) include in gross income the part's FMV and include in the part's basis its FMV when removed, plus the amount paid to remove it from the unit of property, in the tax year the part is uninstalled and placed back into the spare parts supply [Reg. 1.162-3(e)]. If installed and uninstalled again on another unit of property, the cycle of expenditure and income recognition is repeated until the part is finally disposed of. Any remaining tax basis is deducted in the year of disposal.

Because taxpayers may have pools of rotable or temporary spare parts that are treated differently for financial statement purposes, the regulations specify that the optional method for rotable and temporary spare parts, if elected, be used for all parts in the same trade or business. Under the regulations, a taxpayer that uses the optional method for tax purposes must use the optional method for all of the pools of rotable and temporary spare parts used in the same trade or business for which the optional method is used in the books and records. A taxpayer generally is not required to use the optional method for those pools of rotable or temporary spare parts for which it does not use the optional method in its books and records. But if a taxpayer uses the optional method for any pool of rotable or temporary spare parts for which it does not use the optional method in its books and records, then the taxpayer must use the optional method for all its pools of rotable and temporary spare parts in that same trade or business [Reg. 1.162-3(e)(1)].

De Minimis Safe Harbor Election. The *de minimis* safe harbor election is made on a year-by-year basis by attaching a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year in which these amounts are paid. In the case of a partnership, the election is made by the partnership, not the partners [Reg. 1.263(a)-1(f)(5)]. An election is made by attaching a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year in which these amounts are paid. The statement must be titled "Section 1.263(a)-1(f) *De Minimis* Safe Harbor Election" and must include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the *de minimis* safe harbor election under Reg. 1.263(a)-1(f). An election cannot be made by filing an application for change in accounting method or, before obtaining the IRS's consent to make a late election, by filing an amended tax return. See Election E803.

Taxpayers with an applicable financial statement (AFS) are subject to a $5,000 per item *de minimis* safe harbor limit. In addition to a qualifying AFS, the business must have written accounting procedures in effect at the beginning of the tax year for expensing amounts paid for such property under a certain dollar amount, and must treat the amounts as expenses on its AFS in accordance with the policy. Taxpayers with an AFS may expense items that do not exceed $5,000 per invoice or per item (as substantiated by the invoice) or amounts paid for property with an economic useful life of 12 months or less provided the amount per invoice (or item) does not exceed $5,000. Taxpayers must include all costs appearing on the invoice.

An AFS includes (1) a financial statement required to be filed with the Securities and Exchange Commission (SEC) (i.e., the 10-K or the Annual Statement to Shareholders); (2) a certified audited financial statement accompanied by the report of an independent CPA that is used for credit purposes, reporting to owners, or any other substantial nontax purpose; or (3) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the IRS).

Taxpayers without an AFS are subject to a lower $2,500 per-item *de minimis* safe harbor limit (Notice 2015-82). They must have accounting procedures in effect at the beginning of the tax year (which according to the regulations need not be written) for expensing amounts paid for such property under a certain dollar amount, and must treat the amounts as expenses on their books and records in accordance with the policy. Taxpayers without an AFS may expense items that do not exceed $500 per invoice or per item (as substantiated by the invoice) or amounts paid for property with an economic useful life of 12 months or less provided the amount per invoice (or item) does not exceed $2,500. Once again, taxpayers must include all costs appearing on the invoice.

Practice Tip: The *de minimis* safe harbor provision is essentially an election to treat certain outlays for inexpensive assets, materials, and supplies in the same manner for tax purposes as they are treated for financial reporting purposes. If the conditions for making the election are met, costs that a business would otherwise have to capitalize and depreciate over a number of years for tax purposes can be deducted in the year of purchase. There is no aggregate annual dollar limit on the amount that can be deducted under the safe harbor provision (although there are per-item limits as explained earlier). Finally, note that the allowable *de minimis* deduction amounts are only safe

harbors rather than amounts specified by statute. Taxpayers that can justify deducting larger amounts for materials and supplies can choose to do so.

The regulations do not define accounting procedures or describe what the procedures should include. However, many businesses establish a minimum dollar amount that must be spent before a cost is capitalized. Otherwise, the cost is deducted. The following sample wording can be used or modified to fit a business's particular needs:

> It is the company's policy to capitalize assets that cost $________ or more. All capitalized assets will be depreciated in accordance with the company's depreciation policy. Assets that cost less than $________ will be expensed in the period purchased. Amounts paid for assets with an estimated useful life of 12 months or less with a value of $________ or less are expensed in the period purchased as well. Management will periodically review these levels and make modifications as necessary.

Handling Costs to Acquire or Produce Tangible Property

Except as provided in Reg. 1.162-3 (materials and supplies) or Reg. 1.263(a)-1(f) (*de minimis* safe harbor election), the general rule is that taxpayers must capitalize amounts paid to acquire or produce a unit of tangible real or personal property, including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures [Reg. 1.263(a)-2(d)(1)]. Capitalized amounts include the invoice price, transaction costs, and costs for work performed prior to the date the property is placed in service. Once capitalized, the costs are recovered under the rules applicable to that type of property (e.g., depreciated and/or recovered when disposed of).

Note: The following paragraphs focus on amounts paid to acquire tangible property. However, the same rules apply to expenditures paid to produce tangible property.

Transaction costs are amounts paid to facilitate the acquisition [Reg. 1.263(a)-2(f)]. Generally speaking, all costs paid to facilitate an acquisition of tangible property must be capitalized. However, amounts paid to investigate or otherwise pursue the acquisition of real property need not be capitalized if they relate to activities performed in determining whether to acquire real property and which real property to acquire. Inherently facilitative costs are not eligible for this "whether or which" exception and must always be capitalized. Included in the list of inherently facilitative costs are the costs of examining title to the property, securing an appraisal of the property's value, negotiating the terms or structure of the acquisition, obtaining tax advice on the acquisition, paying sales and transfer taxes, preparing documents to effectuate the acquisition, and transporting the property.

Example 15L-2: Deducting transaction costs under the "whether and which" exception.

Chez Grete Boutique Partnership (Chez) conducted research to determine whether to open a new store. In March, Chez hired a consulting firm to perform market surveys and recommend areas for its new store. In September, Chez hired a valuation expert to appraise the proposed site, and in December it acquired the site. Chez need not capitalize the amounts paid to the development consultant because (a) the consulting was performed to determine whether to open a new store and which real property to acquire, and (b) the amounts were not inherently facilitative costs. However, Chez must capitalize amounts paid to the valuation expert because the appraisal costs are inherently facilitative costs. The appraisal costs are included in Chez's basis in the property acquired.

Employee Compensation or Overhead. Amounts paid for employee compensation or overhead are treated as amounts that do not facilitate the acquisition of real or personal property. The amounts paid for compensation or overhead while acquiring or deciding to acquire real or personal property are deductible, unless IRC Sec. 263A applies. However, the business can elect to capitalize compensation, overhead expenses, or both, related to each acquisition [Reg. 1.263(a)-2(f)(2)(iv)(B)]. See Election E804.

Capitalizing Amounts Paid to Improve Tangible Property

Except as provided in Reg. 1.263(a)-3(h) (safe harbor for small taxpayers), Reg. 1.263(a)-3(n) (election to capitalize repair and maintenance costs consistent with books and records), or Reg. 1.263(a)-1(f) (*de minimis* safe harbor election), taxpayers generally must capitalize amounts paid to improve a unit of property. A unit of property is improved if the cost results in a betterment or restoration to the unit of property, or an adaptation of the unit of

property to a new or different use [Reg. 1.263(a)-3(d)]. The "unit of property" is an essential term and, except in the case of a building and its structural components, is defined as all components (real or personal property) that are functionally interdependent to one another. Generally, functionally interdependent means that the components must be placed in service together at the same time in order to perform their intended function [Reg. 1.263(a)-3(e)(3)(i)]. For example, a computer and printer would not be functionally interdependent, since placing the computer in service is not dependent on placing the printer in service.

Observation: The smaller the unit of property, the more likely a component part would materially add to the value of the property and prolong its useful life and be a capitalized cost. The larger the unit of property, the more likely the component part would be incidental to the unit of property and, therefore, deductible as an incidental cost.

Buildings and Building Systems. A cost is a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems. A building structure consists of the building [as defined in Reg. 1.48-1(e)(1)] and its structural components [as defined in Reg. 1.48-1(e)(2)], other than the structural components designated as building systems. Building systems include the heating, ventilation, and air conditioning (HVAC) systems; plumbing systems; electrical systems; escalators; elevators; fire protection, alarm, and security systems; gas distribution systems; and other systems identified in published guidance. If the taxpayer leases part of a building, the unit of property is the portion of the building subject to the lease along with the structural components associated with the leased portion [Reg. 1.263(a)-3(e)(2)].

Property Other than Buildings. In general, all components of real or personal property (other than buildings) that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer. Special rules apply to plant property, network assets, and leased property [Reg. 1.263(a)-3(e)(3)].

Safe Harbor for Routine Maintenance. Costs of regularly scheduled, routine maintenance do not have to be capitalized. Routine maintenance includes amounts paid for inspection, cleaning, testing, replacing damaged or worn parts, and other recurring maintenance that keeps property in its ordinarily efficient operating condition [Reg. 1.263(a)-3(i)]. Factors in determining whether maintenance costs are routine include industry practice, manufacturer's recommendations, and the taxpayer's experience.

For property other than buildings, activities are routine if, when the property is placed in service, the taxpayer reasonably expects to perform them more than once during the asset's class life (generally its alternative depreciation system recovery period). For buildings, *routine* means the activity is expected to be performed more than once in the 10-year period after the placed in service date. There must be a reasonable expectation when the property is placed in service that the activities will be performed more than once during the class life of the unit of property. However, the failure to actually perform the maintenance a second time is not fatal, assuming that the taxpayer can substantiate that its expectation was reasonable when the property was placed in service.

Routine maintenance does not include amounts paid (not a complete list) (1) to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use; (2) for repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of accounting under [Reg. 1.162-3(e)]; (3) for betterment of a unit of property; (4) to adapt a unit of property to a new or different use; or (5) for repairs, maintenance, or improvement of network assets [Reg. 1.263(a)-3(i)(3)].

Election for Small Taxpayers with Eligible Building Property. Taxpayers with average annual gross receipts for the three preceding tax years of $10 million or less can elect not to capitalize improvements to an eligible building property if the total amount paid during the year for repairs, maintenance, improvements, and similar activities performed on the building does not exceed the lesser of $10,000 or 2% of the building's unadjusted basis [Reg. 1.263(a)-3(h)]. Eligible building property is a building unit of property the taxpayer owns or leases that has an unadjusted basis of $1 million or less.

A taxpayer makes the election by attaching a statement to its timely filed original federal tax return (including extensions) for the year in which amounts are paid for repairs, maintenance, improvements, and similar activities performed on the eligible building property. The statement must be titled, "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers" and include the taxpayer's name, address, taxpayer identification number, and a

description of each eligible building property subject to the election. In the case of an S corporation or a partnership, the election is made by the S corporation or the partnership. See Election E805.

Safe Harbor for Retail and Restaurant Remodeling. Rev. Proc. 2015-56 provides a safe harbor accounting method that certain retail and restaurant operators can use to determine whether costs paid to refresh or remodel a qualified building are deductible repairs and maintenance expenses under IRC Sec. 162(a), or if they must be capitalized under IRC Sec. 263(a) or IRC Sec. 263A. This safe harbor method minimizes the need to perform a detailed factual analysis to determine whether each remodel/refresh cost is for repair and maintenance and capitalizes the remaining 25%.

Observation: Practitioners should discuss with clients the possible negative impact on "book income" of elections that allow expensing of tangible property costs. For example, a business's earnings before interest, taxes, depreciation, and amortization (EBITDA) is not decreased by depreciation, but it is decreased by the expensing of assets. Therefore, if a business were sold for six times EBITDA, a $100,000 deduction made as a result of making an election to expense amounts could reduce the sales price by $600,000. Another example of a negative impact from making these types of elections can result for construction businesses that might have trouble in acquiring bonding for jobs due to the reduced EBITDA and lower asset values reported on their balance sheets.

Reporting Dispositions of Property

Under Reg. 1.168(i)-8, a disposition occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use in a trade or business or for the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. The manner of disposition (e.g., normal versus abnormal retirement) is not considered in determining whether a disposition occurs or a gain or loss is recognized.

A disposition also includes a partial disposition under Reg. 1.168(i)-8(d). The partial disposition rule allows taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or upon the disposition of a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event. This minimizes circumstances when an original part and any subsequent replacement of the same part are required to be capitalized and depreciated simultaneously.

While the partial disposition rule is elective in many cases, it must be applied to the disposition of a portion of an asset (1) as a result of a Section 165 casualty event; (2) when gain is not recognized in whole or in part under the Section 1031 like-kind exchange or the Section 1033 involuntary conversion rules; or (3) in a step-in-the-shoes transaction described in IRC Sec. 168(i)(7)(B) (which includes Section 721 transfers of property to a partnership in exchange for a partnership interest, and Section 731 distributions by a partnership to a partner). It also must be applied to the sale of a portion of an asset. For other transactions, a disposition includes a disposition of a portion of an asset only if the taxpayer makes the partial disposition election for that disposed portion.

Example 15L-3: Dispositions under the tangible property regulations.

The Allright Partnership owns an office building and replaces one of the four elevators. The elevator is a structural component of the office building, and the office building (including its structural components) is the asset for disposition purposes. Allright does not make the partial disposition election for the elevator. Therefore, the retirement of the replaced elevator is not a disposition. Depreciation continues for the cost of the building (including the cost of the retired elevator and the building's other structural components), and Allright does not recognize a loss for the retired elevator. If Allright makes the partial disposition election, the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement, taking into account the applicable convention, and Allright recognizes a loss upon this retirement.

The partial disposition election is made on a timely filed original tax return, including extensions, for the tax year in which the portion of the asset is disposed of by reporting the resulting gain, loss, or other amount [Reg. 1.168(i)-8(d)(2)]. The election cannot be made or revoked by requesting a change in method of accounting. See Election E802.

If it is impracticable to determine the unadjusted depreciable basis of the disposed portion, the taxpayer can use any reasonable method for determining the unadjusted depreciable basis of that portion. If a taxpayer disposes of more than one portion of the same asset and it is impracticable to determine the unadjusted depreciable basis of the first

disposed portion of the asset, the reasonable method must be consistently applied to all portions of the same asset for purposes of determining the unadjusted depreciable basis of each disposed portion of the asset.

Similarly, if the asset is in a multiple asset account or pool and it is impracticable to determine the unadjusted depreciable basis of the disposed portion of the asset, the reasonable method used by the taxpayer must be consistently applied to all assets in the same multiple asset account or pool. The regulations provide examples of reasonable methods, including a pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion versus the replacement cost of the asset.

Capitalizing Costs Resulting in a Betterment to Property

Costs that result in the betterment to a unit of property must be capitalized. There is a betterment when the cost (1) ameliorates a material condition or defect that existed before the taxpayer's acquisition of the unit of property, or arose during the production of the property; (2) results in a material addition to the unit of property; or (3) results in a material increase in capacity, productivity, efficiency, strength, quality, or output of the unit of property [Reg. 1.263(a)-3(j)].

All of the relevant facts and circumstances must be considered when determining whether an amount paid results in a betterment, including the purpose of the expenditure, the physical nature of the work performed and the effect of the expenditure on the unit of property. When a particular event necessitates an expenditure (e.g., a new city ordinance setting higher safety building standards because of earthquake concerns), the determination of whether an expenditure results in a betterment is made by comparing the condition of the property after the expenditure with the condition of the property before the event [Reg. 1.263(a)-3(j)(2)(iv)].

Example 15L-4: Parts replacement as betterment to a unit of property.

The Marshall Partnership operates a retail store that suffered storm damage. Marshall paid a contractor to replace the wooden shingles on the roof with new wooden shingles. Marshall need not treat the amount paid to replace the shingles as a betterment because the work does not result in a material addition, or material increase in the capacity, productivity, efficiency, strength, or quality of the building structure, compared to the condition of the structure before the storm.

Capitalizing Costs That Restore Property

Taxpayers must capitalize amounts paid to restore a unit of property [Reg. 1.263(a)-3(k)]. The regulations provide a list of situations where the unit of property is restored, such as if the expenditure (1) returns a unit of property that had deteriorated to a state of disrepair (and can no longer be used for its intended purpose) to its ordinarily efficient operating condition; (2) results in the rebuilding of the unit of property to a like-new condition after the end of its class life (is considered to be new, rebuilt, remanufactured, or has a similar status under a federal regulation or the manufacturer's specifications); or (3) replaces a part or a combination of parts that comprise a major component or substantial structural part of a unit of property. The latter situation requires the consideration of the facts and circumstances. For example, the replacement of a minor part (incidental component), even one that affects the function of the unit of property, generally will not constitute a major component [Reg. 1.263(a)-3(k)].

Example 15L-5: Roof replacement as restoration of a unit of property.

The Pants Place Partnership operates a retail clothing store. The partnership discovers a leak in the roof and hires a contractor to inspect and fix the roof. The contractor determines that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. Pants Place has the contractor replace the entire roof with a new roof. Because the roof performs a discrete and critical function, it is part of the building structure and comprises a major component or substantial structural part of the building.

Accordingly, Pants Place must treat the amount paid to replace the roof as an improvement to the building that must be capitalized.

Costs that Adapt Property to New or Different Use

Taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. This occurs when the adaptation is not consistent with the taxpayer's intended ordinary use of the property at the time it was originally placed in service [Reg. 1.263(a)-3(l)]. The regulations do not provide bright line tests or additional guidance for these

standards, instead relying on a facts and circumstances approach. One example would be the conversion of a manufacturing building into a showroom. The amounts paid to convert the manufacturing facility adapt the building to a new or different use that is not consistent with the intended use of the building when it was placed in service. In that case, the amounts paid would have to be capitalized.

KEY ISSUE 15M Depreciating Assets in General Asset Accounts.

Assets That Can Be Grouped

Note: A full discussion of general asset accounts is beyond the scope of this *Deskbook*. The discussion in this key issue is designed to introduce general asset accounts and highlight some of their unique features.

According to IRC Sec. 168(i)(4) and Reg. 1.168(i)-1(c)(2), an election can be made to group assets subject to the Section 168(a) general depreciation system or the Section 168(g) alternative depreciation system into one or more general asset accounts if the assets have been placed in service in the same tax year and have the same (1) asset class, (2) applicable depreciation method, (3) applicable recovery period, and (4) applicable convention (including mid-quarter and mid-month conventions). Passenger automobiles subject to the limits on passenger automobile depreciation must be grouped into a separate general asset account. Listed property other than passenger autos must be grouped into a separate general asset account. Property not eligible for bonus depreciation or property on which the taxpayer elected out of bonus depreciation must be grouped into a separate general asset account. If bonus depreciation was taken, the property may only be grouped into a general asset account with property on which the same percentage applies.

For each general asset account, the depreciation allowance is computed by using the depreciation method, recovery period, and convention applicable to that particular account. The accumulated depreciation for each account is then recorded as the depreciation reserve [Reg. 1.168(i)-1(d)]. In other words, each general asset account is treated as a single asset for depreciation purposes. This treatment of a group of assets as a single asset applies for purposes of computing AMT depreciation as well (per the preamble to the regulations).

One of the main advantages of using general asset account depreciation is the simplified recordkeeping and depreciation computations required when there are numerous assets and a large amount of activity in the fixed asset accounts. Therefore, it is used mainly by larger businesses that have these characteristics. The rules regarding dispositions and other items may not make the use of this system attractive to smaller businesses.

Dispositions

The general rules for dispositions of MACRS or depreciable property are provided in Reg. 1.168(i)-8. The specific rules for dispositions of assets accounted for under the general asset account rules are provided in Reg. 1.168(i)-1(e).

When asset dispositions occur, there is no immediate recovery of basis. Instead, the disposed asset in a general asset account is treated as having an adjusted basis of zero for determining gain or loss on its sale. Therefore, no loss is realized on the disposition of such an asset. All sale proceeds are treated as ordinary income (from depreciation recapture) to the extent of the original depreciable basis of the general asset account. Once this amount has been recovered, additional amounts realized are taxed under the rules (for example, IRC Sec. 1231) that normally apply to gain from other than depreciation recapture. The basis of the disposed asset is not removed from the general asset account unless a special election is made. Instead, assets disposed of continue to be part of the amount being depreciated.

The disposition rules apply to a partial disposition of an asset (such as the disposition of part or all of a roof) [Reg. 1.168(i)-1(e)(1)(ii)]. This allows taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event. The “partial disposition rule” also minimizes the times when an original part and a replacement part are capitalized and depreciated simultaneously.

The regulations treat the disposition of a building (including its structural components), a condominium (including its structural components), or a cooperative (including its structural components) as a single asset under the disposition rules in IRC Sec. 168 [Reg. 1.168(i)-1(e)(2)(viii)(B)]. Therefore, taxpayers can choose to forego the recognition of a loss on the disposition of a structural component without making a general asset account election.

KEY ISSUE 15N Oil and Gas Depletion.

This key issue is based on the assumption that the taxpayer meets the definition of an independent producer. Thus, this discussion does not apply to large oil companies, retailers, or refiners. An independent producer is defined as a taxpayer whose average daily production of domestic crude oil and natural gas does not exceed the equivalent of 1,000 barrels per day.

Depletion (whether cost or percentage) for the partnership's oil and gas properties is computed by each partner and not by the partnership. While this requirement [IRC Sec. 613A(c)(7)(D)] makes sense from a conceptual standpoint, the partnership usually will compute *tentative* depletion for each of its partners. This tentative depletion figure is still subject to certain partner level limitations (e.g., the 65% of taxable income limitation). Generally, oil and gas properties eligible for percentage depletion qualify for a 15% rate. Worksheet W111 can be used to provide information to partners for calculating depletion.

Example 15N-1: Presentation of depletion information on Schedule K-1.

The Gusher #1-205 Joint Venture has production from three oil and gas properties that must be reported in its initial return. The partners (not the partnership) are required to compute depletion for these properties.

What information should be provided to the partners to enable them to compute their own depletion allowances? Under Reg. 1.613A-3(l), the partnership should report each partner's share of—

1. gross income;
2. operating expenses, production taxes, depreciation, and allocated overhead;
3. intangible drilling costs (IDC);
4. original share of and subsequent adjustments to the basis in the properties (leasehold costs);
5. estimated reserves; and
6. production in barrels or cubic feet for the tax year from each depletable property.

All of the above items should be reported by taxable unit of property (TUP). (The discussion of how to determine TUPs is beyond the scope of this chapter. See Reg. 1.614-1.) In addition to the above items, the partnership should classify each partner's share of oil and gas production into the following categories:

1. Marginal production properties [potentially eligible for percentage depletion rates in excess of 15% under IRC Sec. 613A(c)(6)]. The percentage depletion rate for marginal properties for 2019 is 15% (Notice 2019-38).
2. Natural gas sold under a qualifying fixed price contract (eligible for a 22% depletion rate).
3. Production reported separately (i.e., in barrels of oil and cubic feet of gas) from properties eligible for the independent producer exemption (production limited to 1,000 barrels a day) and therefore eligible for percentage depletion.

Effect of Depletion on Partners' Capital Accounts

While depletion is calculated at the partner and not the partnership level, it must still be reflected in the partners' capital accounts if the partnership's capital accounts are intended to comply with the Section 704(b) safe harbor regulations. In certain instances, the partnership may not have the requisite information for each partner's individual depletion calculations. Because of this, Reg. 1.704-1(b)(2)(iv)(k)(2) permits the partner's book capital accounts (see Chapter 26) to be adjusted for *simulated* depletion. This calculation is made on a property-by-property basis using either simulated cost or percentage depletion after considering the depletion rules and limitations, but without consideration of any limitations applicable at the partner level (e.g., the 65% of taxable income limitation). Thus, the ending capital account reflected on the Schedule K-1 may or may not precisely reflect the partner's outside tax basis in the partnership interest.

The depletion amounts should run through the partner's Schedule K-1 capital account reconciliation as an item causing a current year decrease.

Recapture upon Disposition

During the course of an oil and gas partnership's operations, properties are often disposed of. As explained in Example 15N-2, special ordinary income recapture provisions apply, under IRC Sec. 1254(a), to previously deducted IDC and depletion amounts.

Example 15N-2: Recapture of IDC and depletion.

In 2018, Johnny Highroller acquired a lease and drilled a producing well—the High Plains Lease #1-15. The costs to drill the well and applicable operating costs were as follows:

Leasehold acquisition costs	$ 50,000
IDC (deducted by Johnny in 2018)	500,000
Lease and well equipment (tangible property)	100,000
Accumulated depreciation	25,000
Accumulated depletion	35,000

On June 30, 2019, Johnny sold his entire interest in the well to an unrelated third party for $1 million. He allocated $910,000 of the sale price to the producing leasehold and $90,000 to the lease and well equipment.

For properties placed in service on or after 1986, the amount recaptured and reported as ordinary income is the lesser of the gain or the partner's share of IDC with respect to the property plus the cumulative deductions for depletion to the extent the deductions reduced the adjusted tax basis of the property. Reg. 1.1254-5(b)(1) provides that the recapture is determined at the partner level.

For properties placed in service before 1987, depletion deductions are not required to be recaptured. Also, the IDC required to be recaptured is reduced by the amount, if any, by which the depletion deduction would have increased if the IDC had been capitalized as a leasehold cost and the depletion allowance recalculated. Since Johnny's property was placed in service after 1986, the recapture amount is computed as follows:

Calculation of overall gain on sale of oil and gas property

Sales price		$ 1,000,000
Adjusted basis of property sold:		
Leasehold	$ 50,000	
Less: Accumulated depletion to extent of basis	(35,000)	
Subtotal		(15,000)
Lease and well equipment	100,000	
Less: Accumulated depreciation	(25,000)	
Subtotal		(75,000)
Total gain to be recognized		$ 910,000

Character of recognized gain

Depreciation recapture ($90,000 – $75,000)	$ 15,000
Depletion recapture[a]	35,000
IDC recapture[b]	500,000
Total ordinary income recapture	550,000
Section 1231 gain	360,000
Total gain to be recognized	$ 910,000

Notes:

[a] Lesser of depletion claimed ($35,000) or tax basis in leasehold costs ($50,000).

[b] For post-December 31, 1986 properties, represents all IDC incurred and deducted in drilling the well.

Ordinary income recapture under IRC Sec. 1254 should be reported on line 11 of Schedule K-1 (code I).

Percentage Depletion Preference

Computing allowable oil and gas depletion is a partner-level item. However, for all practical purposes, the calculation is often made at the partnership level. For tax years beginning before 1993, the deduction for percentage depletion was always an AMT preference item to the extent it exceeded the partner's share of the depletable oil and gas property's adjusted basis at year-end [IRC Sec. 57(a)(1)]. The Comprehensive National Energy Policy Act of 1992 included an AMT relief provision for independent producers repealing the excess percentage depletion preference for oil and gas for tax years beginning after 1992 [IRC Sec. 57(a)(1)].

Schedule K-1 Reporting Issues

Because oil and gas working interests constitute a trade or business, the partner's share of income net of expenses (other than specially allocated items and separately stated items such as Section 1231 gain, the Section 179 expense deduction and depletion) should appear on line 1 of Schedule K-1 as an ordinary income (loss) amount.

Specially allocated oil and gas income and expenses (which would otherwise be reported on line 1) should be reported on line 11 (code I).

If the partnership does not calculate tentative depletion for the partner, the information for the partner to make the calculation should be reported on a Schedule K-1 statement referencing line 20 (code T). On line 20, enter T* in the code column, and enter STMT in the entry column. If the partnership *does* calculate tentative depletion for the partner, the tentative depletion amount can be reported on a statement referencing line 20 of Schedule K-1 (code AH). On line 20, enter AH* in the code column and type STMT in the entry column.

ILLUSTRATION 15-1

Filled-out Form 4562 Showing Change in Use (See Example 15K-1)

Form **4562** | **Depreciation and Amortization** (Including Information on Listed Property) ▶ Attach to your tax return. ▶ Go to *www.irs.gov/Form4562* for instructions and the latest information. | OMB No. 1545-0172 **2019** Attachment Sequence No. **179**

Department of the Treasury Internal Revenue Service (99)

DRAFT AS OF July 3, 2019 DO NOT FILE

Name(s) shown on return	Business or activity to which this form relates	Identifying number
X Partnership	Beta line of business	75-2121667

Part I Election To Expense Certain Property Under Section 179

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	
2	Total cost of section 179 property placed in service (see instructions)	2	—
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	—
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	—

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	—
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	—
10	Carryover of disallowed deduction from line 13 of your 2018 Form 4562	10	—
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	—
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	—
13	Carryover of disallowed deduction to 2020. Add lines 9 and 10, less line 12 ▶	13	

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.**)**

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	—
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	—

Part III MACRS Depreciation (Don't include listed property. See instructions.**)**

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2019	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2019 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						—
b 5-year property		22,311	5yrs	N/A	200DB	8,924
c 7-year property						—
d 10-year property						—
e 15-year property						—
f 20-year property						—
g 25-year property			25 yrs.		S/L	—
h Residential rental			27.5 yrs.	MM	S/L	—
property			27.5 yrs.	MM	S/L	—
i Nonresidential real			39 yrs.	MM	S/L	—
property				MM	S/L	

Section C—Assets Placed in Service During 2019 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	—
b 12-year			12 yrs.		S/L	—
c 30-year			30 yrs.	MM	S/L	—
d 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	—
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	8,924
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2019)

ILLUSTRATION 15-2

Partner's Schedule K-1 Reporting Disposition of Section 179 Property and Recapture of Section 179 Deductions (See Example 15F-6)

651119

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) 2019
Department of the Treasury
Internal Revenue Service

For calendar year 2019, or tax year beginning / / 2019 ending / /

Partner's Share of Income, Deductions, Credits, etc. ► See back of form and separate instructions.

DRAFT AS OF September 26, 2019 DO NOT FILE

Part I Information About the Partnership

A Partnership's employer identification number
95-2679111

B Partnership's name, address, city, state, and ZIP code
SOS Partnership
123 Main St
Sherman, TX 72101

C IRS Center where partnership filed return ► Ogden, Utah

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number (Do not use TIN of a disregarded entity. See instructions.)
444-55-6789

F Partner's name, address, city, state, and ZIP code
Susan Simpson
234 Mockingbird Lane
Sherman, TX 72101

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☒ Domestic partner ☐ Foreign partner
☐ Disregarded entity:
Name of beneficial owner

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	50 %	50 %
Loss	50 %	50 %
Capital	50 %	50 %

Check if decrease is due to sale or exchange of partnership interest . . ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

☐ Check this box if Item K includes liability amounts from lower tier partnerships.

L **Partner's Capital Account Analysis**

	Tax Basis Capital
Beginning capital account	$ 50,000
Capital contributed during the year . .	$ —
Current year net income (loss)	$ 26,000
Other increase (decrease) (attach explanation)	$
Withdrawals & distributions	$ (—)
Ending capital account	$ 76,000

M Did the partner contribute property with a built-in gain or loss?
☐ **Yes** ☒ **No** If "Yes," attach statement. See instructions.

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $
Ending . . . . $

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

Line	Item	Amount
1	Ordinary business income (loss)	
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4a	Guaranteed payments for services	
4b	Guaranteed payments for capital	
4c	Total guaranteed payments	
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
6c	Dividend equivalents	
7	Royalties	
8	Net short-term capital gain (loss)	
9a	Net long-term capital gain (loss)	
9b	Collectibles (28%) gain (loss)	
9c	Unrecaptured section 1250 gain	
10	Net section 1231 gain (loss)	13,500
11	Other income (loss)	
I		12,500
12	Section 179 deduction	
13	Other deductions	
14	Self-employment earnings (loss)	
A		11,200
15	Credits	
16	Foreign transactions	
17	Alternative minimum tax (AMT) items	
18	Tax-exempt income and nondeductible expenses	
19	Distributions	
20	Other information	
L*		STMT
M*		STMT

21 ☐ More than one activity for at-risk purposes*
22 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R **Schedule K-1 (Form 1065) 2019**

Susan Simpson
ID# 444-55-6789
Schedule K-1 Supporting Statements from SOS Partnership, ID# 95-2679111

Schedule K-1, Line 11, Code I Information:

Your share of the Section 1245 recapture income from selling Asset #1: $12,500

Schedule K-1, Line 20, Code L Information:

In 2019, the partnership sold an asset for which a Section 179 expense deduction was passed through to you in 2017 when the asset was placed in service. If you deducted the passed-through Section 179 expense deduction amount, use the following information to understand your Schedule K-1 and to complete the Form 4797 worksheet for partners to figure gain or loss on dispositions of property for which a Section 179 expense deduction was claimed.

1. Description of asset: Asset #1 from SOS Partnership.
2. Date asset was acquired: January 5, 2017.
3. Date asset was sold: July 1, 2019.
4. Your share of asset's sale price: $26,000.
5. Your share of asset's basis: $12,500.
6. Your share of the asset's depreciation allowed or allowable: $0
7. Your share of the Section 179 expense deduction from asset: $12,500.
8. Your share of the total gain from selling asset: $26,000. $13,500 of this amount is reported to you as Section 1231 gain on Schedule K-1, line 10, and $12,500 of this amount is reported to you as other income (ordinary income) on Schedule K-1, line 11 (code I).

If you did *not* deduct the passed-through Section 179 expense deduction from this asset, consult your tax adviser.

Schedule K-1, Line 20, Code M Information:

In 2019, the partnership's business-use percentage declined for an asset for which a Section 179 expense deduction was passed through to you in 2018 when the asset was placed in service. This requires recapturing part of the Section 179 expense deduction by reporting it as income. If you deducted the passed-through Section 179 expense deduction amount, use the following information to understand your Schedule K-1 and to prepare your federal income tax return.

- Your share of the Section 179 expense deduction for the asset passed through to you in 2018: $17,500 (enter this amount on line 33 of Form 4797).
- Your share of recomputed depreciation for the asset: $6,300 (enter this amount on line 34 of Form 4797).
- Your share of Section 179 expense recapture income from the asset: $11,200 ($17,500 – $6,300). This amount is included in the self-employment earnings amount reported on Schedule K-1, line 14 (code A).

If you did *not* deduct the passed-through Section 179 expense deduction from this asset, consult your tax adviser.

Illustration 15-2 (Continued)

ILLUSTRATION 15-3

Reporting Depreciation of Basis Adjustment (after Section 754 Election) to Partner (See Key Issues 15D and 15H)

651119

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2019**

Department of the Treasury
Internal Revenue Service

For calendar year 2019, or tax year

beginning / / 2019 ending / /

Partner's Share of Income, Deductions, Credits, etc. ► See back of form and separate instructions.

DRAFT AS OF [S]eptember 26, 201[9] DO NOT FILE

Part I Information About the Partnership

A Partnership's employer identification number
77-6665555

B Partnership's name, address, city, state, and ZIP code
Peanut Partnership
123 Blue Bird Lane
Austin, TX 78962

C IRS Center where partnership filed return ► Ogden, Utah

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number (Do not use TIN of a disregarded entity. See instructions.)
111-22-3333

F Partner's name, address, city, state, and ZIP code
Alice Meartz
789 Red Bird Lane
Austin, TX 78692

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☒ Domestic partner ☐ Foreign partner
☐ Disregarded entity:
Name of beneficial owner

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to sale or exchange of partnership interest . . ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

☐ Check this box if Item K includes liability amounts from lower tier partnerships.

L **Partner's Capital Account Analysis**

	Tax Basis Capital
Beginning capital account . . .	$
Capital contributed during the year . .	$
Current year net income (loss) . . .	$
Other increase (decrease) (attach explanation)	$
Withdrawals & distributions . . .	$ ( )
Ending capital account	$

M Did the partner contribute property with a built-in gain or loss?
☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $
Ending . . . . $

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

Line	Item	Amount	Line	Item	Amount
1	Ordinary business income (loss)		15	Credits	
2	Net rental real estate income (loss)				
3	Other net rental income (loss)		16	Foreign transactions	
4a	Guaranteed payments for services				
4b	Guaranteed payments for capital				
4c	Total guaranteed payments				
5	Interest income				
6a	Ordinary dividends				
6b	Qualified dividends				
6c	Dividend equivalents		17	Alternative minimum tax (AMT) items	
7	Royalties				
8	Net short-term capital gain (loss)				
9a	Net long-term capital gain (loss)		18	Tax-exempt income and nondeductible expenses	
9b	Collectibles (28%) gain (loss)				
9c	Unrecaptured section 1250 gain				
10	Net section 1231 gain (loss)		19	Distributions	
11	Other income (loss)				
			20	Other information	
12	Section 179 deduction				
13	Other deductions				
*W		2,500			
14	Self-employment earnings (loss)				

21 ☐ More than one activity for at-risk purposes*
22 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2019

Caution: Generally, for the accuracy-related penalty, a tax understatement that is over $5,000 is considered substantial if it is also more than 10% of the tax required to be shown. For taxpayers claiming the QBI deduction, such an understatement is substantial if it is more than 5% of the tax required to be shown [IRC Sec. 6662(d)(1)(C)]. This change to the penalty indicates that Congress is aware of the potential for gamesmanship and is attempting to discourage aggressive positions on the QBI deduction. Note that this change to the penalty applies to all items included on the tax return, not just the QBI deduction.

References

IRS Notice 2019-27, 2019-31 IRB 484.
Rev. Procs. 2019-11, 2019-9 IRB 742 and 2019-38, 2019-42 IRB.
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Groetzinger, Robert, 59 AFTR 2d 87-532 (S. Ct. 1987).
Jackson, Richard M., TC Memo 1975-265 (1975).
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Lagreide, Anders, 23 TC 508 (1954).
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Union National Bank of Troy, 8 AFTR 2d 5133 (DC NY 1961).

KEY ISSUE 18A Identifying Qualified Business Income (QBI).

The first step for determining the QBI deduction is to calculate QBI from each of the taxpayer's *qualified businesses*. (See definition of qualified business at Key Issue 18B.) Generally, QBI is the net amount of qualified income, gain, deduction, and loss from a qualified business that is sourced to the U.S. (including Puerto Rico) to the extent those items are included or allowed in determining taxable income for the year [IRC Sec. 199A(c)(3)(A)].

See Checklist C204 for a checklist to assist in identifying issues related to the QBI deduction.

Qualified REIT dividends and qualified publicly traded partnership (PTP) income are not qualified items from a qualified business [IRC Sec. 199A(c)(1); Reg. 1.199A-3(b)(2)(ii)(G)]. But, these items are added to the computation of the overall deduction. (See Key Issue 18G.)

The following items are *not* qualified items from a qualified business [IRC Sec. 199A(c)(3)(B); Reg. 1.199A-3(b)(2)(ii)]:

1. Short- and long-term capital gains and losses, including any item treated as such under any other provision of the Code (e.g., Section 1231 gains or losses treated as capital gains or losses).
2. Any dividend and dividend equivalents, other than amounts described in IRC Sec. 1385(a)(1) (patronage dividends).
3. Interest income unless it is properly allocable to a trade or business. Interest income from the investment of working capital or similar accounts is not properly allocable to a trade or business. The preamble to the proposed regulations stated that interest income on receivables for goods or services provided by business is allocable to the business, however, the final regulations make no mention of this.
4. Commodity and foreign currency gains.
5. Annuities that are not connected to a trade or business.
6. Income or loss from certain notional principal contracts.
7. Any deduction or loss properly allocable to preceding items in this list.

Also, specifically excluded from QBI are [IRC Sec. 199A(c)(4)]—

1. reasonable compensation received by an S corporation shareholder (but such compensation reduces the S corporation's QBI if the wages are deductible and allocable to the business) [Reg. 1.199A-3(b)(2)(ii)(H)];
2. guaranteed payments for services described in IRC Sec. 707(c) received by partners for services rendered with respect to the business, regardless of whether the partner is an individual or relevant pass-through entity (RPE) (but the partnership's payment reduces its QBI if it is deductible and allocable to the business) [Reg. 1.199A-3(b)(2)(ii)(I)]; and
3. payments for services described in IRC Sec. 707(a) received by partners acting outside their capacity as a partner, regardless of whether the partner is an individual or RPE (but the partnership's payment reduces its QBI to the extent it is deductible and allocable to the business) [Reg. 1.199A-3(b)(2)(ii)(J)].

Observation: The preamble to the final regulations states that a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in the QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

The following rules apply for determining the QBI from a qualified trade or business (assuming the other requirements under IRC Sec. 199A are met, such as the requirement that the income be sourced to the U.S. [Reg. 1.199A-3(b)(1)].

1. Partners treat ordinary income or loss recognized under the Section 751 hot asset rules as QBI.
2. Partners cannot treat guaranteed payments received for the use of capital as QBI, except to the extent the payment is properly allocable to the recipient's business. But the partnership's deduction for the payment reduces its QBI.
3. Section 481(a) adjustments (whether positive or negative) are considered for computing QBI if the adjustment arises in a year ending after 2017.
4. Previously disallowed losses or deductions allowed in the tax year (for example, under the at-risk or passive activity loss rules, or due to the limits on partnership losses due to lack of basis) are taken into account for computing QBI, except for losses or deductions that were disallowed, suspended, limited, or carried over from years ending before 2018. When the taxpayer has previously disallowed losses for years ending both before and after 2018, such losses are taken into consideration for the QBI rules on a first-in, first-out (FIFO) basis.
5. Generally, an NOL deduction under IRC Sec. 172 is not considered for computing QBI. But, for tax years beginning after 2020, an excess business loss under IRC Sec. 461(l) that is treated as an NOL carryover to the following tax year is taken into account for computing QBI in the subsequent tax year in which it is deducted.
6. Deductions attributable to a trade or business are taken into account for the QBI deduction except to the extent provided in IRC Sec. 199A and the regulations thereunder. For the QBI rules, deductions such as the deductible part of the self-employment (SE) tax under IRC Sec. 164(f), the self-employed health insurance deduction under IRC Sec. 162(l), and deductions for qualified plan contributions under IRC Sec. 404 are attributable to a trade or business to the extent that the individual's gross income from the business is considered in calculating the allowable deduction, in proportion to the gross income received from the business. The preamble to the final regulations notes that whether items such as unreimbursed partnership expenses, state and local taxes, and the interest expense to acquire partnership and S corporation interests are attributable to a trade or business is beyond the scope of the regulations, but should be determined by the Code section governing the deduction.

KEY ISSUE 18B Identifying Qualified Businesses.

A *qualified business* is any trade or business under IRC Sec. 162 other than (1) the business of performing services as an employee and (2) a specified service trade or business (SSTB) [IRC Sec. 199A(d)(1)]. But, in any tax year that a taxpayer's taxable income is at or below the threshold amount, that taxpayer can treat an SSTB as a qualified trade or business [IRC Sec. 199A(d)(3)]. (See Key Issue 18D for detailed discussion on SSTBs.)

Sch K-1 Line	Description		Information	*Deskbook* Reference Chapter (e.g., 9) or Key Issue (e.g., 10A)
		• Any information needed for partners filing Form 8886 (Reportable Transaction Disclosure Statement)		20K
		• Any income or gain reported on lines 1 through 11 of Schedule K-1 that qualifies as inversion gain, if the partnership is an expatriated entity or is a partner in an expatriated entity (IRC Sec. 7874)		
		• Interest and additional tax on compensation deferred under a Section 409A nonqualified deferred compensation plan that does not meet the requirements of IRC Sec. 409A. This amount must also be included on Schedule K-1, line 4, guaranteed payments to partners		
		• The amounts that the partner will use to compute the credit for qualifying advanced coal project property on Form 3468 (Investment Credit)	One of the credits that composes the General Business Credit.	23A
		• The amounts that the partner will need to compute the credit for qualifying gasification project property on Form 3468	One of the credits that composes the General Business Credit.	23A
		• Conservation reserve payments		
		• Any other information needed to reconcile partner's tax basis to information presented on Schedule K-1		

Sch K-1 Line	Description		Information	*Deskbook* Reference Chapter (e.g., 9) or Key Issue (e.g., 10A)
		• Qualified advanced energy project credit supporting documentation	One of the credits that composes the General Business Credit.	23A
		• The information needed to complete Schedule P (Form 1120-F), List of Foreign Partner Interests in Partnerships		
		• Information to comply with the limitation on excess farm losses		
		• Medical and dental expenses, including insurance premiums paid on behalf of the partner that are treated as distributions	These amounts can be deducted by the individual partners above-the-line on their Form 1040 if they meet the requirements of Rev. Rul. 91-26. If amounts are treated as guaranteed payments, these amounts should be reported on line 13 (code M).	31
		• Corporate dividends-received deduction	Corporate partners are eligible in some cases for a dividends-received deduction, requiring the information necessary to determine eligibility for the corporate dividends-received deduction to be provided on a statement attached to the corporate partner's Schedule K-1.	
		• Information necessary to calculate the deduction for a domestic corporate partner under IRC Sec. 250 for the eligible percentage for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).		

2. the partner's rights and obligations for that specific limited class of interest are identical to the rights and obligations of limited partners that hold the same limited class of partnership interest.

Related SE Tax Issues

Guaranteed Payments. Guaranteed payments, whether received for services or for the use of capital, are included in an individual's net earnings subject to SE tax unless they are received from a partnership that is not engaged in a trade or business [Reg. 1.1402(a)-1(b)]. With a few limited exclusions, trade or business has the same broad meaning for this purpose as it has in IRC Sec. 162 [IRC Sec. 1402(c); Reg. 1.1402(c)-1]. The exclusions are those set forth in IRC Secs. 1402(c)(1) through (6) and Regs. 1.1402(c)-2 through 1.1402(c)-7 (e.g., services performed as an employee covered by social security or the Railroad Retirement System, certain services performed as a public official, and certain services performed by ordained ministers and other religious personnel).

A guaranteed payment constitutes SE income only if the recipient is an individual or a disregarded entity, such as a single-member LLC (SMLLC) or a grantor trust, the income of which is taxed to an individual. (Other types of recipients, such as C corporations, S corporations, or partnerships, are not subject to SE tax.) If a guaranteed payment is received by the partnership, the income will pass through to the partners and may be subject to SE tax under generally applicable rules, but not because the income received by the partnership was a guaranteed payment [IRC Sec. 1402(a)].

Retirement Payments. Retirement payments to partners are not subject to SE tax provided they are structured in accordance with IRC Sec. 1402(a)(10) and Reg. 1.1402(a)-17. To qualify for this exemption the following criteria must be met:

1. The payments must be pursuant to a written plan.

2. The payments must satisfy the services requirements.

3. The payments must be made due to the retirement of partners on a periodic basis continuing at least until the partner's death.

4. The retiring partner cannot render any services for any of the partnership's trades or businesses.

5. As of the close of the partnership's tax year, no obligations other than the retirement payments can exist between the remaining partners and the retiring partner.

6. As of the close of the partnership's tax year, the retired partner's capital in the partnership must be repaid.

Rental Payments. The general rule is that rental payments are not subject to SE tax. However, the instructions to Form 1040, Schedule E indicate that income from the rental of personal property should be reported on Schedule C if the taxpayer is in the business of renting property. The instructions go on to provide that the rental of personal property is a business if the primary purpose for renting the property is income or profit and the taxpayer is involved in the rental activity on a continuous and regular basis. An exception to the rule that real estate rentals create no SE income is for general partners in partnerships owning hotels, since the operation of a hotel is not considered a rental activity.

Additional 0.9% Medicare Tax. Higher income individuals may owe an additional 0.9% Medicare tax on earned income above $200,000 for single filers and heads of household, $250,000 for married couples filing jointly, and $125,000 for married filing separately [IRC Sec. 3101(b)(2)]. Wages, SE income, and other compensation are potentially subject to the additional 0.9% Medicare tax.

The distributive share of partnership income from any trade or business in which the taxpayer is not a limited partner is potentially subject to the additional 0.9% Medicare tax because it is SE income, as is the value of taxable fringe benefits. Guaranteed payments for services and for the use of partnership capital (if the partnership is engaged in a trade or business) are also considered SE income. A limited partner does not include his or her share of partnership income as SE income, with the exception of guaranteed payments for services rendered to the partnership.

For added discussion on the additional 0.9% Medicare tax, see Key Issue 31G.

How to Report SE Items on Schedule K-1

The instructions to Schedule K-1 indicate that if net earnings from SE income reported on line 14 is a loss, enter only the deductible amount on Form 1040, Schedule SE. Therefore, if a loss from a partnership trade or business reported to the partner is not fully deductible due to basis, at-risk, or PAL limitations, these limitations should be considered when calculating the partner's SE income/loss from the partnership. This is in line with reasoning followed in Ltr. Rul. 9750001 where the IRS concluded that passive activity losses (PALs) that were disallowed in prior years for income tax purposes should also have been excluded from the calculation of net earnings from self-employment in those prior years. In some situations, when a partner receives a guaranteed payment in addition to his or her distributive share of partnership trade or business loss, the amount reported as SE income/loss on Schedule K-1, line 14 might not result in a loss. The authors feel that even in these situations, if a limitation is applied to the trade or business loss, this limitation should be considered in computing the amount of partnership SE income/loss that is included on the partner's Schedule SE. The instructions to Form 1065 provide a worksheet for calculating the partnership's total reportable net earnings from self-employment.

KEY ISSUE 21G Limitations on Losses and Deductions.

Losses and deductions generally are not limited at the partnership level. Rather, losses and deductions pass through to partners in full, and are subjected to limitations, if any, at the partner level. An exception to this rule is the Section 179 expense deduction, which is limited at both the partnership and partner levels. See Chapter 15 for additional discussion on the Section 179 expense deduction. A second exception is the limit on business interest expense under IRC Sec. 163(j). See Key Issue 14G for discussion of this limitation.

Another exception applies when a lower-tier partnership, passes through losses, and the upper-tier partnership does not have sufficient basis to deduct the entire loss. (See Example 21C-3 for basis limitation.)

As discussed in Chapter 24, losses and deductions passed through to the partner can be deducted only to the extent of the partner's basis in the partnership interest (outside basis). Losses limited by lack of basis carry over indefinitely and can be deducted in a later year to the extent that the partner has sufficient outside basis at the end of that year.

Ideally, amounts reported on the Schedule K-1 lines should be allocated among the partnership's activities on a white paper schedule attached to each partner's Schedule K-1 to allow partners to apply the at-risk rules (see Chapter 29), the passive activity loss (PAL) rules (see Chapter 30), and any other applicable rules at the partner level. (See Illustration 21-5.)

Note: The 2019 Form 1065 and Schedule K-1 have added additional reporting requirements for passive and at-risk activities. Item K on page one of Form 1065 includes a box to be checked if activities have been grouped for Section 465 at-risk purposes or Section 469 passive activities purposes. Schedule K-1, Part III, question 21 is now a box to be checked if there is more than one activity for at-risk purposes, while question 22 is to be checked if there is more than one activity for passive activity purposes. If the passive activity box is checked, a statement providing separate information for each passive activity must be attached.

While the at-risk rules under IRC Sec. 465 are applicable at the partner level, and the calculations are performed separately for each partner, the partnership should supply each partner with sufficient information to perform the requisite calculations and complete Form 6198 (At-Risk Limitations) if necessary. (See Chapter 29.)

Caution: Page 12 of the 2019 instructions for Form 1065, and page three of the instructions for Schedule K-1, require that a statement be attached to the partners' Schedules K-1 to report certain additional information for each separate at-risk activity. However, the IRS received negative comments on this requirement from practitioners stating that it would not be possible to timely comply. The IRS has issued Notice 2019-66 that postpones this requirement. For 2019, partnerships are not required to report information for each separate at-risk activity that was not required for 2018 tax years. Presumably, reporting this additional information for separate at-risk activities will be required for partnership taxable years beginning on or after January 1, 2020, although Notice 2019-66 does not explicitly state this.

Amounts attributable to passive activities (or activities that will be passive if the partner does not materially participate) should be reported on the appropriate Schedule K-1 lines. For example, a passive Section 1231 gain from the sale of rental property should be reported on line 10. Similarly, a Section 179 expense deduction for a

general partner who does not materially participate in the partnership's trade or business activities should be reported on line 12. (See Chapter 30.)

Excess Business Loss Limitation

Law Change Alert: The CARES Act delayed the effective date for the application of the excess business loss limitation to tax years beginning after 2020 [IRC Sec. 461(l)(1)(B)]. Individual taxpayers who have filed returns for 2018 or 2019 showing an excess loss limitation can amend those returns to deduct the amount of the loss that was limited by IRC Sec. 461(l).

For tax years beginning after 2020 and before 2026, any *excess business loss* of a taxpayer other than a C corporation is not allowed for the tax year. These losses are carried forward and treated as part of the individual taxpayer's net operating loss (NOL) carryforward in subsequent tax years [IRC Sec. 461(l)].

An excess business loss for the tax year is the excess of the taxpayer's aggregate deductions attributable to the taxpayer's trades or businesses [determined before this limit, but after the passive activity loss (PAL) rules], over the sum of the taxpayer's aggregate gross income or gain from such trades or businesses plus $500,000 (for MFJ; $250,000 for all other filers). This threshold amount is indexed for inflation.

In the case of a partnership, the provision applies at the partner level. Each partner's share of the entity's items of income, gain, deduction, or loss is taken into account in applying the partner's limit on excess business losses for the year.

KEY ISSUE 21H Reporting Foreign Transactions.

When domestic businesses operate in foreign countries or raise capital from foreign investors to expand their business in the U.S., they must deal with a complex array of foreign income tax rules. A brief summary of those rules follows.

Reporting Requirements for Foreign Bank Accounts

Report of Foreign Bank and Financial Accounts (FBAR). A partnership with foreign portfolio income during the calendar year might have an interest in or signature power over a foreign bank account, and may therefore be required to file FinCen Form 114 [formerly Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts)]. It is not a tax form and is not attached to the partnership Form 1065. The form is filed with the Department of the Treasury by April 15 of the following calendar year with a maximum extension of six months ending on October 15. Penalties resulting from a failure to file or failure to request an extension may be waived by the Secretary for first-time filers.

Note: Electronic filing of FBARs is mandatory. For help with electronic filing of the FBAR visit **http://bsaefiling.fincen.treas.gov/main.html**.

Foreign Account Tax Compliance Act (FATCA). FATCA was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act and is an important initiative to improve tax compliance involving foreign financial assets and offshore accounts. Under FATCA, specified individuals and specified domestic entities with specified foreign financial assets that exceed $50,000 on the last day of tax year or $75,000 at any time during the tax year must report those assets to the IRS on Form 8938 (Statement of Specified Foreign Financial Assets). Partnerships attach Form 8938 to Form 1065. If the entity does not have to file a tax return for the tax year, Form 8938 is not required to be filed for that tax year either.

Observation: Proposed regulations issued in August 2018, related to the centralized partnership audit regime include guidance for the coordination of foreign withholding requirements and FATCA [Prop. Reg. 301.6241-7(b)]. The proposed regulations affect partnership tax years beginning after 2017 (unless the partnership elects to apply the rules early to tax years beginning on or after November 2, 2015, and before 2018.

Specified foreign financial assets are (1) depository or custodial financial accounts maintained at foreign financial institutions, and (2) to the extent not held in an account at a financial institution: (a) stocks or securities issued by foreign corporations (b) any other financial instrument or contract held for investment that is issued by or has a counter party that is not a U.S. person, and (c) any interest in a foreign entity [IRC Sec. 6038D(b); Reg. 1.6038D-3]. If the value of the specified foreign financial assets is more than the appropriate reporting threshold and no exception

applies, taxpayers must file Form 8938 even if none of the specified foreign financial assets affect their tax liability for the tax year [Reg. 1.6038D-2(a)(8)].

Specified domestic entities include closely held partnerships that have at least (1) 50% of gross income that comes from passive income or (2) 50% of their assets produce or are held for the production of passive income.

A closely held domestic partnership is closely held if on the last day of the partnership's tax year, a specified individual directly, indirectly, or constructively holds at least 80% of the capital or profits interest in the partnership. IRC Secs. 267(c) and 267(e) apply for determining constructive ownership in a domestic corporation or partnership. IRC Sec. 267(c)(4) is applied as if the family of an individual includes the spouses of the specified individual's family members.

Passive income means the portion of gross income that consists of the following:

- Dividends, including substitute dividends.
- Interest, income equivalent to interest, including substitute interest.
- Rents and royalties, other than that derived in the active conduct of a trade or business conducted, at least in part by employees of the partnership.
- Annuities.
- The excess of gains over losses from the sale or exchange of property described in Reg. 1.6038D-6(b)(3)(i)(F) and that give rise to the types of passive income listed above.
- The excess of gains over losses from transactions (including futures, forwards, and similar transactions) in any commodity, but not including (1) any commodity hedging transaction described in IRC Sec. 954(c)(5)(A) or (c)(2) active business gains or losses from the sale of commodities, but only if substantially all of the corporation's or partnership's commodities are property described in IRC Sec. 1221(a)(1), (2), or (8).
- The excess of foreign currency gains over foreign currency losses as defined in IRC Sec. 988(b) attributable to any Section 988 transaction.
- Net income from notional principal contracts.

The passive asset percentage is determined based on a weighted average approach. Under this test, partnerships may use either the fair market value or book value to determine the value of their assets. They may be required to substantiate their determination of the passive asset percentage upon request by the IRS [Reg. 1.6038D-6(b)(1)(ii)].

Failure to disclose the required information may result in a $10,000 penalty. An additional penalty may apply for each 30-day (or fraction thereof) period in which the information is not filed. The maximum penalty imposed shall not exceed $50,000 [IRC. Sec. 6038(b)].

The rules are complex and not to be confused with the reporting requirements for FBAR, "Report of Foreign Bank and Financial Accounts." These are different reporting requirements, with their own set of rules. Regulations have been issued under FATCA, but widespread questions remain among practitioners. Practitioners should monitor these rules for continuing developments. The IRS website has FAQs, a summary of key FATCA provisions, and a comparison chart between the filing requirements for Form 8938 and FBAR. Go to **www.irs.gov** and search for "FATCA FAQs."

Taxation of Foreign Owners

As a general rule, foreign individuals and corporations are subject to tax at a 30% (or lower treaty) rate on U.S. source income that *is not* effectively connected with the conduct of a U.S. trade or business [IRC Secs. 871(a)(1) and 881]. U.S. source income includes interest [except original issue discount (OID), portfolio, and deposit interest], dividends, rents, salaries, premiums, annuities, and other fixed or determinable annual or periodic gains, profits, and income from sources within the U.S. [IRC Secs. 871(a)(1)(A) and 881(a)(1)]. In addition, foreign individuals and corporations are taxed at regular U.S. graduated rates on income (regardless of source) that *is* effectively connected with a U.S. trade or business. For example, in Rev. Rul. 2004-3, the IRS ruled that under the terms of the U.S./Germany tax treaty, a German nonresident member of a personal service LLC that had a fixed location in the U.S. was subject to tax, even if the member did not perform any services in the U.S. The ruling states that it is applicable in

Example 24D-5: Deferred loss.

Carol is a partner in Delta Queens, a general partnership that manufactures playing cards. Carol's outside basis is $25,000, and her share of the current year's loss is $10,000. Carol does not materially participate in the business, but has $4,000 of other passive income.

Under the PAL rules of IRC Sec. 469, Carol can only deduct $4,000 of Delta Queens' current year loss. The remaining $6,000 of PALs are suspended and used in future years against any passive income. However, Carol's outside basis is reduced by the full $10,000, even though $6,000 cannot be deducted currently.

In determining the impact of the outside basis, at-risk, PAL limitations, and the excess business loss disallowance rules, take the following steps in the following order:

Step 1 Recognize that losses and deductions up to the amount of the partner's outside basis are tentatively allowed, pending application of the at-risk and PAL limitations and the excess business loss disallowance rules. However, regardless of the impact of these limitations, losses up to the amount of the partner's outside basis reduce the partner's outside basis (but not below zero).

Step 2 Next, determine the partner's amount at risk under the at-risk rules explained in Chapter 29. The tentatively allowable loss amount from Step 1 is tentatively allowed up to the amount at risk. However, loss amounts that are limited by the at-risk rules still reduce the partner's outside basis (but not below zero).

Step 3 Next, the tentatively allowable loss amount from Step 2 can be deducted to the extent allowed under the PAL rules. However, loss amounts that are limited by the PAL rules still reduce the partner's outside basis (but not below zero).

Preparation Pointer: Worksheet W101 helps maintain correct outside basis records for partners.

Effect of Partnership Charitable Donations and Foreign Taxes on Outside Basis

As explained earlier in this key issue, IRC Sec. 704(d) stipulates that a partner cannot deduct partnership losses in excess of the partner's tax basis in the partnership interest (outside basis). For partnership tax years beginning after 2017, the TCJA clarifies that a partner's share of partnership deductions for charitable donations and foreign taxes reduce outside basis. However, for charitable donations of appreciated property (FMV higher than tax basis), the excess of FMV over basis does not reduce outside basis. In other words, only the partner's allocable share of the basis of donated appreciated property reduces the partner's outside basis. [See IRC Sec. 704(d).]

Partner-Level Deduction for Qualified Business Income Has No Impact on Outside Basis

For tax years beginning in 2018–2025, the TCJA established a new deduction based on an individual taxpayer's share of qualified business income (QBI), including QBI passed through from a partnership (or LLC treated as a partnership for tax purposes). The deduction generally equals 20% of QBI, subject to restrictions that can apply at higher income levels and another restriction based on the partner's taxable income. (See IRC Sec. 199A.) The QBI deduction has no impact on a partner's outside basis. For a detailed discussion on the QBI deduction see Chapter 18.

Contributing Corporate Partner's Own Stock

Rev. Rul. 99-57 indicates that if a corporate partner contributes its own stock to a partnership in exchange for a partnership interest, and the partnership later exchanges the stock in a taxable transaction, then the partnership will realize gain that will be allocated to the partners under IRC Sec. 704. Under IRC Sec. 1032, however, the corporate partner will not recognize the gain allocated to it with respect to the sale or exchange of the stock. Furthermore, under IRC Sec. 705, the corporate partner increases its outside basis by an amount equal to its share of the gain resulting from the partnership's sale or exchange of the stock.

In connection with Rev. Rul. 99-57, the IRS issued Reg. 1.705-2 which bars corporate partners from adjusting their outside basis when that partnership owns, then sells, the corporation's stock. These regulations apply to a corporation that acquires a partnership interest when there is no Section 754 election in effect for that partnership. The intent is to limit a corporation's outside basis increase to the amount of its share of Section 1032 gain that it would have realized if a Section 754 election had been made.

For example, assume XYZ Corporation (XYZ) purchased a 50% interest in ABC Partnership (ABC) for $100,000. ABC's only asset is XYZ stock, with a $100,000 basis and a $200,000 FMV. If ABC does not make a Section 754 election when it disposes of its XYZ stock for $200,000, XYZ would be allocated a $50,000 gain. Under IRC Sec. 1032, the gain allocated to XYZ is not taxable. If XYZ's outside basis in ABC was increased to $150,000 under IRC Sec. 705(a)(1), XYZ would recognize a corresponding $50,000 loss (or reduced gain) when selling its interest in ABC. In this case, it is inconsistent with the intent of IRC Sec. 705 to increase XYZ's outside basis in ABC for the gain XYZ did not have to recognize. To do so would allow a tax loss (or reduced gain) where no economic loss was incurred and no offsetting taxable gain was previously recognized.

KEY ISSUE 24E Outside Basis Adjustment Ordering Rules.

Under IRC Sec. 704(d), a partner's allocable share of loss is deductible only to the extent of the partner's outside basis at the partnership's year-end. In determining a partner's outside basis at year-end, adjustments for increases and decreases are made in a specific order according to Reg. 1.704-1(d)(2).

First, the partner's basis is increased by all positive basis adjustments (including current-year cash and property contributions) and all items of income (both taxable and nontaxable) [IRC Sec. 705(a)(1)].

Next, basis is decreased (though not below zero) for current-year distributions. While nonliquidating distributions may have been made throughout the year, they are generally deemed to have been made on the last day of the partnership year [Reg. 1.731-1(a)(1)(ii) and Rev. Rul. 66-94]. (Chapter 33 discusses the distinction between advances or draws and other nonliquidating distributions.) If both cash and other property are distributed in the same transaction or are deemed to have been distributed at year-end, the cash is considered to be distributed first [IRC Sec. 732(a)(2)].

Finally, basis is decreased (though not below zero) by the partner's share of all items of partnership losses for the year, including any carryovers from prior years [Reg. 1.704-1(d)(2)].

Example 24E-1: Limiting a deductible loss after adjusting basis.

Stephanie is a partner in Carolina Travelers, a general partnership operating a travel website. Her outside basis at the beginning of the year is $5,000. The partnership loss allocated to her this year is $3,500, consisting of $3,000 of ordinary loss and $500 of capital loss. The partnership also distributes $3,000 (treated as an advance or draw) to her during the year.

The $3,000 distribution is a tax-free return of partner capital reducing Stephanie's $5,000 partnership basis to $2,000—prior to the adjustment for any current-year losses. Since Stephanie cannot reduce her basis below zero, she will be allowed to deduct only $2,000 of her allocable loss. The remaining $1,500 loss will carry forward until there is adequate basis to claim the deduction. (If the partnership waits until next year to distribute cash to Stephanie, she may have sufficient basis to claim the full $3,500 loss. However, unless there is income next year, only $1,500 of the $3,000 distribution will be tax-free. The remaining $1,500 will be taxable since it exceeds her basis.) Example 24E-2 illustrates the composition of suspended losses in a particular scenario.

Warning: In some cases, a distribution not characterized as an advance or draw can result in unexpected gain recognition for the distributee partner. See the discussion in Chapter 33 regarding the distinction between the timing of distributions that are advances or draws versus the timing of other nonliquidating distributions.

Allocation of Suspended Loss Among Separate Components and Impact on AMT Items

As noted previously, when the loss allocated to a partner exceeds his or her outside basis, the deductible loss is limited by IRC Sec. 704(d). Typically, the partner's overall net loss is made up of several separately stated components that may include long-term or short-term capital loss, ordinary loss from operations, investment interest expense, etc. In a year in which the various separately stated partnership items combine to produce an overall loss that exceeds the partner's outside basis, it becomes necessary to determine which loss items are reported currently

- A special rule is provided under the safe harbor that reduces a partnership's net income in a CFTE category to the extent foreign law allows such a deduction, either in the current or a different tax year. This amount is not treated as an allocation in determining partners' shares of net income in a CFTE category [Reg. 1.704-1(b)(4)(viii)(c)(4)(iii)].
- Conversely, an upward adjustment must be made to net income in a CFTE category to the extent that foreign law does not allow a deduction for a guaranteed payment that is deductible for U.S. income tax purposes. The upward adjustment is made only to the extent that the amount allowed as a U.S. tax deduction exceeds the amount allowed for foreign taxes. The entire upward adjustment is allocated to the recipient of the guaranteed payment for purposes of determining partners' shares of net income in a CFTE category [Reg. 1.704-1(b)(4)(viii)(c)(4)(ii)].

KEY ISSUE 26L Interaction of Allocation Rules with Loss Limitation Provisions.

A partner cannot deduct a tax loss to the extent the loss exceeds the adjusted tax basis of his partnership interest (outside basis) at the end of the partnership tax year in which the loss occurs [IRC Sec. 704(d)]. Any loss disallowed is carried over and deducted in a future year when sufficient basis exists to absorb the loss. (See Chapter 24.) If a partner has been properly allocated a tax loss under the Section 704(b) rules and has sufficient outside basis in the partnership interest to deduct the loss, it may still be subject to other loss limitations at the partner level.

For example, a partner's otherwise allowable deductions could also be restricted by the at-risk limitation under IRC Sec. 465 (Chapter 29), the passive activity loss rules under IRC Sec. 469 (Chapter 30), the limitations on Section 179 expense deductions (Chapter 15), the investment interest expense limitation under IRC Sec. 163(d), or the limitation on excess business losses under IRC Sec. 461(l) (for tax years beginning after 2020). This list is not exhaustive. See Table T621. Such other limitations come into play at the partner level after applying the allocation rules discussed in this chapter and after applying the outside basis limitation discussed in Chapter 24.

KEY ISSUE 26M Noncompensatory Partnership Options: Effect on Allocations and Capital Account Maintenance.

Final regulations issued in 2013 address the effect of the granting and exercise of noncompensatory partnership options. Under the regulations, a noncompensatory partnership option means an option issued by a partnership other than an option granted in connection with the performance of services (Key Issue 2I). The regulations, which are found in TD 9612, are effective for noncompensatory partnership options granted on or after February 5, 2013. This key issue summarizes what the regulations say about the effect of noncompensatory options on partnership allocations and partnership capital account maintenance.

Effect on Allocations

If the option holder is treated as a partner, and the partnership agreement grants the option holder a right to share in partnership capital that exceeds (or is less than) the amount paid to the partnership to acquire and exercise the option, allocations of income, gain, loss, and deduction to the other (existing) partners while the noncompensatory option is outstanding cannot have economic effect [Reg. 1.704-1(b)(4)(ix)(a)]. This is because the option holder, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction if the noncompensatory option is exercised.

Allocations of partnership income, gain, loss, and deduction to the other (existing) partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership (PIP) (see Key Issue 26J) if the conditions listed below are satisfied. [See Reg. 1.704-1(b)(4)(ix)(a).]

1. The holder of the noncompensatory option is not treated as a partner under Reg. 1.761-3. Non-partner status will often be the case, and it is the preferred scenario from a tax perspective. (See Key Issue 2I.)
2. The partnership agreement requires that while a noncompensatory option is outstanding, the partnership will comply with the rules for revaluing capital accounts and that upon the exercise of the noncompensatory option, the partnership will make the capital account adjustment explained later in this key issue.

3. All material allocations and capital account adjustments under the partnership agreement would be respected under IRC Sec. 704(b) if there were no outstanding noncompensatory options issued by the partnership.

Effect on Capital Account Maintenance

Reg. 1.704-1(b)(2)(iv)(d)(4) provides that a partner's book capital account is increased by the FMV of property contributed on the exercise of a noncompensatory option by that partner. The amount of the increase does not include the FMV of the option privilege, but does include the consideration paid to the partnership to acquire the option and the FMV of any property (other than the option) contributed to the partnership on the exercise of the option. For convertible debt, the FMV of the property contributed on the exercise of the option is the adjusted issue price of the debt and the accrued but unpaid qualified stated interest [as defined in Reg. 1.1273-1(c)] on the debt immediately before the conversion, plus the FMV of any property (other than the convertible debt) contributed to the partnership on the exercise of the option.

Ensuring Compliance with Safe Harbor Capital Account Maintenance Rules. If upon the exercise of a noncompensatory option, the partnership agreement grants the exercising partner the right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid to the partnership to acquire and exercise the option, capital accounts are not considered to be maintained in accordance with the safe harbor rules summarized in Key Issue 26F unless the following conditions are satisfied. [See Reg. 1.704-1(b)(2)(iv)(s).]

1. In lieu of revaluing partnership property under Reg. 1.704-1(b)(2)(iv)(f) (see Key Issue 26F) immediately before the exercise of the option, the partnership revalues partnership property immediately after the exercise of the option.

2. In determining the capital accounts of the partners (including the exercising partner), the partnership first allocates any unrealized income, gain, or loss in partnership property (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement. The partnership then allocates any remaining unrealized income, gain, or loss (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, or loss in partnership property would be allocated among those partners if there were a taxable disposition of the property for FMV on that date. If the exercising partner's initial capital account would be less than his or her right to share in partnership capital, only income or gain from partnership properties with unrealized appreciation may be allocated to that partner, in proportion to the respective amounts of unrealized appreciation. If the exercising partner's initial capital account would be greater than his or her right to share in partnership capital, only loss from partnership properties with unrealized loss may be allocated to that partner, in proportion to the respective amounts of unrealized loss. However, any allocation must take into account the economic arrangement of the partners with respect to the property.

3. If after making the allocations described in item 2, the exercising partner's capital account does not reflect that partner's right to share in partnership capital, the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account reflects his or her right to share in partnership capital (a capital account reallocation). Any increase or decrease in the capital accounts of existing partners that occurs as a result of a capital account reallocation must be allocated among the existing partners in accordance with the principles outlined in item 2.

4. The partnership agreement requires corrective allocations to take into account all capital account reallocations made under item 3.

Corrective Allocations. If a partnership makes a capital account reallocation according to item 3, the partnership must make corrective allocations to take into account the reallocation [Reg. 1.704-1(b)(4)(x)]. The corrective allocations must begin with the tax year of the exercise and be made in all succeeding tax years until the required allocations are fully taken into account. A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item. (See Example 26M-1.) IRC Sec. 706 and the related regulations and principles apply in determining the items of income, gain, loss, and deduction that may be subject to corrective allocation [Reg. 1.704-1(b)(4)(x)(b)].

Key Issue 26M

to limitation since Elroy's tax basis of $162,000 exceeds the amount he paid for his interest (i.e., $90,000—Elroy's share of partnership liabilities) by more than $12,000.

Example 29E-6: Gift of partnership interest when the donor partner has a positive amount at risk.

Assume the same facts as in Example 29E-5, except George has an amount at risk in JSC Partners of $40,000 and has no previously suspended at-risk losses. Elroy's initial outside basis in the gifted partnership interest is $112,000 (the $100,000 carryover basis + the $12,000 gift tax). His amount at risk will be $52,000 (the $40,000 carryover at-risk amount + the $12,000 gift tax). However, Elroy's amount at risk is limited to $22,000, since that is the amount his outside basis of $112,000 exceeds the amount he paid for the partnership interest (i.e., $90,000—his share of partnership liabilities).

When a partner dies owning an at-risk activity with suspended losses, the treatment of such losses is not clear in the regulations. However, since these losses are treated as personal to the transferor under the rules of Prop. Reg. 1.465-67(b), it appears suspended at-risk losses *disappear* upon the death of a partner. The regulations do address the calculation of the successor partner's amount at risk (Prop. Reg. 1.465-69). A partner who inherits an interest in an at-risk activity receives the amount at risk of the decedent.

Regulations address transfers of at-risk activities from an individual to the individual's bankruptcy estate (Reg. 1.1398-2). These regulations also address transfers of at-risk activities from an individual's bankruptcy estate to the individual (either prior to or at the time the estate terminates). A bankruptcy estate [arising under Chapter 7 (relating to liquidations) or Chapter 11 (relating to reorganizations) of Title 11 of the United States Code] succeeds to the unused at-risk losses of an individual debtor as of the first day of the tax year in which the bankruptcy case commences. A transfer of an activity from the bankruptcy estate to the debtor *before* the estate's termination is not treated as a taxable disposition. The debtor succeeds to the estate's unused at-risk losses from the activity. If only a portion of the assets used in an activity are transferred, an allocation of unused at-risk losses is made. The regulations also provide that the debtor succeeds to the estate's unused at-risk losses upon termination of the estate.

KEY ISSUE 29F Recapturing Previously Deducted At-risk Losses.

A taxpayer must recapture previously deducted at-risk losses if his amount at risk falls below zero. Events triggering recapture income include distributions or changes in debt structure that reduce a partner's amount at risk (such as a recourse debt becoming nonrecourse or a debt ceasing to be a debt for which the partner is genuinely liable).

If a partner receives a distribution of cash in excess of his amount at risk (or if for some other reason his amount at risk falls below zero), the partner must recognize income. The income recognized under these provisions is offset by the *creation* of a suspended at-risk loss that is carried forward to the next year. If the partner's amount at risk is subsequently increased, the suspended loss becomes deductible [IRC Sec. 465(e)]. (See Table T621 and Worksheet W112.)

In *Zeluck*, a partner in an oil and gas drilling partnership was required to recognize $200,000 of income in 2003 pursuant to the at-risk recapture rule. In that year, the partner's amount at risk was reduced by $200,000 because his personal assumption of $200,000 of partnership debt ceased to be genuine, according to the IRS and the Tax Court. Payments on the assumed debt were not made, and there was no effort to enforce the assumed debt's repayment terms after the partnership was terminated and liquidated in 2003. Thus, the partner's amount at risk was reduced from zero to negative $200,000 during 2003, which triggered $200,000 of recapture income in that year.

Example 29F-1: Recapture of at-risk losses when distribution reduces amount at risk below zero.

Simon owns a 50% partnership interest in which he has a $100,000 tax basis (i.e., outside basis—Chapter 24) and zero at risk due to previously deducted losses. The calendar-year partnership has one at-risk activity which is its only activity. During the current year, Simon receives a $10,000 distribution and is allocated a $20,000 tax

loss. Since the distribution reduces Simon's at-risk amount below zero, he is required to report income of $10,000 for the current year. Since a loss allocation cannot reduce a partner's at-risk amount below zero, Simon cannot deduct any of the $20,000 partnership loss for the current year. The $20,000 disallowed loss is suspended and carried forward until Simon's at-risk amount is increased, as is the $10,000 loss that is recaptured in the current year. [The recaptured loss and suspended losses (the recaptured loss and the loss generated in the current year) only affect Simon; the partnership and other partners are unaffected.]

While Example 29F-1 requires the recapture of at-risk losses when distributions reduce the amount at risk below zero, recapture can also occur when recourse debts are converted to nonrecourse debts. Some lenders may permit loans to be switched from recourse to nonrecourse status when there has been a history of on-time payments for a period of years or when certain performance criteria are met. In that case, any previously deducted losses in excess of the partner's amount at risk after the switch must be recaptured.

Example 29F-2: Recapture of at-risk losses upon conversion of recourse debt to nonrecourse debt.

The High Flying Limited Partnership has a $100,000 recourse debt from Low Interest Bank and a single general partner, Ted. Ted's amount at risk (including the $100,000 recourse debt) is $75,000, as a result of $25,000 of loss deductions. In the current year, High Flying allocates Ted $15,000 of income. In addition, Low Interest changes the loan from recourse to nonrecourse during the current year because of the partnership's favorable financial performance. Assume the nonrecourse loan is not qualified nonrecourse financing (Key Issue 29D). In the current year, Ted must recapture $10,000 of losses, calculated as follows:

Amount at risk at the beginning of year	$ 75,000
Current year income	15,000
Decrease in amount at risk from change in loan status	(100,000)
Amount at risk at end of year before recapture	$ (10,000)

Observation: The legislative history of IRC Sec. 465 does not address the nature of income reported when a taxpayer's amount at risk falls below zero. A practical approach would be to either report the entire amount as ordinary income or to report a prorata share of the income as capital, ordinary, Section 1231, etc., based on the total amount of at-risk losses previously deducted. An alternative would be to report the income as though the interest in the partnership has been sold. This could prove beneficial in real estate deals where there would usually be minimal or no ordinary income from depreciation recapture, with the bulk of the gain taxed at more favorable rates.

KEY ISSUE 29G Limitations on the Ability to Deduct Losses and Deductions

Taxpayers are only able to deduct losses resulting from their investment to the extent they have basis in their interest. Once the basis hurdle is cleared, they must consider the IRC Sec. 163(j) limitation [Prop. Reg. 1.163(j)-3(b)(4)]. (See Key Issue 14G .) Then taxpayers must also overcome the at-risk limitation (IRC Sec. 465), the passive activity loss (PAL) limitation (IRC Sec. 469; see Chapter 30), and, for tax years beginning after 2020, the excess business loss limitation [IRC Sec. 461(l)] (see Key Issue 21G), in this order [Temp. Reg. 1.469-2T(d)(6)].

Note: There is no IRS form for calculating a partner's Section 704(d) outside basis limitation. Form 6198 *(At-Risk Limitations)* is used to calculate a partner's Section 465 at risk limitation. (See Illustrations 29-1, 29-2, and 29-3 at the end of this chapter.) Form 8582 *(Passive Activity Loss Limitations)* is used to calculate an affected partner's Section 469 PAL limitation.

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ELECTION E302

Electing the Alternative Minimum Tax (AMT) Depreciation Method for Regular Tax

(See Key Issue 15A)

A taxpayer can elect to use the AMT depreciation method (150% declining balance over the MACRS recovery period) for 3, 5, 7, or 10-year MACRS property for regular tax purposes. For property placed in service before 1999, the recovery period for AMT was the class life of the asset. Thus, for that property, the generally longer class life-based recovery period is used for both regular and AMT depreciation if this election was made.

The election is made for all property placed in service during the year in the recovery period class for which the election is made. Thus, the election can be made class-by-class and year-by-year. The election is irrevocable.

AMT depreciation is the same as the regular tax depreciation under this election. Therefore, a taxpayer is relieved of maintaining an additional set of depreciation records. (For property placed in service after 1989 and before 1994, corporate taxpayers must still calculate separate ACE depreciation.)

In addition to easing the administrative burden of maintaining several sets of depreciation records, this election may be considered when a taxpayer is subject to AMT or when there is no need for accelerated depreciation deductions (e.g., due to NOLs).

Who Can Elect

Any taxpayer placing depreciable property in service during the tax year.

When To Elect

By the due date, including extensions, of the return for the tax year in which the property is placed in service.

How to Elect

By attaching a statement to the return and entering “150 DB” under column (f) in Part III of Form 4562 (Depreciation and Amortization).

Authorities and References

IRC Sec. 168(b)(2)(C) and (b)(5); Reg. 301.9100-8.

Sample Election

ELECTION TO USE THE 150% DECLINING BALANCE METHOD OF DEPRECIATION

The taxpayer hereby elects under IRC Sec. 168(b)(5) to have the provisions of IRC Sec. 168(b)(2)(C) apply to all tangible personal property placed in service in the tax year ended __________[Date]__________ and classified as __[3, 5, 7, OR 10]__-year recovery property. Depreciation deductions for such property are included on Form 4562.

ELECTION E303

Adopting the Alternative Depreciation System (ADS) for Regular Tax

(See Key Issue 15A)

A taxpayer can elect to depreciate property using the straight-line method over the appropriate asset depreciation range (ADR) class life (40-year straight-line for non-residential real property and 30-year straight-line for residential real estate) rather than using the accelerated depreciation method, and generally shorter recovery period, under MACRS. The election applies to all property in a given class placed in service during the year except that, for real property, ADS may be elected on a property-by-property basis. The mid-year and mid-quarter conventions continue to apply to personal property.

Electing the ADS method for regular tax eliminates the need for separate AMT calculations since this method must be used for AMT purposes. In addition, corporate taxpayers using ADS generally use such method for adjusted current earnings (ACE) purposes thereby avoiding another depreciation calculation (applicable to property placed in service after 1989 and before 1994 following the repeal of the ACE depreciation requirement for post-1993 additions).

Observation: Beginning in 2018, corporations are no longer subject to AMT, so separate calculations will no longer be required for them [i.e., IRC Sec. 56(g) was repealed by the 2017 Tax Cuts and Jobs Act]. Individuals, estates, and trusts are still subject to AMT. The higher exemption amounts for individuals will cause fewer individual taxpayers to be subject to AMT. However, the exemption amounts for estates and trusts were not increased and are only adjusted for inflation.

The election is irrevocable. The election should be considered when it is appropriate or desirable to defer depreciation deductions to later years or when the taxpayer wants to minimize burdensome fixed asset recordkeeping.

Note: As stated previously, if elected for regular tax, the ADS method must also be used for AMT purposes. For taxpayers wishing to simplify their recordkeeping, another alternative is using AMT depreciation for regular tax purposes since it also relieves the taxpayer of having to make a separate AMT depreciation calculation; however, the AMT method provides a slightly faster rate of depreciation than ADS. (See Election 16D.)

Who Can Elect

Any taxpayer placing depreciable property in service during the tax year.

When To Elect

By the due date, including extensions, of the return for the tax year in which the property is placed in service.

How to Elect

By attaching a statement to the return and completing the ADS section of Form 4562 (Depreciation and Amortization).

Authorities and References

IRC Secs. 168(g)(7), 56(a)(1)(A)(i), and former 56(g)(4)(A); Temp. Reg. 301.9100-7T.

Sample Election

ELECTION TO USE THE ADS DEPRECIATION METHOD FOR PERSONAL PROPERTY

The taxpayer hereby elects under IRC Sec. 168(g)(7) to use the alternative depreciation system for all [Specify class of recovery property.] personal property placed in service during the tax year ended [Date]. Cost recovery deductions covered by this election are included on Form 4562.

Sample Election

ELECTION TO USE THE ADS DEPRECIATION METHOD FOR REAL PROPERTY

The taxpayer hereby elects under IRC Sec. 168(g)(7) to use the alternative depreciation system for the following real property placed in service during the tax year ended ______[Date]______. Cost recovery deductions covered by this election are included on Form 4562:

_[Property Description]____

____

ELECTION E304

Electing Out of MACRS Depreciation

(See Key Issue 15A)

This election allows a taxpayer to use the units-of-production or another method of depreciation not expressed in a term of years instead of cost recovery under MACRS. This election is made on a property-by-property basis. There is no guidance as to what methods are available other than the units-of-production method and the income forecast method. However, other permissible methods may include the actual-hours-of-use method and the operating days method. The statute specifically states that the retirement-replacement-betterment or similar method of depreciation cannot be used.

Note: The Taxpayer Relief Act of 1997 clarified that for property placed in service after August 5, 1997, the income forecast method of depreciation is available only for (1) motion picture films, (2) video tapes, (3) books, (4) patents, (5) master sound recordings, (6) copyrights, and (7) other property designated by the IRS.

This election is advantageous when the depreciation method selected yields a greater depreciation deduction in the early years or a shorter useful life than that under regular MACRS. For instance, under the units-of-production method, depreciation is based on the estimated number of units that will be produced before the asset is no longer useful [which may be based on either the production that wears out the asset or the production that depletes a source of supply in which the asset is used (e.g., a mineral deposit)]. The income forecast method is ideally suited for the industries (listed in the preceding Note) where fluctuating income is the rule rather than the exception.

In addition, when electing out of MACRS depreciation, it is not necessary to make an AMT or ACE adjustment when an asset is depreciated under this election.

The election is irrevocable.

Who Can Elect

Any taxpayer placing property in service that is depreciable using a method not expressed in terms of years.

When To Elect

By the due date, including extensions, of the return for the tax year in which the property is placed in service. However, if the taxpayer filed its return for the placed-in-service year without filing the election, it can make the election by filing an amended return within six months of the return due date (excluding extensions).

How to Elect

By attaching a statement to the return and completing Form 4562 (Depreciation and Amortization).

Authorities and References

IRC Secs. 168(f)(1) and 167(g); Temp. Reg. 301.9100-7T; Prop. Reg. 1.168-4(b).

Sample Election

ELECTION TO EXCLUDE CERTAIN PROPERTY FROM THE MODIFIED ACCELERATED COST RECOVERY SYSTEM

Taxpayer hereby elects in accordance with IRC Sec. 168(f)(1) not to use MACRS for property placed in service during the year ending ______[Date]______ and to use the depreciation method indicated in the following table to recover the cost of such property. The deductions so determined are included on Form 4562. This election shall apply to the following property:

ELECTION E306

Electing Out of Bonus Depreciation
(See Key Issue 15B)

A taxpayer may elect not to deduct the additional first-year bonus depreciation for any class of property placed in service during the tax year. The term “class of property” refers to (1) 3, 5, 7, 10, 15, and 20-year recovery period classes; (2) water utility property; (3) depreciable computer software; (4) qualified film or television production property; and (5) qualified live theatrical production property [IRC Sec. 168(k)(2)(A)(i)].

Law Change Alert: The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) retroactively assigns a 15-year recovery period to qualified improvement property, making it eligible for bonus depreciation.

If the election to forgo claiming bonus depreciation is made, then the increased depreciation limit for passenger automobiles under IRC Sec. 168(k)(2)(F) also does not apply.

The election to not claim the bonus depreciation must be made for all additions within an entire class placed in service for the tax year.

Note: The Section 168(k)(7) election out of bonus depreciation is made with respect to a class (or classes) of assets and applies to all assets in that class placed in service during the year for which the election is made. QIP placed in service after 2017 is in the 15-year property class and is not a separate class of property, unlike QIP placed in service before 2018, which is a separate class of property [Reg. 1.168(k)-2(f)(1)(ii)(D)].

Once made, the election is irrevocable without IRS consent.

Law Change Alert: Rev. Proc. 2020-25, Sec. 5.02(2), allows taxpayers that placed depreciable property in service during their 2018, 2019, or 2020 tax year and who made the election out of bonus depreciation under IRC Sec. 168(k)(7) on a timely filed original return filed on or before April 17, 2020 (or who made a late election under Rev. Proc. 2019-33 before that date) to revoke those elections, by filing amended returns for the placed in service year and any affected succeeding years on or before October 15, 2021 (or if earlier, before the statute of limitations expires). Or, the elections can be revoked by filing a Form 3115 to request an automatic accounting method change.

Partnerships subject to the centralized audit regime generally cannot file amended returns. However, Rev. Proc. 2020-23 allows certain partnerships to file amended returns for their tax years beginning in 2018 and 2019 to take tax law changes under the CARES Act into consideration. Partnerships that choose not to file amended returns as permitted under Rev. Proc. 2020-23 or that cannot file amended returns because the placed-in-service year for the QIP is not within the scope of Rev. Proc. 2020-23 can file an administrative adjustment request (AAR) for the QIP’s placed-in-service year and any affected succeeding years that are filed on or before October 15, 2021 (or, if earlier, the date the statute of limitations expires).

Who Can Elect

Any taxpayer. The election is made separately by each person owning qualified property (i.e., by the taxpayer actually owning the property).

When To Elect

By the due date, including extensions, of the return for the tax year the property is placed in service. If the return was timely filed without the election, an amended return may be filed within six months of the original due date (not including extensions). “Filed pursuant to Section 301.9100-2” should be written on the amended return. Once made, the election may be revoked only with the written consent of the IRS (i.e., a private letter ruling must be requested).

Law Change Alert: Special rules apply for 2018 and 2019 due to the retroactive change to the recovery period for qualified improvement property provided for in the CARES Act. Rev. Proc. 2020-25 extends the deadline to elect out of bonus depreciation by filing an amended return for the placed-in-service year on or before October 15, 2021. Alternatively, the election can be made by filing a Form 3115 with the taxpayer’s timely filed original return for either (1) the first or second tax year after the year the property is placed in service or (2) that is filed after April 17, 2020, and on or before October 15, 2021.

Partnerships subject to the centralized audit regime generally cannot file amended returns. However, Rev. Proc. 2020-23 allows certain partnerships to file amended returns for their tax years beginning in 2018 and 2019 to take tax law changes under the CARES Act into consideration. Partnerships that choose not to file amended returns as permitted under Rev. Proc. 2020-23 or that cannot file amended returns because the placed-in-service year for the QIP is not within the scope of Rev. Proc. 2020-23 can file an administrative adjustment request (AAR) for the QIP's placed-in-service year and any affected succeeding years that are filed on or before October 15, 2021 (or, if earlier, the date the statute of limitations expires).

How to Elect

By following the instructions provided on Form 4562, which indicate to attach a statement to the return.

Authorities and References

IRC Sec. 168(k)(7); Reg. 1.168(k)-1(e); Prop. Reg. 1.168(k)-2(e)(1); Reg. 1.168(k)-2(f)(1); Rev. Procs. 2017-33, 2017-19 IRB 1236; 2019-33, 2019-33 IRB 662; 2020-23, 2020-18 IRB; and 2020-25, 2020-19 IRB.

Sample Election

ELECTION COMPLETELY OUT OF BONUS DEPRECIATION

Taxpayer elects under IRC Sec. 168(k)(7) to not claim the additional first-year bonus depreciation deduction for the following classes of property placed in service during the tax year ended _[Year-end]_: _[List for which Election Is Made.]__________.

Sample Election

REVOCATION OF ELECTION COMPLETELY OUT OF BONUS DEPRECIATION

Under the guidance provided by Rev. Proc. 2020-25, taxpayer revokes its election under IRC Sec. 168(k)(7) to not claim the additional first-year bonus depreciation deduction for the following classes of property placed in service during the tax year ended _[Year-end]_: _[List for which Election Is Made.]__________.

ELECTION E502

Allocating Interest Expense Incurred to Finance Distributions

(See Key Issue 14B)

Under the general interest tracing rules, interest on debt incurred to fund a pass-through entity's distributions to owners must be reported separately to them on Schedule K-1. The owners then use the general interest tracing rules to determine how the debt-financed distribution proceeds were used, which determines how interest on that debt is characterized.

However, a pass-through entity may elect to allocate interest expense associated with debt proceeds distributed to the owners to other expenditures made by the entity during the tax year. Thus, the entity may be able to characterize the interest expense as a trade or business expense.

Making this election often allows the pass-through entity to characterize some or all of the interest expense as fully deductible trade or business interest. However, the debt reallocated among pass-through entity expenditures cannot exceed the total amount of such expenditures.

Who Can Elect

A pass-through entity (i.e., partnership or S corporation) with debt-financed distributions.

When To Elect

By the due date, including extensions, of the tax return for the tax year in which the election is to apply (i.e., the year the distribution and expense occur).

How to Elect

By reporting the interest expense as a deduction on the pass-through entity's return rather than passing it through to the owners on their Schedules K-1 as a separately stated item.

Authorities and References

IRC Sec. 163; Temp. Reg. 1.163-8T; IRS Notices 88-20, 1988-1 CB 487 and 89-35, 1989-1 CB 675.

Sample Election

None required. However, the entity should maintain records to clearly document the allocation of the debt proceeds to expenditures other than distributions.

ELECTION E503

Election for Excepted Trades or Businesses from the Section 163(j) Limit on the Deduction for Business Interest Expense

IRC Sec. 163(j) limits the deduction for business interest expense. However, *real property trades or businesses* and *farming businesses* can elect to be exempt from the Section 163(j) limit. But, if this *Section 163(j)(7) election* out of the business interest expense limit is made, the electing real property trade or business or electing farming business is required to depreciate certain assets under the alternative depreciation system (ADS), which, in addition to using a longer recovery period, means that the assets do not qualify for bonus depreciation.

The election is made for a particular trade or business and not for a particular entity and applies for the tax year made and all subsequent years. The election is irrevocable [IRC Sec. 163(j)(7)(B)]. However, Rev. Proc. 2020-22, Section 5, allows businesses that filed an election with their timely filed (including extensions) return for their tax years beginning in 2018, 2019 or 2020 (i.e., their 2018, 2019 or 2020 tax year) to withdraw their election. In this case, they are treated as if the election were never made.

The election generally terminates automatically if the taxpayer ceases to exist or the trade or business ceases operation. However, if the taxpayer transfers all of the assets of the electing trade or business to a related party, the election does not terminate.

Who Can Elect

Real Property Trade or Business. A real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business as described in IRC Sec. 469(c)(7)(C) and Reg. 1.469-9(b)(2) for purposes of qualifying as a real estate professional under the passive activity loss rules or a real estate investment trust (REIT) that qualifies under the safe harbor in Prop. Reg. 1.163(j)-9(g) [Prop. Reg. 1.163(j)-1(b)(12)].

Caution: If at least 80% of the business's real property, determined by FMV, is leased to a trade or business under common control with the real property trade or business, the election will not be available to the real property trade or business. Common control in this case means 50% of the direct and indirect ownership interests in both businesses are held by related parties within the meaning of IRC Sec. 267(b) or 707(b) [Prop. Reg. 1.163(j)-9(h)].

Farming Business. A farming business as defined in IRC Sec. 263A(e)(4) or Reg. 1.263A-4(a)(4), or any trade or business of a specified agricultural or horticultural cooperative as defined in IRC Sec. 199A(g)(4) [Prop. Reg. 1.163(j)-1(b)(11)].

When To Elect

By the due date of the federal income tax return, including extensions.

However, Rev. Proc. 2020-22, Section 4, allows eligible businesses that timely filed (including extensions) their return for their 2018, 2019 or 2020 tax years without making the Section 163(j)(7) election to make a late election by filing an amended return. This ability to make a late election also applies to businesses that withdraw their election under Section 5 of Rev. Proc. 2020-22. [See Rev. Proc. 2020-23 for special rules allowing partnerships subject to the centralized audit regime to file amended returns for their 2018 and 2019 tax years. If they do not file an amended return, partnerships make the election by filing an administrative adjustment request (AAR)]. The amended return or AAR must be filed on or before October 15, 2021 (or, if earlier, before the statute of limitations closes).

In addition, Rev. Proc. 2020-22, Section 5, allows businesses that made a Section 163(j)(7) election with their returns for their 2018, 2019, or 2020 tax years to withdraw that election by filing an amended return or AAR. [See Rev. Proc. 2020-23 for special rules allowing partnerships subject to the centralized audit regime to file amended returns for their 2018 and 2019 tax years]. The amended return or AAR must be filed on or before October 15, 2021 (or, if earlier, before the statute of limitations closes).

How to Elect

By attaching an election statement to a timely filed original federal income tax return, including extensions. If the taxpayer has multiple trades or businesses, an election that specifies and describes each such trade or business must be made.

The election is made by the agent of a consolidated group's trade or business. An election for a partnership must be made on the partnership's return and does not apply to a trade or business conducted by a partner outside of the partnership.

A late election or an election withdrawal under Rev. Proc. 2020-22 is made by filing an amended return (or AAR) containing an election statement. The amended return or AAR must take into account any collateral adjustments to taxable income or tax liability, such as the amount of depreciation allowed or allowable in the affected year. If applicable, amended returns must also be filed for any affected succeeding years.

Authorities and References

Prop. Reg. 1.163(j)-9; Rev. Proc. 2020-22; Rev. Proc. 2020-23.

Sample Election

Note: The following statement is used to make the Section 163(j)(7) election.

SECTION 1.163(j)-9 ELECTION

[Taxpayer's Name]

[Taxpayer's Address]

[Social Security or Employer ID number]

Description of electing trade or business and principal business activity code:

____

The taxpayer is making an election under:

________IRC Sec. 163(j)(7)(B) to be an electing real property trade or business.

________IRC Sec. 163(j)(7)(C) to be an electing farming business.

Sample Election

Note: The following statement must be attached to an amended return (or AAR) filed to make a late Section 163(j)(7) election under Rev. Proc. 2020-22, Section 4.

REVENUE PROCEDURE 2020-22 LATE SECTION 163(j)(7) ELECTION

[Taxpayer's Name]

[Taxpayer's Address]

[Social Security or Employer ID number]

Description of electing trade or business and principal business activity code:

____

The taxpayer is making an election under:

________IRC Sec. 163(j)(7)(B) to be an electing real property trade or business.

________IRC Sec. 163(j)(7)(C) to be an electing farming business.

Sample Election

Note: The following statement must be attached to an amended return (or AAR) filed to withdraw a Section 163(j)(7) election under Rev. Proc. 2020-22, Section 5.

REVENUE PROCEDURE 2020-22 SECTION 163(j)(7) ELECTION WITHDRAWAL

[Taxpayer's Name]

[Taxpayer's Address]

[Social Security or Employer ID number]

Description of electing trade or business and principal business activity code:

____

Pursuant to Revenue Procedure 2020-22, the taxpayer is withdrawing its election under:

________IRC Sec. 163(j)(7)(B) to be an electing real property trade or business.

________IRC Sec. 163(j)(7)(C) to be an electing farming business.

ELECTION E504

Substitute Cost Method for Interest Capitalization

(See Key Issue 14F)

A taxpayer can elect to capitalize a proportionate share of all otherwise deductible expenses rather than capitalizing interest expense allocable to excess accumulated production expenditures under IRC Sec. 263A.

Taxpayers with production costs that exceed the amount of directly related debt are subject to the avoided cost debt rule whereby a portion of interest on other eligible debt is allocated to the produced asset. The asset must have a long useful life, an estimated production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million. The debt that is taken into account is that portion of the eligible debt (i.e., generally, debt other than that producing nondeductible, personal, or qualified residence interest) to the extent the production costs exceed directly traced debt (avoided cost debt).

This election allows a taxpayer to avoid some of the administrative complexity involved in determining the amount of avoided cost debt and the associated interest capitalization. This election applies to such expenses as marketing and selling, but not to (1) permanently nondeductible costs, (2) costs deductible in a future year but not deductible currently (e.g., suspended passive losses), or (3) costs required to be capitalized under IRC Sec. 263A or 460.

This election is treated as an accounting method and cannot be changed without IRS consent. See Rev. Proc. 95-19 for details.

Who Can Elect

A taxpayer subject to interest capitalization under the IRC Sec. 263A rules.

When To Elect

No specific guidance exists, but apparently by the due date, including extensions, for the first tax year in which the election is to be effective.

How to Elect

By properly accounting for the substituted costs on the taxpayer's return. However, the authors suggest a statement be attached to the return.

Authorities and References

IRC Sec. 263A(f); Reg. 1.263A-9(g)(2)(iv); Rev. Proc. 95-19, 1995-1 CB 664; Notice 88-99, 1988-2 CB 422.

Sample Election

ELECTION TO USE SUBSTITUTE COST METHOD

Pursuant to Reg. 1.263A-9(g)(2)(iv) taxpayer hereby elects to adopt the substitute cost method for the deduction of interest on indebtedness attributable to the taxpayer's excess accumulated production expenditures.

ELECTION E601

Ratable Accrual of Real Property Taxes

(See Key Issue 14H)

An accrual basis taxpayer may elect to ratably accrue real property taxes over the period to which they relate. For example, if the property tax year is July 1 through June 30, a calendar year taxpayer accrues and deducts in its Year 1 tax return (1) half of the amount from the property tax year ending June 30, Year 1 plus (2) half of the amount from the property tax year ending June 30, Year 2.

Under the general rules of IRC Sec. 461(h), economic performance does not occur with respect to taxes until they are paid. This election overrides the general rule and allows real property taxes to be accrued ratably over the period to which they relate. The election may be made without IRS consent in the first year the taxpayer incurs real property taxes. Subsequent elections require IRS consent. Once made, the election is binding.

Although the election applies to all real property taxes of the taxpayer's trade, business, or investment activities, separate elections may be made for each separate trade, business, or investment activity (provided the activities are accounted for separately). For real property taxes, another option a taxpayer might consider is adopting the recurring item exception pursuant to IRC Sec. 461(h)(3). (See Election E907.) If available, the recurring item method may allow for accrual of the taxes sooner than would be allowed under this ratable accrual election.

Who Can Elect

Any accrual basis taxpayer. This is an entity-level election.

When To Elect

By the due date, including extensions, of the tax return for the first tax year in which the real property taxes are incurred.

How to Elect

By attaching a statement to the return.

Authorities and References

IRC Sec. 461(c); Reg. 1.461-1(c).

Sample Election

ELECTION TO RATABLY ACCRUE REAL PROPERTY TAXES

Pursuant to IRC Sec. 461(c), the taxpayer hereby elects to ratably accrue real property taxes.

Description of trade, business, or investment activity to which election applies: ______________________________

Method of accounting used for above: ____

Property tax year to which the taxes relate: ____

Computation of deduction: [Show computation or summarize method used.] .

ELECTION E602

Electing to Capitalize Carrying Charges

(See Key Issue 14J)

A taxpayer may elect to capitalize interest, taxes, and other deductible carrying charges with respect to property. The capitalized costs increase the property's basis, thereby reducing the gain upon the eventual sale of the property and increasing depreciation or depletion, if applicable. The election generally is considered when current deduction of these costs yields little or no tax benefit. The election does not apply to items that are not otherwise deductible. By capitalizing these costs, a taxpayer defers the tax benefit to future years when greater tax benefit may be realized. The election applies to four classes of carrying charges:

1. *Unimproved and Nonproductive Real Property.* Mortgage interest, property taxes, and other true carrying charges may be capitalized.

2. *All Real Property.* Expenses incurred in development of the property or in construction of improvements up to the time the development or construction is completed can be capitalized. However, capitalization of many of these items may be required under other Code sections (e.g., IRC Sec. 263A). Eligible expenses include interest, taxes, and other necessary expenses incurred in either the development or construction phase. The election applies to the development or construction of a taxpayer's personal residence as well as commercial property.

3. *Personal Property.* Interest and taxes (including payroll and sales taxes) incurred up to the date of installation or first use, whichever date is later. However, capitalization of these items may be required under other Code sections.

4. *Other Taxes and Carrying Charges.* This relates to property that can be capitalized under sound accounting principles.

An election does not have to apply to all eligible carrying charges, but an election to capitalize an item must include all such items for that particular project.

An election to capitalize annual carrying costs and taxes with respect to unimproved and nonproductive real property can be changed from year to year. In contrast, an election with respect to real property being developed or personal property continues to be in effect until the real property development is completed or the personal property is installed or in use. Therefore, an election with respect to these properties may be effective for more than one tax year.

Who Can Elect

Any taxpayer; this is an entity-level election.

When To Elect

With the original return for the year of the election. Presumably, this is the due date of the return including extensions, although the regulations do not specifically state this.

How to Elect

By attaching a statement to the tax return.

Authorities and References

IRC Sec. 266; Reg. 1.266-1(c).

Sample Election

ELECTION TO CAPITALIZE PROPERTY CARRYING CHARGES

The taxpayer hereby elects pursuant to IRC Sec. 266 to capitalize, rather than to deduct, the following carrying costs incurred with respect to __[Describe property.]__ located at ____________________________________.

Description	Amount
[Describe cost.]	$________________
[Describe cost.]	$________________
[Describe cost.]	$________________
[Describe cost.]	$________________

ELECTION E701

Deducting Intangible Drilling Costs

(See Key Issue 22B)

Taxpayers may elect to deduct intangible drilling and development costs (IDC) incurred in the development of (1) oil and gas, or (2) geothermal wells. If a taxpayer does not make these elections, the IDC must be recovered through depletion (or depreciation for physical property).

A corporate taxpayer that is an integrated oil company, i.e., a company with oil and gas retail sales in excess of $5 million or a refiner of crude oil with average daily refinery runs exceeding 75,000 barrels a day during the tax year may make this election but is subject to a 30% reduction of the allowable deduction. The disallowed portion is recovered ratably over 60 months beginning with the month in which the costs are paid or incurred.

For oil and gas wells, the election is binding for all IDC incurred in subsequent tax years. For geothermal properties, the election can be revoked on an amended return filed within the statute of limitations period for the year the election was made.

Who Can Elect

A taxpayer owning an oil, gas, or geothermal working or operating interest in any tract or parcel of land, either as a fee owner or under a lease, or any other form of contract granting working or operating rights. This is an entity-level election.

When To Elect

For oil and gas wells:
By the due date of the tax return for the tax year in which IDC is first paid or incurred. Presumably, this is the due date including extensions. In several Letter Rulings, the IRS has allowed elections made on delinquent returns since these were the first returns filed by the respective taxpayers that included IDC. However, courts have denied the election when made on an amended return (*Burford Oil Co.* and *Titus Oil & Investment Co.*).

For geothermal wells:
By the due date of an original or amended return for the year IDC is first paid or incurred.

How to Elect

By claiming the deduction on the return. Although an election statement is not required, the authors suggest attaching a statement due to the importance of making the election in the year IDC is first paid or incurred.

Authorities and References

IRC Secs. 263(c) and 291(b); Reg. 1.612-4 and -5; *Burford Oil Co.*, 153 F.2d 745, 34 AFTR 1055 (5th Cir. 1946); *Titus Oil & Investment Co.*, 132 F.2d 969, 30 AFTR 716 (10th Cir. 1943); Ltr. Ruls. 8341032, 8341055, and 8341056.

Sample Election

ELECTION TO DEDUCT INTANGIBLE DRILLING COSTS ON OIL AND GAS WELLS

Taxpayer hereby elects, pursuant to IRC Sec. 263(c) and Reg. 1.612-4 to deduct all intangible drilling costs paid or incurred in the drilling and preparation of wells.

Sample Election

ELECTION TO DEDUCT INTANGIBLE DRILLING COSTS ON GEOTHERMAL WELLS

Taxpayer hereby elects, pursuant to IRC Sec. 263(c) and Reg. 1.612-5 to deduct all intangible drilling costs paid or incurred in the drilling and preparation of wells.

ELECTION E702

Deducting Intangible Drilling Costs on Nonproductive Wells

(See Key Issue 22B)

Taxpayers who do not elect to expense intangible drilling costs (IDC) under IRC Sec. 263(c) may still elect to expense IDC incurred in the drilling of nonproductive (dry hole) oil, gas, and geothermal wells. The election for oil and gas wells is separate from that for geothermal wells.

This election allows a taxpayer that has elected to capitalize IDC to deduct the IDC associated with a nonproductive well or dry hole. It is available with regard to nonproductive wells located inside and outside the United States.

For oil and gas properties, the election is binding for all IDC incurred on nonproductive wells in subsequent years. For geothermal properties, the election can be revoked on an amended return filed within the statute of limitations period for the year the election was made.

Who Can Elect

A taxpayer owning an oil, gas, or geothermal working or operating interest in any tract or parcel of land, either as a fee owner or under a lease, or any other form of contract granting working or operating rights. This is an entity-level election.

When To Elect

By the due date of the tax return for the first tax year in which a nonproductive well is completed. Presumably, this is the due date including extensions. For geothermal wells, the election can be made on an original or amended return. The regulations do not provide for making the election on an amended return for oil and gas wells.

How to Elect

The regulations require “a clear statement of election,” although no specific guidelines are provided. Claiming the deduction and adequately describing it on the return may be sufficient. However, the authors suggest attaching a statement to the return to ensure an affirmative election is made.

Authorities and References

IRC Sec. 612; Reg. 1.612-4(b)(4) and -5(b)(4).

Sample Election

ELECTION TO DEDUCT INTANGIBLE DRILLING COSTS ON A NONPRODUCTIVE OIL AND GAS WELL

Taxpayer hereby elects, pursuant to Reg. 1.612-4(b)(4) to deduct all intangible drilling and development costs incurred in the drilling of nonproductive wells.

Sample Election

ELECTION TO DEDUCT INTANGIBLE DRILLING COSTS ON A NONPRODUCTIVE GEOTHERMAL WELL

Taxpayer hereby elects, pursuant to Reg. 1.612-5(b)(4) to deduct all intangible drilling costs incurred in the drilling of nonproductive wells.

ELECTION E703

Treating Operating Interests in Oil, Gas, and Geothermal Deposits as Separate Properties

(See Key Issue 7E)

A taxpayer with multiple operating interests in oil and gas wells (or geothermal deposits) in one tract or parcel of land may elect to treat the interests as separate properties. Absent the election, all interests in the same tract or parcel are combined and treated as one property.

A taxpayer may elect to either treat each operating interest on a tract or parcel of land as a separate property or combine one or more of the interests into a separate property with the remaining interests each being treated as separate properties. Only one combination of properties is allowed for each tract or parcel. If an additional operating interest is subsequently acquired or discovered on the same tract, the taxpayer may elect to either aggregate the interest with an existing interest (or combination of interests if one was previously elected) or treat it as a separate property. Absent a further election, the additional interest is treated as a separate property if the original election treated all interests as separate properties, or it is combined with the existing combination of interests if a combination was originally elected.

The election statement must identify each operating mineral interest unless the taxpayer is making a blanket election to treat all operating interests in a specific tract or parcel as separate properties. In that case, only the tract or parcel must be identified.

Who Can Elect

Any taxpayer. This is an entity-level election.

When To Elect

By the due date, including extensions, of the return for the first tax year that includes any expenditure for development or operation. Development includes intangible drilling costs but not delay rentals.

How to Elect

By attaching a statement to the return.

Authorities and References

IRC Sec. 614(b)(2); Reg. 1.614-8.

Sample Election

ELECTION TO TREAT OPERATING MINERAL INTERESTS AS SEPARATE PROPERTIES

Taxpayer hereby elects under IRC Sec. 614(b)(2) to treat as separate properties the following operating interests in mineral interests. The identification of the separate properties is as follows:

Name or Identification of Separate Mineral Interest	Tract or Parcel Containing the Mineral Interest

Facts supporting the treatment of the tract or parcel as a single and entire tract or parcel: [Describe.]

ELECTION E801

Election to Capitalize Rotable, Temporary, and Standby Emergency Spare Parts
(See Key Issue 15L)

Rotable and temporary spare parts are generally treated as materials and supplies. These are parts acquired for installation on a unit of property (UOP) or temporarily used until a new or repaired part can be installed. Rotable and temporary spare parts are then removed and either reinstalled on other property or stored for later use.

Standby emergency spare parts are all of the following:

- Acquired when particular machinery or equipment is acquired (or later and set aside for use in that particular machinery or equipment).
- Set aside for use as replacements to avoid lost time due to equipment emergencies or failures.
- Located at or near the equipment to be readily available,
- Directly related to the particular machinery or equipment they serve,
- Typically expensive,
- Only available on special order and not readily available from a vendor or manufacturer,
- Not subject to normal periodic replacement,
- Not interchangeable in other machinery or equipment,
- Not repaired and reused.

Taxpayers may elect (on an asset-by-asset basis) to capitalize and depreciate the cost of any rotable, temporary, or standby emergency spare part other than the following:

1. Parts placed in service and disposed of in the same tax year.
2. Parts intended to be used as a component of a UOP with a useful life of 12 months or less or costing $200 or less.
3. Parts intended to be used as a component of a UOP where the taxpayer did not (or cannot) elect to capitalize and depreciate that property.
4. Rotable or temporary spare parts accounted for under the optional method of Reg. 1.162-3(e).

Once made, the election can be revoked only by filing a private letter ruling request.

Who Can Elect

Taxpayers who purchase or produce rotable, temporary or standby emergency spare parts. For partnerships and S corporations, the election is made at the entity level.

When To Elect

By the due date of the tax return, including extensions for the year the asset is placed in service for depreciation.

How to Elect

By capitalizing amounts paid to acquire or produce the rotable, temporary or emergency spare part on the original, timely filed tax return for the year the asset is placed in service for depreciation.

Authorities and References

Reg. 1.162-3(d).

Sample Election

None required.

ELECTION E802

Election to Treat a Partial Disposition as a Disposition
(See Key Issue 15L)

The rules for dispositions of MACRS property are generally provided in Reg. 1.168(i)-8. For these rules, dispositions include the following dispositions of a portion of an asset:

- Sales of a portion of an asset.
- Dispositions as a result of a casualty.
- Dispositions for which gain is not recognized (in whole or in part) under the like-kind exchange rules under IRC Sec. 1031 or the involuntary conversion rules under IRC Sec. 1033.
- Transfers of a portion of an asset in a step in the shoes transaction described in IRC Sec. 168(i)(7)(B).

Taxpayers can elect to treat other dispositions of a portion of an asset as a disposition under Reg. 1.168(i)-8. If the asset is properly included in asset classes 00.11 through 00.4 of Rev. Proc. 87-56, the election can only be made if the taxpayer classifies the replacement portion of the asset under the same asset class as the disposed portion of the asset.

Once made, the election can be revoked only by filing a private letter ruling request.

Who Can Elect

Taxpayers who dispose of a portion of an asset (if the partial disposition is not, by definition, treated as a disposition).

When To Elect

By the due date, including extensions, of the tax return for the year in which the portion of the asset is disposed of. A special rule permits late elections after an IRS adjustment disallowing a deduction for amounts incurred to replace a portion of an asset and deducted as a repair.

How to Elect

By treating the partial disposition as a disposition and reporting the related gain, loss or other deduction on a timely filed, including extensions, original tax return for the year. Elections made after an IRS adjustment to income are made by filing an application for an accounting method change.

Authorities and References

Reg. 1.168(i)-8(d)(2); Rev. Proc. 87-56, 1987-2 CB 674.

Sample Election

None required.

ELECTION E803

De Minimis Safe Harbor Expensing Election
(See Key Issue 15L)

Taxpayers may elect annually to apply a *de minimis* safe harbor under which amounts paid to acquire or produce tangible property are not capitalized under Reg. 1.263(a)-2 or 1.263(a)-3 or, if applicable, treated as materials or supplies under Reg. 1.162-3. The election can be made for items with an economic useful life of 12 months or less or that cost less than a specified threshold. For taxpayers with an applicable financial statement (AFS), the safe harbor threshold is $5,000 per invoice or per item, as substantiated by invoice. For taxpayers without an AFS, the safe harbor threshold is $2,500 per invoice or per item, as substantiated by invoice.

The election applies to amounts paid to acquire or produce tangible property including materials and supplies, except for amounts paid for any of the following:

1. Inventory.
2. Land.
3. Rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate under Reg. 1.162-3(d).
4. Rotable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for spare parts under Reg. 1.162-3(e).

Amounts to which the election applies can be deducted, provided they are ordinary and necessary business expenses.

Once made, the election cannot be revoked.

Who Can Elect

Taxpayers who pay or incur amounts to acquire or produce tangible property or materials and supplies, provided they have accounting procedures in place at the beginning of the year under which such items are treated as an expense for non-tax purposes. For taxpayers with an AFS, these procedures must be written. For partnerships and S corporations, the election is made at the entity level. For a consolidated group, the election is made for each member of the group by the common parent, and the statement must contain the name and TIN of each member for which the election is made.

When To Elect

By the due date, including extensions, of the tax return for the year the amounts are paid or incurred.

How to Elect

Attach a statement to the timely filed original tax return for the year the amounts are paid or incurred.

Authorities and References

Reg. 1.263(a)-1(f)(5); Notice 2015-82, 2015-50 IRB 859.

Sample Election

Section 1.263(a)-1(f) *De Minimis* Safe Harbor Election

[Taxpayer's name]
[Taxpayer's address]
[Taxpayer's TIN]

The taxpayer hereby makes the *de minimis* safe harbor election under Reg. 1.263(a)-1(f).

ELECTION E804

Election to Capitalize Employee Compensation and Overhead Costs
(See Key Issue 15L)

Amounts paid to facilitate the acquisition of real or personal property generally must be capitalized under Reg. 1.263(a)-2. Amounts paid for employee compensation and overhead are treated as amounts that do not facilitate the acquisition of property. However, taxpayers may elect to treat these amounts as amounts that facilitate the acquisition.

The election is made separately for each acquisition. It applies to employee compensation or overhead or both.

Once made, the election can be revoked only by filing a private letter ruling request.

Who Can Elect

Any taxpayer. For partnerships and S corporations, the election is made at the entity level.

When To Elect

By the due date of the tax return, including extensions, for the year the amounts subject to the election are paid or incurred.

How to Elect

By treating amounts paid for employee compensation and/or overhead as costs that facilitate the acquisition of property on the taxpayer's original tax return for the year the amounts subject to the election are paid or incurred.

Authorities and References

Reg. 1.263(a)-2(f)(2)(iv).

Sample Election

None required.

ELECTION E805

Safe Harbor for Deducting Costs of Improving Eligible Building Property

(See Key Issue 15L)

Qualifying taxpayers can elect to deduct the cost of improvements made during the year to eligible building properties.

An eligible building property is a building (owned or leased), condominium, or cooperative unit of property with an unadjusted basis of $1 million or less. The election is available only to the extent that the total amount paid during the year for repairs, maintenance, improvements and similar activities for the eligible building property is less than or equal to 2% of the eligible property's unadjusted basis (or, if less, $10,000). Amounts not capitalized under the safe harbor under Reg. 1.263(a)-1(f)(5) or deemed not to improve property under the routine maintenance safe harbor under Reg. 1.263(a)-3(i) are included in this determination, which is made on a property by property basis.

Once made, the election cannot be revoked.

Who Can Elect

Taxpayers with average annual gross receipts (for the three preceding years) of $10 million or less. For partnerships and S corporations, the election is made at the entity level.

When To Elect

By the due date of the tax return, including extensions, for the year the amounts qualifying for the election are paid or incurred.

How to Elect

Attach a statement to the original, timely-filed tax return for the year the amounts qualifying for the election are paid or incurred.

Authorities and References

Reg. 1.263(a)-3(h).

Sample Election

SECTION 1.263(a)-3(h) SAFE HARBOR ELECTION FOR SMALL TAXPAYERS

[Taxpayer's name]
[Taxpayer's address]
[Taxpayer's TIN]

Taxpayer makes the safe harbor election under Reg. 1.263(a)-3(h) for the following eligible building properties:

[Describe each eligible building property for which the taxpayer is making this election.]

ELECTION E806

Election to Capitalize Repairs and Maintenance Costs Consistent with Books

(See Key Issue 15L)

Taxpayers may elect to treat otherwise deductible repair and maintenance costs for tangible property as amounts paid to improve that property. Under this election, repair and maintenance costs are capitalized to the tangible property and are subject to depreciation. The taxpayer must capitalize these costs on its books and records.

A taxpayer making this election must capitalize all repair or maintenance costs related to any tangible property that it treats as capital expenditures on its books and records. However, the election does not apply to amounts paid to repair or maintain rotable or temporary spare parts accounted for under the optional method under Reg. 1.162-3(e).

Who Can Elect

Taxpayers who pay or incur repair or maintenance costs with respect to tangible property. For partnerships and S corporations, the election is made at the entity level. For a consolidated group, the election is made for each member of the group by the common parent, and the statement must contain the name and TIN of each member for which the election is made.

When To Elect

By the due date of the tax return, including extensions, of the return for the year the costs subject to the election are paid or incurred.

How to Elect

Attach a statement to the timely-filed original income tax return for the year the costs subject to the election are paid or incurred and begin to depreciate the capitalized improvements in the year they are placed in service.

Authorities and References

Reg. 1.263(a)-3(n).

Sample Election

SECTION 1.263(a)-3(n) ELECTION

[Taxpayer’s name]
[Taxpayer’s address]
[Taxpayer’s TIN]

The taxpayer hereby makes the election to capitalize repair and maintenance costs under Reg. 1.263(a)-3(n).

ELECTION E901

Deducting Research and Experimental Expenditures
(See Key Issue 22B)

A taxpayer may elect to deduct research and experimental (often referred to as research and development, or R&D) expenditures instead of capitalizing them. The election applies only to expenses paid or incurred in connection with a trade or business of the taxpayer.

R&D expenses do not include the cost of acquiring an existing patent, model, production, or process, but they do include costs of obtaining an original patent. Management studies, consumer surveys, or similar expenses generally are not R&D costs.

Once made, the election applies to all R&D expenses paid or incurred in the year of election and in all subsequent years. Consent of the IRS is required if the taxpayer later wants to change its overall accounting method or apply a different method to one or more other R&D projects.

If the election is not made in the first year the expenses are paid or incurred, it cannot be adopted in subsequent years without consent of the IRS. The regulations provide procedures for requesting consent, which must be done no later than the last day of the first tax year for which the election is requested.

For noncorporate taxpayers, currently deducted R&D costs are an AMT adjustment item unless the taxpayer materially participates in the activity. Rather than deducting R&D expenditures, taxpayers can elect to amortize the costs ratably over a 10-year period to avoid the AMT adjustment (see Election E902). This is most likely to be a concern to noncorporate partners in a partnership that conducts R&D activities.

Note that the Tax Cuts and Jobs Act (TCJA) requires R&D expenditures be capitalized and amortized over five years for amounts paid or incurred in tax years beginning after 2021 [IRC Sec. 174(a)].

Who Can Elect

Any taxpayer. This is an entity-level election.

When To Elect

With the return for the first tax year that R&D expenditures are paid or incurred. Presumably, this is the due date of the return including extensions, although the regulations do not specifically state this.

How to Elect

By claiming the expenses as a deduction on the return for the first tax year that R&D expenditures are paid or incurred. No election statement is required.

Authorities and References

IRC Secs. 174(a) and 56(b)(2); Reg. 1.174-3(b).

Sample Election

None required.

ELECTION E902

Amortizing Research and Experimental Expenditures over 10 Years

(See Key Issue 22B)

A taxpayer can elect to capitalize and ratably amortize research and experimental expenditures over a 10-year period in lieu of currently deducting such expenditures. This election is available to taxpayers that have previously elected to deduct currently research and experimental (sometimes referred to as research and development, or R&D) expenditures. Making this election allows a noncorporate taxpayer to avoid an alternative minimum tax (AMT) adjustment item that results from currently deducting these expenditures. (Note, however, that if a taxpayer materially participates in the trade or business, these expenditures are not a tax preference even without the election.)

Although this election requires a longer amortization period than the 60-month period available under an alternative election (see Election E903), it provides more flexibility. The election can apply to all or a portion of the R&D expenditures and is made on an annual basis. Therefore, the election is not binding on all future R&D expenditures, and a taxpayer may elect to capitalize and amortize only the amount necessary to avoid AMT. This election is not available if the taxpayer has made the alternative amortization election. The election can be revoked only with the consent of the IRS.

Who Can Elect

Any taxpayer incurring or paying such expenditures and who has previously elected to expense these costs as paid or incurred. For partnerships and S corporations, the election is made at the partner/shareholder level.

When To Elect

Regulations provide that an election statement must be filed no later than the date (including extensions) for filing the taxpayer's original income tax return for the year that amortization of the qualified expenditures begins.

How to Elect

The election must be made on a statement attached to the taxpayer's tax return (or amended return) for the year in which the amortization of the qualified expenditures begins. The elected amount must be a specific dollar amount. It cannot be described by a formula. The statement must include the taxpayer's name, address, and taxpayer identification number.

Authorities and References

IRC Sec. 59(e)(2)(B); Reg. 1.59-1.

Sample Election

ELECTION TO CAPITALIZE AND AMORTIZE RESEARCH AND EXPERIMENTAL EXPENDITURES OVER 10 YEARS

Pursuant to IRC Sec. 59(e)(4), taxpayer hereby elects to capitalize and amortize ratably over 10 years the following research and experimental expenditures paid or incurred during the tax year. These expenditures are:

Type of Expenditure	Capitalized Amount
______________________	$__________
______________________	__________
______________________	__________
______________________	__________

ELECTION E903

Capitalizing and Amortizing Research and Experimental Expenditures
(See Key Issue 22B)

A taxpayer can elect to capitalize and amortize research and experimental expenditures over a period of not less than 60 months. In the first year research and experimental (R&E) expenditures are paid or incurred, a taxpayer may adopt a method of accounting to expense these costs. If such method is not adopted, these R&E costs must be capitalized. If a useful life is determinable, the costs may then be amortized over such period; otherwise, the expenditures are not recovered until the related intangible asset is disposed of or the project abandoned. This election does not apply to expenditures that are chargeable to assets subject to depreciation or depletion.

Under this election, a taxpayer may select any amortization period provided it is not less than 60 months. The amortization begins in the month in which the taxpayer first realizes benefits. Absent proof, benefits are first realized in the month in which the taxpayer first puts the property to an income-producing use.

The election applies to all of the taxpayer's R&E projects. But, if the taxpayer is conducting more than one R&E project, a different amortization period may be selected for each project. The election is irrevocable. It applies to all R&E expenditures paid or incurred by the taxpayer for the tax year made and all later years unless the IRS consents to a subsequent change. Similarly, the taxpayer must adhere to the amortization period chosen unless the IRS consents to a different period.

Although taxpayers generally prefer the current deduction election for R&E expenditures, some may prefer the better matching of project income and expenditures resulting from this election.

Note that the Tax Cuts and Jobs Act (TCJA) requires R&E expenditures be capitalized and amortized over five years for amounts paid or incurred in tax years beginning after 2021 [IRC Sec. 174(a)].

Who Can Elect

Any taxpayer incurring or paying R&E expenditures. For partnerships and S corporations, this is an entity-level election.

When To Elect

By the due date including extensions of the return for the tax year in which the expenditures are incurred.

How to Elect

By attaching a signed statement to the return.

Authorities and References

IRC Sec. 174(b); Reg. 1.174-4(b).

Sample Election

ELECTION TO AMORTIZE RESEARCH AND EXPERIMENTAL EXPENDITURES

Pursuant to IRC Sec. 174(b), the taxpayer, ____[Name]____, ____[Address]____ hereby elects to treat the following research and experimental expenditures incurred during the tax year as deferred expenses. The first tax year to which this election applies is ____[Tax Year]____. The taxpayer will segregate in its books and records the expenditures to which this election relates.

Project Name	Amount Capitalized	Amortization Period

Signed: ______________________________________ ______________________________

Taxpayer or Authorized Representative Date

ELECTION E904

Section 59(e) Optional Amortization for Certain AMT Preferences

(See Key Issue 22B)

This election allows the taxpayer to avoid treating certain expenses as tax preference items. To avoid tax preference treatment, the item must be deducted ratably over an extended period rather than deducted in the year incurred. The following qualified expenditures will not generate AMT adjustments if capitalized and amortized over a 10-year period (three years in the case of circulation expenditures and 60 months in the case of intangible drilling and development expenditures):

1. Circulation expenditures (IRC Sec. 173).
2. Intangible drilling and development expenditures [IRC Sec. 263(c)].
3. Development expenditures [IRC Sec. 616(a)].
4. Mining exploration expenditures [IRC Sec. 617(a)].
5. Research and experimental expenditures [IRC Sec. 174(a)].

The election can apply to all or any portion of the qualified expenditures incurred in a given year, but it may be revoked only with IRS consent.

Who Can Elect

Any taxpayer incurring an expense item described in IRC Sec. 59(e). For partnerships and S corporations, the election is made at the partner/shareholder level.

When To Elect

By the due date, including extensions, of the return for the tax year in which the expenditure is incurred.

How to Elect

The election must be made on a statement attached to the taxpayer's return (or amended return) for the year that amortization of the qualified expenditures begins. The elected amount must be a specific dollar amount. It cannot be described by a formula. The statement should include the taxpayer's name and address, and taxpayer identification number.

Authorities and References

IRC Sec. 59(e)(1); Reg. 1.59-1(b)(1).

Sample Election

ELECTION TO CAPITALIZE AND AMORTIZE CERTAIN EXPENDITURES

Pursuant to IRC Sec. 59(e)(4), taxpayer hereby elects to capitalize and amortize the following expenditures over the period of time indicated.

Type of Expenditures	Code Section No.	Capitalized Amount	Amortization Period
______	______	$______	______
______	______	______	______

ELECTION E905

To Request Extension of Time for Making an Election (Reg. 301.9100 Relief)

(See Key Issue 4C)

If the deadline for an election is set either by the Internal Revenue Code or regulation, the taxpayer may be able to obtain an extension of time, under Reg. 301.9100-1, to make the election upon showing good cause. This relief provision is useful when an error or some other oversight has caused the taxpayer to fail to make an otherwise beneficial election.

A ruling request for an extension of time to make an election must contain several items:

1. A statement of when the election was required to be filed and when it actually was filed.
2. A copy of any documents referring to the election or relief application.
3. If requested, a copy of any tax return affected by the election.
4. A copy of any other taxpayer's returns affected by the election.
5. An affidavit by the taxpayer detailing the events leading to both the failure to make the election and the discovery of the failure.
6. If the taxpayer relied on a practitioner, the affidavit must describe the extent of the reliance as well as the practitioner's responsibilities and nature of the engagement.
7. Affidavits from other individuals with knowledge of the matter, including the taxpayer's income tax preparer and any other practitioner or attorney who advised the taxpayer concerning the election.
8. The appropriate user fee must accompany these requests.

The taxpayer's affidavit must be signed and must contain the following declaration:

"Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented herein are true, correct, and complete."

If an entity is requesting relief, the declaration must be signed by a person with personal knowledge of the facts and circumstances at issue.

Any other affidavits must be accompanied by the following declaration:

"Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented here are true, correct, and complete."

Requests for relief should be sent to (1) Associate Chief Counsel (Corporate), (2) Associate Chief Counsel (Financial Institutions and Products), (3) Associate Chief Counsel (Income Tax and Accounting), (4) Associate Chief Counsel (International), (5) Associate Chief Counsel (Passthroughs and Special Industries), (6) Associate Chief Counsel (Procedure and Administration), or (7) Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Tax), as appropriate at the following address [Section 7.04(1) of Rev. Proc. 2019-1]:

Mailing Address:

Internal Revenue Service
Attention: CC:PA:LPD:DRU
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044

Mailing Address If Private Delivery Service Used:

Internal Revenue Service
Attn:CC:PA:LPD:DRU
Room 5336
1111 Constitution Ave., NW
Washington, DC 20224

Requests for relief may also be hand delivered between the hours of 8:00 a.m. and 4:00 p.m. to the courier's desk at the loading dock (behind the 12th Street security station) of 1111 Constitution Avenue, N.W., Washington, DC. A

receipt will be given at the courier's desk. The package should be addressed to [Section 7.04(1)(b) of Rev. Proc. 2019-1]:

Courier's Desk:
Internal Revenue Service
Attention: CC: PA: LPD: DRU, Room 5336
1111 Constitution Ave., N.W.
Washington, DC 20224

Who Can Elect

A taxpayer who has missed the filing opportunity under normal circumstances.

When To Elect

As soon as the failure is discovered. Automatic extension must be requested within the six-month or 12-month window provided. Note that the due date for the automatic 12-month extension for regulatory elections is the extended due date of the return if the election can be filed with a return including extensions and the return was extended [Reg. 301.9100-2(a)(1)].

How to Elect

Automatic 12-month extension:

An automatic 12-month extension for making a regulatory election listed in Reg. 301.9100-2(a)(2) is provided by filing an original or amended return making the election or by taking the necessary steps to make the election if it is not required to be filed with the tax return [Reg. 301.9100-2(a)].

Automatic 6-month extension:

An automatic six-month extension from the due date of a return excluding extensions is provided for making a regulatory election not qualifying for an automatic 12-month extension or a statutory election whose deadline is prescribed as the due date of the return (or if applicable, the due date of the return including extensions). The election is made by filing an original or amended return making the election or by taking the necessary steps to make the election if it is not required to be filed with the tax return [Reg. 301.9100-2(b)].

Any return, statement of election, or other form that must be filed to obtain an automatic extension must provide the following statement at the top of the document: "FILED PURSUANT TO REG. 301.9100-2."

For other regulatory elections [or for elections described above not made within the six-month or 12-month window (whichever is applicable)]:

By a ruling request to the IRS's National Office setting forth the facts in the matter and proving (Reg. 301.9100-3):

- The taxpayer acted in good faith.
- Granting relief would not prejudice the government's interest.

Authorities and References

Regs. 301.9100-1 through -3; Section 5.03 of Rev. Proc. 2019-1, 2019-1 IRB 1.

Sample Election

None is required, but see prior discussion of the proper form for requesting a ruling under Reg. 301.9100-1.

ELECTION E906

Reporting Original Issue Discount (OID) Using the Cash Method

(See Key Issue 10H)

Taxpayers can use the cash method of accounting for reporting interest income or expense on certain debt instruments that would otherwise be subject to the OID rules. Then, interest income and expense recognition will correspond to the cash flow from the debt instrument (rather than accrual accounting principles).

The election is available only for "cash method debt instruments." To qualify, the instrument must be issued for other than new Section 38 property, have stated principal not in excess of an inflation-adjusted amount ($4,165,300 or $4,246,200 for 2018 and 2019, respectively or $4,167,600 for taxpayers with debt instruments that arose from a sale or exchange that occurred after December 31, 2017, and before April 30, 2018, or pursuant to a binding written contract entered into before April 30, 2018) when issued, and otherwise be subject to IRC Sec. 1274 (the OID rules). Additionally, the lender cannot use the accrual method of accounting or be a dealer with respect to the property sold.

All sales or exchanges that are part of the same transaction (or series of related transactions) must be aggregated for purposes of the principal limitation rule. All debt instruments arising from the aggregated sales/exchanges are also treated as one instrument for this purpose.

Who Can Elect

Any lender and borrower who jointly elect. This is an entity-level election.

When To Elect

By the earlier of the due date, including extensions, of the return for the lender or borrower for the tax year in which the debt instrument is issued.

How to Elect

By attaching a statement signed by both the lender and the borrower (or a copy thereof) to both taxpayers' returns.

Authorities and References

IRC Sec. 1274A(c); Reg. 1.1274A-1(c); Rev. Rul. 2018-11; Rev. Proc. 2018-57.

Sample Election

ELECTION TO USE CASH METHOD FOR OID INTEREST REPORTING

Lender and borrower hereby elect to use the cash receipts and disbursements method of accounting for interest accrued on the cash method debt instrument dated ____________[Date]____________. Accordingly, the following information is submitted:

Taxpayers' Identification.

Borrower:
Name: ______________________________
Address: ______________________________
____
TIN: ______________________________

Lender:
Name: ______________________________
Address: ______________________________
____
TIN: ______________________________

Election is made pursuant to IRC Sec. 1274A(c)(2) and Reg. 1.1274A-1(c).

The debt instrument subject to this election fulfills the requirements of a cash method debt instrument as set forth in IRC Sec. 1274A(c)(2).

Signed: ______________________________
Borrower

Signed: ______________________________
Lender

ELECTION E907

Adopting the Recurring Item Method for Certain Expenses

(See Key Issue 4B)

Generally, expenses can only be deducted by accrual-method taxpayers in the year economic performance occurs. Under this election, however, an expense can be deducted in the year it becomes fixed and determinable if economic performance occurs on or before the earlier of (1) 8½ months following the close of the tax year or (2) the date the taxpayer files a timely (including extensions) tax return. If economic performance occurs after the date the return is filed but before 8½ months after year-end, an amended return may be filed to deduct the item.

This election is available only for expenses that are immaterial or where the matching of income and expense is better served by using the recurring item method. Immateriality is defined both in absolute terms and in comparison with other items of income and expense. Additionally, the expense must be immaterial for financial statement purposes under generally accepted accounting principles. The better-matching standard is automatically deemed to be met for the following types of liabilities: (1) recurring rebates and returns; (2) awards, prizes, and jackpots; (3) insurance, warranty, and service contracts; and (4) taxes. Therefore, the materiality standard is not applicable to these types of liabilities or others that provide a better matching of the taxpayer's income and expense.

Expenses ineligible for the recurring item exception are (1) interest; (2) worker's compensation claims; (3) tort, breach of contract, and violation of law claims; (4) other liabilities not specifically addressed by the economic performance statute and regulations; and (5) liabilities incurred by a tax shelter [as defined in IRC Sec. 461(i)(3)].

Who Can Elect

Any accrual basis taxpayer. This is an entity-level election.

When To Elect

By the due date, including extensions, of the return for the first tax year an expense (liability) is incurred. For expenses incurred in previous years, an election is a change in accounting method requiring IRS consent.

How to Elect

By deducting the item on the return in the first tax year such expense is incurred. Although not required, attaching an election statement to the return is recommended.

Authorities and References

IRC Sec. 461(h)(3); Regs. 1.461-4(g)(7) and 1.461-5.

Sample Election

ADOPTION OF RECURRING ITEM EXCEPTION METHOD OF ACCOUNTING

Taxpayer is adopting the recurring item exception method of IRC Sec. 461(h)(3) for the following items incurred for the first time during the current tax year.

Listing of each trade or business for which recurring item exception method is adopted: ______________________
____

Listing of all types of liability items for which recurring item exception method is adopted: ______________________
____

These items have been properly deducted on the current year's return under the recurring item method of accounting.

ELECTION E908

Reducing Depreciable Asset Basis First for Excluded Debt Discharge Income

(See Key Issue 12A)

Generally, income from the discharge of indebtedness is included in the taxpayer's gross income. However, under certain circumstances, bankrupt and insolvent taxpayers and certain farmers can exclude the gain from income. The taxpayer may elect to first reduce the basis of depreciable property by the excluded income rather than other tax attributes [such as net operating losses (NOLs) or business credits], as is generally required. The election is revocable only with IRS consent.

The election can be made with respect to all or a portion of the debt discharge income. If no election is made, or if made and the debt discharge income exceeds the basis of depreciable assets, the taxpayer's other tax attributes are reduced in the following order: (1) NOLs and NOL carryovers, (2) general business credits, (3) minimum tax credit, (4) capital loss carryovers, (5) basis of property, (6) passive activity loss and credit carryovers, and (7) foreign tax credit carryovers.

The election may preserve other tax attributes, such as NOLs and NOL carryforwards. It may also be advantageous to a taxpayer owning long-lived depreciable assets. However, the rule for bankrupt or insolvent taxpayers limiting the overall basis reduction to the excess of the aggregate of the bases of property over liabilities immediately after the debt discharge does not apply when the election is made. Thus, taxpayers who would benefit from this limitation should generally not make the election.

A partnership interest is treated as depreciable property to the extent of the partner's interest in the partnership's depreciable property. However, the partnership must agree to reduce the basis of the depreciable property with respect to the bankrupt or insolvent partner.

Who Can Elect

A bankrupt or insolvent taxpayer or certain farmers described in IRC Sec. 108(g). For partnerships, the election is made at the partner level. S corporations make the election at the corporate level.

When To Elect

By the due date of the return, including extensions, for the year the taxpayer excludes income under IRC Sec. 108.

How to Elect

By completing Form 982 [Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)] and attaching to the taxpayer's timely filed federal income tax return. A supporting statement that describes the underlying transactions and identifies the property subject to the basis reduction should be attached to the form.

Authorities and References

IRC Secs. 108(b)(5),1017(b)(2), and 1017(b)(3)(C); Reg 1.108-4(b).

Sample Election

STATEMENT TO ACCOMPANY FORM 982

The transaction that resulted in a reduction of basis was a forgiveness of taxpayer's share of debt owed to _[Lender's Name]_. The amount forgiven was $_[Amount]_. The basis in taxpayer's property has been adjusted pursuant to IRC Sec. 108(b)(5) as follows:

Description of Property	Reduction in Adjusted Basis
__________	$__________
__________	__________
	Total $__________

ELECTION E909

Excluding Discharge of Indebtedness Income with Respect to Qualified Real Property Business Indebtedness

(See Key Issue 12B)

Discharge of indebtedness income generally is excludable from gross income only in cases where the taxpayer is in bankruptcy or insolvent. However, solvent taxpayers (other than C corporations) can elect to exclude cancellation of indebtedness income from gross income if such income is with respect to qualified real property business indebtedness.

Qualified real property business debt includes debt that (1) was incurred or assumed in connection with real property used in a trade or business and is secured by such real property; (2) was incurred or assumed on or after January 1, 1993, and is qualified acquisition debt (debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and (3) is the subject of an election to apply the special rules of IRC Sec. 108(a)(1)(D).

The amount of income excluded cannot exceed the lesser of (1) the excess of the principal amount of the outstanding debt over the fair market value (FMV) of the real property securing the debt, or (2) the aggregate adjusted bases of all depreciable real property held by the taxpayer.

Excluded income must be treated as a reduction in the basis of the taxpayer's depreciable real property. The basis reduction is deemed to occur at the beginning of the tax year following the tax year in which the discharge occurs or, if the property is disposed of, immediately before the disposition.

The election is revocable only with IRS consent.

Who Can Elect

Any taxpayer, other than a C corporation, that is not insolvent or bankrupt. For partnership debt, the election is made at the partner level. However, the partnership must consent to reduce the partner's basis in partnership property (see Election E910).

When To Elect

The election must be made on a timely filed (including extensions) return for the tax year in which the discharge of indebtedness income occurs.

How to Elect

Complete Form 982 [Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)] and attach to taxpayer's tax return.

Authorities and References

IRC Secs. 108(c)(3)(C), 108(a)(1)(D), 108(d)(9), and 1017; Reg. 1.108-5.

Sample Election

Complete Form 982.

ELECTION E910

Consent to Treating a Partnership Interest as Depreciable Property
(See Key Issue 12A)

A taxpayer electing to reduce basis for excluded debt discharge income or income from discharged qualified real property business debt, as described in Elections E908 and E909, can request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) for that taxpayer. The partnership generally may grant or withhold consent in its sole discretion. However, the partnership must consent if the request is made by (1) partners owning (directly or indirectly) an aggregate of more than 80% of the capital and profits of the partnership or (2) five or fewer partners owning (directly or indirectly) an aggregate of more than 50% of the capital and profits interests in the partnership. Also, a taxpayer must request consent if (1) he owns (directly or indirectly) more than 50% of the partnership's capital and profits or (2) reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of discharge of indebtedness income from the partnership.

A taxpayer making the election to first reduce the basis of its depreciable assets rather than its other tax attributes (see Election E908) would typically want to have available for such reduction as large a depreciable asset base as possible. Accordingly, when the Election E908 basis reduction is advantageous, the request to treat a partnership interest as depreciable property should be considered, unless depreciable asset basis can absorb the debt discharge income without the taxpayer considering partnership interests.

Who Can Elect

A partnership that has a partner who makes the election at Election E908 or E909.

When To Elect

The partnership must consent on or before the due date (including extensions) of the partner's tax return for the year the discharge of indebtedness income is excluded by providing the partner a copy of the statement below. The partnership must also attach a copy of the statement to its Form 1065 (U.S. Partnership Return of Income) for the partnership's tax year following the year that ends with or within the tax year the partner excludes income under IRC Sec. 108(a). Note that the taxpayer's request must be made before the due date (including extensions) for filing the taxpayer's federal income tax return for the tax year in which the taxpayer has income excluded under IRC Sec. 108(a).

How to Elect

Taxpayers must retain the statements and keep them available for inspection in the manner required by Reg. 1.6001-1(e), but are not required to attach the statements to their returns.

Authorities and References

IRC Sec. 1017(b)(3)(C); Reg. 1.1017-1(g)(2).

Sample Consent

CONSENT TO REDUCE PARTNER'S BASIS IN PARTNERSHIP PROPERTY IN ACCORDANCE WITH REG. 1.1017-1(g)

In accordance with Reg. 1.1017-1(g) __[Name of Partnership]__ consents to the reduction in basis of __[Partner's Name]__'s __[TIN]__ proportionate interest in the adjusted basis of the partnership's depreciable property/depreciable real property, in the amount of $__________.

ELECTION E911

Treating Real Property Held as Inventory as Depreciable Property

(See Key Issue 12B)

Bankrupt or insolvent taxpayers with discharge of indebtedness income can elect under IRC Sec. 108(b)(5) to first reduce basis in depreciable property before applying the general attribute reduction rules. They can also elect to treat real property held as inventory as depreciable property for purposes of reducing basis in property. Once made, the election may be revoked only with IRS consent. This election can also be made when qualified farm indebtedness [described in IRC Sec. 108(g)(2)] is discharged.

Who Can Elect

A bankrupt or insolvent taxpayer electing to reduce basis in depreciable property under IRC Sec. 108(b)(5) or a taxpayer who is discharged of qualified farm indebtedness.

When To Elect

By the due date, including extensions, for filing the taxpayer's return for the year income is excluded under IRC Sec. 108.

How to Elect

By checking the appropriate box on Form 982 [Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)], which is attached to the taxpayer's timely filed income tax return, and including the real property in the schedule of property whose basis is adjusted under IRC Sec. 1017.

Authorities and References

IRC Sec. 1017(b)(3)(E); Reg. 1.1017-1(f).

Sample Election

STATEMENT TO ACCOMPANY FORM 982

The transaction that resulted in a reduction of basis was a forgiveness of taxpayer's share of debt owed to [Lender's Name]. The amount forgiven was $ [Amount]. The basis in taxpayer's property has been adjusted pursuant to IRC Sec. 108(b)(5) as follows:

Description of Property	Reduction in Adjusted Basis
____________________	$____________
____________________	____________
	Total $____________

ELECTION E912

Requesting a Change in Accounting Method
(See Key Issue 4C)

Once an accounting method is adopted, the taxpayer must apply it consistently. In some cases, taxpayers can elect to change their accounting method. The IRS will not give permission for a change in accounting method unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. Taxpayers must request a change even if changing from an improper method. Changes initiated by the taxpayer are generally given more favorable treatment than those resulting from an IRS examination.

Automatic Changes in Accounting Method.
Certain accounting method changes receive automatic IRS consent. A list of those changes is found in Rev. Proc. 2019-43. The procedures for making the changes are outlined in Rev. Proc. 2015-13. The IRS may issue rulings subsequent to Rev. Proc. 2019-43 that extend the automatic change provisions to additional accounting method changes.

Nonautomatic Changes in Accounting Method.
The general rules and procedures for obtaining IRS approval for taxpayer-initiated accounting method changes that do not receive automatic IRS consent are found in Rev. Proc. 2015-13.

Who Can Elect

Taxpayers desiring to change accounting methods.

When To Elect

For requests requiring IRS approval, any time during the tax year for which the taxpayer desires the change.

Automatic accounting method changes generally are filed by the due date, including extensions, for the income tax return for the year of change. A signed copy of the Form 3115 must be filed with the IRS no earlier than the first day of the year for which the change is effective and no later than when the original is filed with the tax return for the year of change.

How to Elect

For requests requiring IRS approval: by filing Form 3115 *(Application for Change in Accounting Method)* with the IRS National Office in Washington, D.C. [see Rev. Proc. 2015-13, Sec. 6.03(2)] with the required user fee.

For requests with automatic IRS approval: Form 3115 generally is attached to the income tax return for the year of change. In addition, a copy of the Form 3115 (signed and dated) must be filed with the appropriate IRS office no later than the date the tax return is filed. The *designated automatic accounting change number* must be included on the appropriate line of the Form 3115. No user fee is charged.

Authorities and References

IRC Sec. 446(e); Reg. 1.446-1(e); Rev. Procs. 2015-13 and 2019-43.

Sample Election

Completing Form 3115 provides the necessary information.

ELECTION E913

Taking a Section 481(a) Adjustment into Income in One Year
(See Key Issue 4C)

A *de minimis* rule allows a taxpayer to take an entire positive Section 481(a) adjustment into income in the year of change if the adjustment is less than $50,000.

The election should be considered when the taxpayer has net operating losses in the year of change that can offset a positive adjustment.

If the election is not made, the Section 481(a) adjustment period will depend on the type of accounting method change being made (generally, the adjustment period is four years).

Who Can Elect

A taxpayer who changes an accounting method.

When To Elect

By the due date for filing Form 3115 (Application for Change in Accounting Method).

How to Elect

Check the election box in Part IV of Form 3115.

Authorities and References

IRC Sec. 446(e); Reg. 1.446-1(e); 2015-13, 2015-5 IRB.

Sample Election

None. Check the election box in Part IV of Form 3115.

ELECTION E914

Amortizing Intangibles Subject to the Anti-churning Rules
(See Key Issue 37C)

A taxpayer acquiring property subject to the anti-churning rules of IRC Sec. 197 can amortize the property under the provisions of that Section if the seller of the property elects to recognize gain on the sale and pay tax at the highest applicable rate.

Anti-churning rules prevent taxpayers acquiring goodwill and certain other intangibles from related persons after August 10, 1993 from applying the amortization provisions of IRC Sec. 197.

The anti-churning rules do not apply to the acquisition of an intangible by the taxpayer if (1) the basis of the intangible is determined under the rules for property acquired from a decedent or (2) the intangible was an amortizable Section 197 intangible to the seller, but only if the acquisition (or sale) was not part of a transaction or series of related transactions in which the seller previously acquired the intangible.

Making the election requires the seller of the property to pay tax on the gain. The anti-churning rules then apply only to the extent that the acquirer's adjusted basis in the property exceeds the gain recognized. If a partnership (or S corporation) makes the election, each partner (or shareholder) pays tax on the gain allocable to that partner (shareholder).

Who Can Elect

Certain sellers of property subject to the anti-churning provisions of IRC Sec. 197. For partnerships and S corporations, the election is made at the entity level.

When To Elect

The election must be made by the due date (including extensions) of the electing taxpayer's return for the tax year in which the disposition occurs.

How to Elect

By attaching a statement to the seller's return. In addition, the seller must provide to the taxpayer acquiring the Section 197 intangible written notification of the election, on or before the due date of the return on which the election is made. Partnerships or S corporations making the election must attach to Schedules K-1 furnished to partners or shareholders written statements containing all information necessary to determine each partner's or shareholder's additional tax liability resulting from the election.

Authorities and References

IRC Sec. 197(f)(9)(B); Reg. 1.197-2(h).

Sample Election

ELECTION TO RECOGNIZE GAIN AND AVOID SECTION 197 ANTI-CHURNING RULES

The taxpayer hereby elects pursuant to IRC Sec. 197(f)(9)(B) to fully recognize in the current taxable year the gain realized from the sale of an intangible asset subject to the Section 197(f)(9) anti-churning rules.

Identification of the transaction and each person that is a party to the transaction or whose tax return is affected by the election (including the TIN of each such person):

Description of the Transaction	Date of Transaction	Purchaser Name and TIN	Partner Name and TIN

The calculation of the gain realized, the applicable rate of tax, and the amount of the selling taxpayer's additional tax liability resulting from this election:

Amount of Gain Realized	Applicable Tax Rate	Amount of the selling taxpayer's additional tax liability resulting from this election

Signed:______________________________

Taxpayer or Authorized Representative

Sample Notification

Re: Notification of Election under IRC Sec. 197(f)(9)(B)

__________[Name of Selling Taxpayer]__________ hereby notifies you that an election to recognize gain under IRC Sec. 197(f)(9)(B) has been made with respect to the following asset sales:

Date of Sale	Description of Asset Sold	Amount of Gain Allocated

ELECTION E915

Qualified Small Business Stock (QSBS) Capital Gain Rollover

(See Key Issue 11A)

Any taxpayer, other than a corporation, can elect to roll over capital gain from the sale of QSBS held for more than six months if qualified replacement stock is acquired within 60 days. For purposes of the gain rollover provision, the replacement stock must meet the active trade or business requirement for the six-month period following its purchase. The holding period of the stock purchased will generally include that of the stock sold.

For partnerships, the benefit of this rollover flows through to any partner that is not a corporation, if the partner held the partnership interest at all times that the partnership held the QSBS. A similar rule applies to S corporations. If the pass-through entity does not elect to defer the gain on a sale of qualifying QSBS, a noncorporate owner of the pass-through entity (e.g., a partner) can purchase replacement stock within 60 days of the date the pass-through entity sold the QSBS and elect to defer his distributive share of the pass-through entity's gain. This only applies to taxpayers who held their interest in the pass-through entity for the entire time the pass-through entity held its interest in the QSBS. See Reg. 1.1045-1 (effective August 24, 2007) for details on making the election when a partnership owns QSBS and related basis adjustment rules.

If the rollover election is made, capital gain is recognized only to the extent that the amount realized from the sale exceeds the cost of any QSBS purchased during the 60-day period beginning on the date of the sale, reduced by any portion of the cost previously taken into account under this rollover rule. In other words, starting with the first such sale, the cost of stock purchased is applied against the amount realized from QSBS sales for which elections were made and that occurred during the 59 days before the purchase.

Unrecognized gain reduces the basis of QSBS purchased during the 60-day period beginning on the sale date. If more than one purchase occurs, the basis reduction applies to such purchases in the order they were made.

This election is revocable only with the prior written IRS consent.

Who Can Elect

Taxpayers other than C corporations.

When To Elect

On or before the due date, including extensions, for filing the tax return for the year the QSBS is sold.

How to Elect

Report the entire gain realized on Form 8949.

The taxpayer does not have to indicate in the election what specific QSBS shares are being purchased as a replacement. The election includes the cost of any QSBS purchased within the 60-day period beginning on the date of the sale.

Authorities and References

IRC Secs. 1045(a) and 1202; Reg. 1.1045-1; Rev. Proc. 98-48, 1998-2 CB 367.

Sample Election

A separate election statement is not required. Election is made by properly completing Form 8949.

ELECTION E916

Deferring Income on Livestock Sold because of Drought, Floods, or Other Weather-related Conditions

(See Key Issue 11G)

A cash-basis taxpayer whose principal trade or business is farming and who is forced to sell livestock early due to drought, flood, or other weather conditions can elect to include income from the sale of the livestock in the year following the year of the sale. The weather conditions must result in the area being designated as eligible for federal assistance. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other federal departments or agencies.

Taxpayers must establish that, under their usual business practices, the sale would not have occurred in the year of election if not for the weather-related conditions. The election applies to sales of livestock used for draft, breeding, dairy, or sporting purposes, regardless of the time period the livestock have been held. It is made separately for each generic class of animals (e.g., hogs, sheep, cattle). The deferred gain is the gain attributable to the excess of the number of livestock sold over the number that would have been sold if the weather-related conditions had not occurred. The election must be made separately for each year it is to apply. The election cannot be revoked without IRS consent.

Instead of making this election, farmers can use the involuntary conversion rules under IRC Sec. 1033(e) for certain sales of livestock (other than poultry) held for draft, breeding, or dairy purposes. Under these rules, the gain from sales of such livestock is deferred by reinvesting the sales proceeds in similar property within a certain period. The livestock subject to IRC Sec. 1033(e) treatment are those animals sold during the year that would not have been sold if there had not been a drought, flood, or other weather-related condition. (See Election E917 for more on involuntary conversions.)

Who Can Elect

Cash-basis taxpayers whose principle trade or business is farming. This is an entity-level election.

When To Elect

Generally, by the due date, including extensions, of the return for the year of sale. An amended return may be used only if it is filed by the extended due date of the return for the year of sale. However, if the sale qualifies for the four-year replacement period for involuntary conversions under IRC Sec. 1033(e)(2) (see Election E917), the election to defer income must be made by the end of the fourth year after the year the weather-related sale is made.

How to Elect

By attaching a statement to the return for the year of sale. If the election is made after the return for the year of sale is filed [because the sale qualified for the four-year replacement period under IRC Sec. 1033(e)(2)], the statement presumably would be attached to an amended return for the sale year. In addition, an amended return for the following year would also be required to report the gain.

Caution: Reg. 1.451-7 has not been amended to reflect changes by the 1988 Tax Act or American Jobs Creation Act of 2004.

Authorities and References

IRC Secs. 451(g) and 1033(e); Regs. 1.451-7 and 1.1033(e)-1; Notice 89-55, 1989-1 CB 696.

Sample Election

ELECTION TO DEFER INCOME FROM LIVESTOCK SOLD BECAUSE OF WEATHER-RELATED CONDITIONS

Taxpayer hereby elects under IRC Sec. 451(g) and Reg. 1.451-7 to defer income from the sale of livestock until the tax year ending ______[Date]______.

Taxpayer submits the following information in accordance with Reg. 1.451-7(g):

1. Evidence of weather-related conditions and date declared eligible for federal relief due to such conditions: ____________________

2. Statement explaining relationship of weather conditions to early sale of livestock: ____________________

3. Total number of animals sold in each of the preceding three years:

Ending date of third preceding tax year	____________	Number of livestock sold during this year	____________
Ending date of second preceding tax year	____________	Number of livestock sold during this year	____________
Ending date of first preceding tax year	____________	Number of livestock sold during this year	____________

4. Number of animals that would have been sold in the current tax year under normal conditions: ________

5. Number of animals actually sold and number sold on account of weather-related conditions during the current year: ____________________

6. Computation of deferred income using the following formula: $____________________

$$\frac{\text{Income from Sales of All Livestock}}{\text{Number of Livestock Sold}} \times \begin{array}{c}\text{Excess Number Sold Due to}\\ \text{Weather-related Conditions}\end{array}$$

ELECTION E917

Deferring Gain from Involuntary Conversions

(See Key Issue 11G)

A taxpayer may elect to defer gain on an involuntary conversion of property resulting from destruction, theft, seizure, condemnation, or threat thereof to the extent the amount of money (or "dissimilar" property) realized upon conversion does not exceed the cost of replacement property (i.e., property similar to or related in use to the converted property). Thus, gain is recognized only to the extent that the amount realized upon conversion exceeds the cost of replacement property. If property is converted directly into similar or related-use property, nonrecognition is mandatory and this election is not necessary.

Replacement must occur within two years (three years for condemned real property used in a trade or business or held for investment and replaced with like-kind property or four years for a principal residence involuntarily converted as the result of a federally declared disaster) after the close of the year that any gain is realized.

Sales of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number that would ordinarily be sold under the taxpayer's normal business practices can be treated as an involuntary conversion if the sale or exchange was solely due to weather-related conditions (e.g., drought or flood). Under a special rule, the replacement period is extended to four years after the close of the first tax year in which a weather-related sale is made, if the weather-related conditions resulted in the area becoming eligible for federal assistance. Notice 2006-82 provides that if a sale or exchange of livestock is treated as an involuntary conversion because of drought, the four-year replacement period is extended until the end of the taxpayer's first tax year ending after the first drought-free year for the applicable region. The first drought-free year for the applicable region is the first 12-month period that: (1) ends on August 31; (2) ends in or after the last year of the taxpayer's four-year replacement period; and (3) does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region. Notice 2019-54 provides guidance regarding an extension of the replacement period for livestock sold due to drought in specified counties.

If converted property is not replaced within the required time or is replaced at a lower cost than anticipated, the tax liability for the year of the gain shall be recomputed on an amended return.

The taxpayer may revoke the election (by filing an amended return recognizing the gain) before the replacement property is actually purchased. However, once the taxpayer has purchased the replacement property under either a formal or deemed election, the election becomes irrevocable.

The statute of limitations for any gain year remains open until three years after the IRS is notified of replacement or failure to replace. Therefore, a statement should be included in the return for the year of replacement (if no gain is recognized), or with the amended return for the gain year (if gain must be recognized).

Who Can Elect

Any taxpayer; this is an entity-level election.

When To Elect

Within the replacement period for the converted property.

How to Elect

By excluding the deferred portion of the gain from gross income on the return for the year of the involuntary conversion and by attaching a statement to the return reporting all details of the conversion. Although the information statement is required by the regulations, failure to provide the statement will not invalidate the election. Merely excluding the deferred portion of the gain is a deemed election under IRC Sec. 1033. Although the regulations state that the election can be made any time during the replacement period, it is unclear how to do so if the return for the conversion year was filed without an election. Presumably, including the information required by the regulations in a return filed for a year within the replacement period will suffice. Then, the taxpayer would generally file a refund claim (on an amended return) for any tax paid on the gain in the conversion year. While the election must be made during the replacement period, the claim for refund can be made as long as the statute of limitations is open for that year.

Authorities and References

IRC Secs. 1033(a)(2)(A), (a)(2)(B), (e), (g), and (h); Reg. 1.1033(a)-2; Notices 2006-82, 2006-29 IRB 529, and 2019-54, 2019-42 IRB 935; Rev. Rul. 63-127, 1963-2 CB 333; FSA 200147053.

Sample Election

ELECTION UNDER IRC SEC. 1033(a)(2)(A) NOT TO RECOGNIZE GAIN FROM COMPULSORY OR INVOLUNTARY CONVERSION

Taxpayer hereby elects in accordance with IRC Sec. 1033(a)(2) and Reg. 1.1033(a)-2 not to recognize a realized gain in the amount of $ [Deferred Gain] from the involuntary conversion of the following property: [Description of property involuntarily converted]

The involuntary conversion occurred on [Date]. The realization of gain occurred on [Date]. The taxpayer intends to replace the converted property with property that is similar or related in service or use within the replacement period.

ELECTION E918

Deducting Disaster Losses in Previous Tax Year

(See Key Issue 11H)

A taxpayer that sustains a loss occurring in a disaster area (as subsequently determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act) may elect to deduct the loss in the tax year before the year the loss occurred. The taxpayer thus has the option of selecting either the year of the loss or the prior year in which to claim the deduction. If the election is made to select the year prior to the year of loss, the casualty resulting in the loss is treated for purposes of the Internal Revenue Code as having occurred in that prior year.

Although the loss generally will be a casualty loss, it does not have to be. Certain trade or business losses such as drought-related losses may also qualify. For casualty losses, any other limitations [e.g., 10% of an individual's adjusted gross income (AGI) for nonbusiness casualty losses] continue to apply.

The IRS periodically announces areas designated as federally declared disaster areas. This information can also be found on the Federal Emergency Management Agency's website at **www.fema.gov/disasters**.

The election may be revoked by filing an amended return that contains a revocation statement for the preceding year on or before 90 days after the due date for making the original election.

Who Can Elect

Any taxpayer. For partnerships and S corporations, it appears this is an entity-level election if the property is trade or business property or held for investment. However, if the property that is destroyed is not trade or business or investment property, the loss must be separately stated on each partner's or shareholder's Schedule K-1 and the election made at the partner or shareholder level.

When To Elect

Taxpayers must make the election within six months after the due date of the taxpayer's federal income tax return for the disaster year (determined without regard to any extension of time to file). An extension does not need to be requested in order to make the election after the original due date of the return for the year in which the loss occurred. If the taxpayer originally deducts the loss in the year of disaster, he must file an amended return for the disaster year to remove the loss prior to deducting the loss on the previous year's original or amended return.

If the taxpayer chooses to revoke the election within the 90-day period and deduct the loss in the disaster year, an amended return for the prior year must be filed prior to filing the original or amended return for the disaster year.

How to Elect

Deduct the disaster loss on either an original return or an amended return for the year preceding the disaster. If the election is made on an original return, the information required should be provided on line 1 or 19 (as applicable) of Form 4684 (Casualties and Thefts). This election may be made by completing Part I of Section D on the Form 4684 and attaching to the return or amended return for the preceding year which reports the disaster loss deduction. Complete Part II of Section D of the Form 4684 to revoke a prior election to deduct a loss attributable to a federally declared disaster. For prior years, if the return is filed electronically, the statement can be attached to the electronic return as a PDF document if there is insufficient space on line 1 or 19 (as applicable) of Form 4684 to provide the required information. For an amended return, the taxpayer may provide the information by any reasonable means. Reasonable means include, but are not limited to, writing the name or description of the disaster, the address where the damaged or destroyed property was located at the time of the disaster, and "Section 165(i) Election" on the top of Form 4684 and providing the rest of the required information in the explanation of changes on the amended return form, attaching a statement if there is insufficient room on the form.

Authorities and References

IRC Sec. 165(i); Reg. 1.165-11; Rev. Proc. 2016-53, 2016-44 IRB 530; *Matheson, Chester*, 74 TC 836 (1980), *acq.* 1981-2 CB 2.

ELECTION E918

Sample Election

ELECTION TO DEDUCT DISASTER LOSS IN PREVIOUS TAX YEAR UNDER REG. 1.165-11

Taxpayer hereby elects under IRC Sec. 165(i) to deduct the casualty loss occurring on [Date] that occurred as a result of [Name of Disaster] in the tax year ended [Tax Year End], which is the year prior to the year of loss.

The location of the property that was damaged or destroyed by the disaster is [City or Town, County or Parish, State, and Zip Code]. The disaster loss amount is $[Amount].

Sample Election

REVOCATION OF ELECTION TO DEDUCT DISASTER LOSS IN PREVIOUS TAX YEAR UNDER REG. 1.165-11

Taxpayer hereby revokes the election under IRC Sec. 165(i) to deduct the casualty loss occurring on [Date] that occurred as a result of [Name of Disaster] in the tax year ended [Tax Year End], which was the year prior to the year of loss.

The location of the property that was damaged or destroyed by the disaster is [City or Town, County or Parish, State, and Zip Code]. The disaster loss amount was $[Amount].

ELECTION E919

Statement for Required Disclosure of Aggregation for Section 199A Qualified Business Income Deduction

Individual taxpayers or relevant pass-through entities (RPE) can aggregate trades or businesses to treat them as a single trade or business for purposes of applying the limits for computing the qualified business income (QBI) deduction under IRC Sec. 199A. Aggregation, however, is not required. Failure to aggregate is not considered to be an election to aggregate. Once an individual or RPE chooses to aggregate two or more trades or businesses, they must consistently aggregate these trades or businesses in all subsequent tax years unless there is a significant change in facts and circumstances. Newly created or newly acquired trades or businesses can be added to existing aggregated groups if the requirements for aggregation are met. An individual also must report aggregated trades or businesses of an RPE in which the individual holds a direct or indirect interest.

If the individual or RPE fails to attach the required statement, the IRS may disaggregate the taxpayer's trades or businesses. In such cases, the taxpayer may not reaggregate those businesses for the following three tax years.

Who Can Elect

Trades or businesses may be aggregated only if the individual or RPE can show that:

1. The same person or group of persons, directly or by attribution under IRC Sec. 267(b) or 707(b), owns 50% or more of each trade or business that is to be aggregated. In the case of an S corporation, 50% or more of the issued and outstanding shares of the corporation is required. In the case of a partnership, 50% or more of the capital or profits is required.
2. The ownership described in 1. existed for the majority of the tax year and includes the last day of the tax year in which the items attributable to each trade or business to be aggregated are included in income.
3. All of the items attributable to each trade or business to be aggregated are reported on returns with the same tax year, not taking into account short tax years.
4. None of the trades or businesses being aggregated are specified service trades or businesses (SSTB) as defined in Reg. 1.199A-5; and
5. The trades or businesses that are being aggregated satisfy at least two of the following factors:
    a. They provide products, property, or services that are the same or customarily offered together.
    b. They share facilities or such things as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
    c. They are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

An RPE can aggregate trades or businesses operated directly or through a lower-tier RPE to the extent aggregation is not inconsistent with the aggregation of a lower-tier RPE. If an RPE does not aggregate, multiple owners of an RPE do not need to aggregate in the same manner. If an RPE aggregates multiple trades or businesses, the RPE must compute and report QBI, W-2 wages, and unadjusted basis immediately after acquisition (UBIA) of qualified property for the aggregated trade or business as required under Reg. 1.199A-6(b). An RPE cannot remove trades or businesses from an aggregated group of a lower-tier RPE but they can aggregate additional trades or businesses with the lower-tier RPE aggregation.

An individual can aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE's aggregation if the rules of this section are otherwise satisfied.

When To Elect

The individual or RPE must report the aggregated trades or business in the first year of aggregation.

How to Elect

By attaching a statement to an originally filed federal income tax return of the RPE (attach to the pass-through owners' Schedules K-1) in the year of aggregation and all subsequent years. Individuals make this election on Schedule B (Aggregation of Business Operations) of Form 8995-A (Qualified Business Income Deduction). Generally, an individual or RPE may not aggregate on an amended return, with the exception of an amended return for the 2018 tax year.

Authorities and References

Regs. 1.199A-4(c)(4)

Sample Statement

Annual Disclosure for RPE Taxpayer Aggregating Trades or Businesses as Required by Reg. 1.199A-4(c)(4)

1. Description of each trade or business: ______________________________
____

2. Name and EIN of each entity in which the trade or business is operated:
____
____
____
____
____
____

3. Name and EIN of any trade or business that was—
   a. formed during the year:
   ____
   ____
   b. ceased operations during the year:
   ____
   ____
   c. was acquired during the year:
   ____
   ____
   d. disposed during the tax year:
   ____
   ____

4. Name and EIN of any aggregated trade or business of an RPE in which the RPE holds an ownership interest: ______________________________
____
____

5. Other information as required by the IRS: ______________________________

____

____

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WORKSHEET W136

Percentage-of-completion Calculation Worksheet[a]

(See Key Issue 4D)

Taxpayer: ______________________ Year: ______________________

Completed by: ______________________ Date: ______________________

Purpose: This worksheet can be used to properly account for contract activity for tax purposes. It provides a useful document to organize and consolidate the information used in percentage-of-completion computations. If additional columns are needed, the worksheet can be copied and combined to make a single worksheet. The last column can be used to cross foot to a row total, if necessary. By completing this worksheet for each contract in progress as of a tax year end, a contractor can determine the adjustments that are required to properly state contract amounts at the appropriate basis.

Line No.	Description	Calcula-tion	Contract No.	Contract No.	Contract No.	Contract No.	Contract No.
	Contract #						
	Project manager						
	Customer						
	Commencement date						
	Completion date						
1.	Original contract price						
2.	Change orders since inception						
3.	Contract price and change orders	1+2					
4.	Adjustments to contract price, if any						
5.	Revised contract price	3+/–4					
6.	Original total cost estimate						
7.	Costs of change orders since inception						
8.	Total costs including change orders	6+7					
9.	Adjustments to original estimate, if any						
10.	Revised total cost estimate	8+/–9					
11.	Estimated gross profit (loss)	5–10					
12.	Adjusted cost incurred as of prior year						
13.	Current year costs						
14.	Adjustments to current year costs						
15.	Adjusted current year costs	13+14					
16.	Total costs since inception	12+15					
17.	Tax return cost-to-cost % of completion	16÷10					
18.	Cumulative gross profit (loss)	17×11					
19.	Prior year adjusted cumulative gross profit (loss)						
20.	Current year gross profit (loss)	18–19					

Note:

[a] Taxpayers meeting the average annual gross receipts test under IRC Sec. 448(c) are not required to use the PCM.

WORKSHEET W137

Limit on Business Interest Expense Worksheet[a]
(See Key Issue 14G)

Client Name/ID: ______________________ Tax Year Ended: ______________________

Prepared by: ______________________ Date Prepared: ______________________

Reviewed by: ______________________ Date Reviewed: ______________________

A	Enter the percentage of adjusted taxable income (ATI) used to compute the Section 163(j) limit	b	________
B	For tax years beginning in 2020, is business electing to use 2019 ATI to compute the limit?	c	________
C	If business elects to use 2019 ATI in 2020, enter 2019 ATI		$________

PART I BUSINESS INTEREST INCOME

1.	Business interest income (including excess business interest income from pass-through entities)		$________

PART II BUSINESS INTEREST EXPENSE

2.	Current year business interest expense before Section 163(j) limit (not including floor plan financing interest expense)		________
3.	Disallowed business interest expense carryforwards from prior years (Partnerships enter ZERO)		________
4.	Partner's excess business interest expense treated as paid or accrued in the current year	d	________
5.	Floor plan financing interest expense		________
6.	Total Business Interest Expense (Sum of lines 2-5)		$________

If Box B is "Yes" input is complete.

PART III ADJUSTED TAXABLE INCOME

7.	Taxable income or loss		$________

Subtractions (to the extent included in line 7)

Note: Enter lines 8 through 12 as positive numbers.

8.	Items of gain not properly allocable to a trade or business		________
9.	Business interest income not from a pass-through entity		________
10.	Distributive share of income or gains from pass-through entities	e	________
11.	Floor plan financing interest expense (line 5)		________
12.	Other subtractions		________
13.	**Total subtractions (sum of lines 8 through 12)**		$________

Additions (to the extent included in line 7)

Note: Enter lines 14 through 22 as positive numbers.

14.	Items of deduction or loss not properly allocable to a trade or business		$______
15.	Business interest expense not from a pass-through entity		______
16.	NOL deduction under IRC Sec. 172		______
17.	Qualified business income deduction under IRC Sec. 199A		______
18.	Depreciation, amortization, or depletion deductions attributable to a trade or business (enter zero for tax years beginning after 2021)		______
19.	Distributive share of loss or deduction items from pass-through entities	e	______
20.	ATI of pass-through entities that are exempt from the IRC Sec. 163(j) limit	e	______
21.	Current year excess taxable income passed through from partnerships or S corporations	f	______
22.	Other additions		______
23.	**Total additions (sum of lines 14 through 22)**		______
24.	**Adjusted Taxable Income (line 7 - line 13 + line 23) (or if elected, 2019 ATI)**		$______

PART IV EXCESS BUSINESS INTEREST EXPENSE

25.	Applicable percentage of ATI (line 24 × applicable percentage, but not less than zero)		$______
26.	Business interest income (line 1)		______
27.	Floor plan financing interest expense (line 5)		______
28.	Section 163(j) limit on business interest expense (sum of lines 25, 26 and 27)		______
29.	Interest expense allowed (lesser of 6 or line 28)		______
30.	**Excess Business Interest Expense (line 6 – line 29, but not less than zero)**	g	______

C Corporations and Individuals Stop Here

PART V PARTNERSHIP AND S CORPORATION CALCULATIONS

Excess Business Taxable Income

31.	Business interest expense net of floor plan financing interest (line 6 – line 5)		______
32.	Business interest income (line 1)		______
33.	Net business interest expense (line 31 – line 32, but not less than zero)		______
34.	Applicable percentage of ATI less net business interest expense (line 25 – line 33, but not less than zero)		$______
35.	Ratio (line 34 ÷ line 25)		______
36.	**Excess Taxable Income (line 24 × line 35)**	h	______

Excess Business Interest Income

37. Subtract the sum of lines 2, 3 and 4 from line 1, but not less than zero [i] ______________

Notes:

[a] This worksheet can be used to calculate the limit on business interest expense under IRC Sec. 163(j). The limit does not apply to businesses (other than tax shelters) that meet the gross receipts test under IRC Sec. 448(c) or to certain farming businesses and real estate trades or businesses that elect out under IRC Sec. 168(j)(C) and (B) respectively.

[b] Under the CARES Act, businesses include 50% of ATI in their Section 163(j) limit for tax years beginning in 2019 and 2020, unless they elect out of using the 50% threshold in which case, 30% of ATI is included in the limit. For partnerships, this option only applies to tax years beginning in 2020. Also, for their years beginning in 2020, partners treat 50% of any excess business interest expense allocated to them by a partnership in its 2019 tax year as business interest expense paid or accrued and not subject to the Section 163(j) limit. The other half continues to be treated as business interest expense paid or accrued only to the extent the partner is allocated excess taxable income or excess business interest income in a later year by the same partnership. Such amount is reported on line 4.

[c] For tax years beginning in 2020, businesses can elect to use their 2019 ATI to compute their Section 163(j) limit on business interest expense.

[d] If the business is a partner in any partnership(s), enter any excess business interest expense from the partnership(s) that is considered to be paid or accrued in the current year and subject to the Section 163(j) limit [see Form 8990, Schedule A, line 44, column (h)].

[e] ATI does not include the business's distributive share of income, gain, deduction or loss from pass-through entities.

Exception: If the business owns an interest in a pass-through entity that is not subject to the business interest expense limit, the pass-through entity's ATI is included in the business's ATI. Enter the distributive share of income/gains and losses/deductions from such an entity on lines 10 and 19, respectively, and the pass-through entity's ATI on line 20.

[f] If the business for which the business interest expense limit is being calculated is a partner in any partnership(s), enter any excess taxable income allocated from the lower-tier partnership(s) (see Form 8990, Schedule A, line 44(f)].

[g] For all entities other than partnerships, excess business interest expense is carried forward and treated as paid or accrued in the following year. For partnerships, excess business interest expense is allocated to the partners under the rules of Prop. Reg. 1.163(j)-6(f)(2). Worksheets A and B in the Form 8990 instructions can be used to make the allocation.

[h] Excess taxable income is allocated to the partners under the rules of Prop. Reg. 1.163(j)-6(f)(2). Worksheets A and B in the Form 8990 instructions can be used to make the allocation. S corporations allocate this amount to their shareholders pro rata under IRC Sec. 1366(a).

[i] Excess business interest income is allocated to partners in a partnership under the rules of Prop. Reg. 1.163(j)-6(f)(2). Worksheets A and B in the Form 8990 instructions can be used to make the allocation. S corporations allocate it to their shareholders pro rata under IRC Sec. 1366(a).

TABLE T101

Recovery Periods for Common Assets[a]

Use this table to determine the recovery period when an asset is placed in service. The recovery period is used in Tables T301–T403 to determine the percentage depreciation rate to be applied each year to the basis of the asset to arrive at the depreciation deduction for that year.

	RECOVERY PERIOD (YEARS)	
	MACRS	ADS
ASSETS USED IN ALL BUSINESS ACTIVITIES		
Office furniture and equipment	7	10
Computers and peripheral equipment	5	5
Typewriters, calculators, copiers	5	6
Airplanes (noncommercial) and helicopters	5	6
Automobiles	5	5
Light general purpose trucks (less than 13,000 lbs.)	5	5
Heavy general purpose trucks (13,000 lbs. or more)	5	6
Tractor units (for over-the-road use)	3	4
Trailers	5	6
ASSETS USED IN AGRICULTURAL ACTIVITIES[b]		
Agricultural machinery and equipment	7/5[c]	10
Breeding or dairy cattle	5	7
Breeding or work horses, 12 years old or less	7	10
Race horses, more than 2 years old[d]	3	12
Breeding hogs	3	3
Breeding sheep and goats	5	5
Farm buildings, other than single purpose (see below)	20	25
Single purpose agricultural or horticultural structures [IRC Secs. 168(e)(3)(D)(i) and 168(g)(3)(B)]	10	15
Trees and vines, fruit or nut-bearing [IRC Secs. 168(e)(3)(D)(ii) and 168(g)(3)(B)]	10	20
Drainage tile, culverts	15	20
ASSETS USED IN MINERAL EXTRACTION		
Mining assets (i.e., to mine sand, gravel, clay, etc.)	7	10
Assets used in drilling oil and gas wells	5	6
Assets used in exploration and production of oil and gas	7	14
ASSETS USED IN DISTRIBUTIVE TRADES AND SERVICES ACTIVITIES		
Assets unique to wholesale and retail trade, and personal and professional services[e]	5	9
Section 1245 assets used in marketing petroleum and petroleum products	5	9
High technology medical equipment defined in IRC Sec. 168(i)(2)(C)	5	5
REAL PROPERTY		
Land improvements (sidewalks, roads, drainage facilities, bridges, fences, landscaping, radio towers, drip irrigation systems, water wells)	15	20
Section 1245 real property with no class life	7	40
Qualified improvement property[f]	15	20
Residential rental real property	27.5	30 (40 if placed in service before 2018)
Nonresidential real property (generally placed in service before 5/13/93)	31.5	40
Nonresidential real property (generally placed in service after 5/12/93)[g]	39	40
OTHER		
Assets used in construction activities (i.e., by general building contractors, real estate subdividers, and developers)	5	6
Assets used in recreation activities, other than specialized land improvements	7	10
Timber-cutting equipment	5	6
Personal property with no class life	7	12

Notes:

[a] Applies generally to assets placed in service after 1986. See Rev. Proc. 87-56 as modified by Rev. Proc. 88-22 for the complete table of class lives and recovery periods published by the IRS.

[b] Generally, for farm property placed in service after 1988 and before 2018, the 150% declining balance method over the MACRS recovery period is used for regular tax purposes.

[c] Qualified farming property (most farming machinery and equipment) that was new and placed in service in 2009 or after December 31, 2017, has a five-year MACRS recovery period.

[d] Prior to January 1, 2021, any race horse, not just those older than two years, is assigned the shorter three-year recovery period. Beginning January 1, 2021, race horses two years old or younger no longer qualify for the shorter depreciable life [IRC Sec. 168(e)(3)(A)(ii)].

[e] Assets that are not unique to the business (such as a desk that could be used in almost any business) must use the regular category for that type of asset (e.g., 7 years MACRS for a desk) (*Norwest Corporation*).

[f] Qualified improvement property is defined as any improvement that is Section 1250 property to an interior of a building that is nonresidential real property as long as that improvement is placed in service after the building was first placed in service by any taxpayer [IRC Sec. 168(e)(6) and Reg. 1.168(b)-1(a)(5)]. Qualified improvement property excludes expenditures for the enlargement of a building, elevators or escalators, or the internal structural framework of a building. Qualified improvement property qualifies for the Section 179 election and is eligible for bonus depreciation.

[g] **Warning:** Rev. Procs. 87-56 and 88-22 (see note a) have not been updated to reflect the change from 31.5 to 39 years for property placed in service after May 12, 1993. They still show 31.5 years.

TABLE T201

Summary of Regular Tax Depreciation Rules

Assets Placed in Service after 12/31/86

Depreciation System Available	Type of Property	Recovery Period	Depreciation Method	Convention	Tables
MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS) APPLICABLE TO ALL TANGIBLE PROPERTY EXCEPT— • Listed property (e.g., autos) not used predominantly (over 50%) for qualified business use. • Transition property, e.g., constructed under contract binding on 3/1/86. • Property subject to units-of-production or income-forecast methods. • Certain property acquired from or leased to a related party. • When alternate MACRS (ADS) is elected or required (see below) or when AMT method is elected.	Tangible personal property	3, 5, 7, 10, 15, or 20	200% declining balance (150% for 15- or 20-year property and for property used in farming if placed in service before 2018). Can elect (on a class-by-class basis) straight-line using regular recovery periods or elect to follow AMT rules. Bonus depreciation for qualified original use property (only new property if placed in service before 9/28/17).	Half-year for additions and dispositions unless midquarter convention required. Midquarter for additions and dispositions if cost of property placed in service in last three months of tax year is more than 40% of total placed in service in entire year. Property placed in service and disposed of within the same year is disregarded.	T301 T302 through T305
	Residential rental property	27.5	Straight-line (no salvage)	Midmonth for additions and dispositions.	T401
	Nonresidential real property	31.5 before 5/13/93 39 after 5/12/93	Straight-line (no salvage)	Midmonth for additions and dispositions.	T402 and T403
	Qualified improvement property.	39 after 12/31/15[a] (15 if qualified leasehold improvement, retail improvement or restaurant property—see below)	Straight-line (no salvage) Bonus depreciation for qualified original use property (only new property if placed in service before September 28, 2017).	Mid-month	T404
		15 after 12/31/17[a]	Bonus depreciation for qualified original use property.		
	Qualified leasehold improv., restaurant, and retail improv.	15 after 10/22/04 and before 1/1/18 (after 12/31/08 and before 1/1/18 for retail improv.)	Bonus depreciation if qualified improvement property placed in service before 1/1/18.	Half-year	

Depreciation System Available	Type of Property	Recovery Period	Depreciation Method	Convention	Tables
ALTERNATIVE DEPRECIATION SYSTEM (ADS) WHEN ELECTED by taxpayer (applies to all personal property in a class placed in service that year; applied on property-by-property basis for real property). or WHEN REQUIRED. Generally required for— • Listed property (e.g., autos) not used predominantly (over 50%) for qualified business use. • Real property business, required for buildings and improvements if election made to exempt business from business interest deduction limit • Farm property, if election to avoid uniform capitalization rule or if election to exempt farming from business interest deduction limitation made. • Property used predominantly outside U.S. • Tax-exempt use property. • Property financed by tax-exempt interest obligation. • Certain imported property.	Tangible personal property	Tied to ADR class lives	Straight-line (no salvage) Bonus depreciation for qualified original use property (only new property if placed in service before September 28, 2017).	Half-year for additions and dispositions unless midquarter convention required. Midquarter for additions and dispositions if cost of property placed in service in last three months of tax year is more than 40% of total placed in service in entire year. Property placed in service and disposed of within the same year is disregarded.	
	Residential rental or nonresidential real property	40	Straight-line (no salvage) Bonus depreciation for qualified improvement property.	Midmonth for additions and dispositions.	
	Qualified improvement property	20			

See Chapter 15 for additional discussion of tax depreciation issues.

Note:

[a] Per the Joint Explanatory Statement for the 2017 Tax Cuts and Jobs Act (TCJA), qualified improvement property was to have a 15-year recovery period for regular tax pruposes and a 20-year recovery period for ADS. However, this shorter recovery period was not included in the TCJA legislation. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) retroactively makes the technical correction, and assigns a 15-year recovery period (20-year recovery period for ADS) to QIP; therefore, it qualifies for bonus depreciation. Because this provision is retroactive, taxpayers may amend their 2018 tax returns.

TABLE T202

Summary of AMT Depreciation Rules

Assets Placed in Service after 12/31/86

Depreciation System Available	Type of Property	Recovery Period	Depreciation Method	Convention
ALTERNATIVE MINIMUM TAX DEPRECIATION SYSTEM 150% DB can also be elected for regular tax (for property in 3-, 5-, 7- or 10-year recovery classes) to eliminate AMT adjustment. As an alternative, the ADS method (see Table T201) can also be elected for both regular tax and AMT.	Tangible personal property	Tied to ADR class lives if property placed in service before 1999. Property placed in service after 1998 uses MACRS recovery periods.	150% declining balance or straight-line Bonus depreciation for qualified new or used property.	Half-year for additions and dispositions unless mid-quarter convention required. Midquarter for additions and dispositions if cost of property placed in service in last three months of tax year is more than 40% of total placed in service in entire year. Property placed in service and disposed of within the same year is disregarded.
	Residential rental or nonresidential real property	40 years if property placed in service before 1999. If placed in service after 1998, use MACRS recovery periods (15, 27.5 or 39 years).	Straight-line (no salvage) Bonus depreciation for qualified improvement property.	Midmonth for additions and dispositions.

Preparation Pointer: Electing to use the same method for regular tax and AMT can avoid double recordkeeping for fixed assets. Clients may prefer to sacrifice a small tax advantage to avoid the necessity for keeping two sets of fixed assets tax records.

Note: See Chapter 15 for additional discussion of tax depreciation issues.

TABLE T203

Summary of Depreciation Allowable in Year of Disposition[a]

Depreciation Method	Personal Property	Real Property
MACRS (Post-1986)[b]	If subject to half-year convention, half-year depreciation If subject to midquarter convention, depreciate through middle of quarter in which disposition occurs (e.g., an April 15 disposition for a calendar-year taxpayer is treated as occurring on May 15, thus $^{4.5}/_{12}$ of a year's depreciation under the midquarter rules is allowed)	Half-month depreciation for month of disposition plus depreciation for preceding months in the same tax year (e.g., with a calendar-year taxpayer and an April 5 disposal, 3.5 months of depreciation is allowed or $^{3.5}/_{12}$ of amount otherwise allowed for full year)
ACRS (1981–1986)[c]	None	Same as MACRS real property for 18- and 19-year ACRS property. For 15-year property and low-income housing, depreciation is allowed through month prior to sale

Notes:

[a] These rules do not apply to:

1. MACRS or ACRS personal property placed in service or disposed of in a short tax year [instead see Rev. Proc. 89-15 for MACRS property and former IRC Sec. 168(f)(5), immediately before its amendment by the Tax Reform Act of 1986 (TRA '86), for ACRS property];
2. Mass asset accounts [see IRC Sec. 168(i)(4) and Reg. 1.168(i)-1(e)(2) for MACRS property; former IRC Sec. 168(d)(2), immediately before its amendment by TRA '86, for ACRS property; and Reg. 1.167(a)-10(b) for pre-1981 property]; and
3. MACRS personal property placed in service and disposed of in the same tax year. [See Reg. 1.168(d)-1(b)(3).]

[b] IRC Sec. 168(d)(4).

[c] Former IRC Sec. 168(b)(2) and (d)(2)(B).

a. Qualified new personal property acquired and placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property placed in service in 2010 after September 8), as well as during 2012 through September 27, 2017, and was available after May 5, 2003, and before January 1, 2005.

b. Qualified improvement property placed in service after December 31, 2015, and before September 28, 2017.

c. Qualified leasehold improvement property placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property place in service in 2010 after September 8), as well as during 2012–2015 and was available after May 5, 2003, and before January 1, 2005.

d. Qualified disaster assistance property purchased and placed in service after December 31, 2007, for disasters declared after 2007 and occurring before January 1, 2010.

e. Qualified reuse and recycling property purchased and placed in service after August 31, 2008.

f. Qualified Gulf Opportunity Zone new personal property and certain leasehold improvements placed in service after August 27, 2005, and before January 1, 2008 (January 1, 2009, for qualifying nonresidential real property and residential rental property).

g. Qualified cellulosic biomass ethanol plant property placed in service after December 20, 2006, and before January 3, 2013, and qualified second generation biofuel plant property placed in service before January 1, 2021.

6. 60% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2024 [IRC Sec. 168(k)].

7. 80% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2023 [IRC Sec. 168(k)].

8. 100% bonus depreciation is generally available for qualified new and used property, including qualified improvement property, acquired and placed in service after September 27, 2017, and before January 1, 2023 [IRC Sec. 168(k)] and was available for qualified new property after September 8, 2010, and before January 1, 2012. 100% bonus depreciation is generally available for property with a recovery period of 20 years or less; certain computer software; water utility property; and qualified film, television or live theatrical productions placed in service after September 27, 2017, and before January 1, 2023.

TABLE T302

MACRS Personal Property, Midquarter Convention—1st Quarter

APPLY TO: Tangible personal property placed in service during the first quarter of a year subsequent to 1986 if midquarter convention is required. (Note that this table is generally *not* used for farm property acquired before January 1, 2018, because 150% DB is normally required for such property.)

METHOD: Declining balance (DB) switching to straight-line (SL) (200% for 3-, 5-, 7-, and 10-year classes, 150% for 15- and 20-year classes).

Year	Depreciation Rate for Recovery Period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	58.33	35.00	25.00	17.50	8.75	6.563
2	27.78	26.00	21.43	16.50	9.13	7.000
3	12.35	15.60	15.31	13.20	8.21	6.482
4	1.54	11.01	10.93	10.56	7.39	5.996
5		11.01	8.75	8.45	6.65	5.546
6		1.38	8.74	6.76	5.99	5.130
7			8.75	6.55	5.90	4.746
8			1.09	6.55	5.91	4.459
9				6.56	5.90	4.459
10				6.55	5.91	4.459
11				0.82	5.90	4.459
12					5.91	4.460
13					5.90	4.459
14					5.91	4.460
15					5.90	4.459
16					0.74	4.460
17						4.459
18						4.460
19						4.459
20						4.460
21						0.557

Year	Depreciation Rate If 30% First-year Bonus Depreciation Was Claimed					
	3-year	5-year	7-year	10-year	15-year	20-year
1	70.83	54.50	47.50	42.25	36.13	34.594
2	19.45	18.20	15.00	11.55	6.39	4.900
3	8.64	10.92	10.72	9.24	5.75	4.538
4	1.08	7.71	7.65	7.39	5.17	4.197
5		7.70	6.13	5.92	4.66	3.882
6		0.97	6.12	4.73	4.19	3.591
7			6.12	4.59	4.13	3.322
8			0.76	4.59	4.14	3.122
9				4.59	4.13	3.122
10				4.58	4.14	3.122
11				0.57	4.13	3.122
12					4.13	3.122
13					4.13	3.122
14					4.13	3.122
15					4.13	3.122
16					0.52	3.122
17						3.122
18						3.122
19						3.122
20						3.122
21						0.390

Year	Depreciation Rate If 40% First-year Bonus Depreciation Was Claimed					
	3-year	5-year	7-year	10-year	15-year	20-year
1	74.998	61.000	55.000	50.500	45.250	43.938
2	16.668	15.600	12.858	9.900	5.478	4.200
3	7.410	9.360	9.186	7.920	4.926	3.889
4	0.924	6.606	6.558	6.336	4.434	3.598
5		6.606	5.250	5.070	3.990	3.328
6		.0.828	5.244	4.056	3.594	3.078
7			5.250	3.930	3.540	2.848
8			.0.654	3.930	3.546	2.676
9				3.936	3.540	2.676
10				3.930	3.546	2.676
11				0.492	3.540	2.676
12					3.546	2.676
13					3.540	2.676
14					3.546	2.676
15					3.540	2.676
16					0.444	2.676
17						2.676
18						2.676
19						2.676
20						2.676
21						0.333

Year	Depreciation Rate if 50% First-year Bonus Depreciation Was Claimed					
	3-year	5-year	7-year	10-year	15-year	20-year
1	79.165	67.500	62.500	58.750	54.375	53.2815
2	13.890	13.000	10.715	8.250	4.565	3.5000
3	6.175	7.800	7.655	6.600	4.105	3.2410
4	0.770	5.505	5.465	5.280	3.695	2.9980
5		5.505	4.375	4.225	3.325	2.7730
6		0.690	4.370	3.380	2.995	2.5650
7			4.375	3.275	2.950	2.3730
8			0.545	3.275	2.955	2.2295
9				3.280	2.950	2.2295
10				3.275	2.955	2.2295
11				0.410	2.950	2.2295
12					2.955	2.2300
13					2.950	2.2295
14					2.955	2.2300
15					2.950	2.2295
16					0.370	2.2300
17						2.2295
18						2.2300
19						2.2295
20						2.2300
21						0.2785

Notes:

1. In the year of disposition, multiply the depreciation obtained from these tables by $^{1.5}/_{12}$, $^{4.5}/_{12}$, $^{7.5}/_{12}$, or $^{10.5}/_{12}$, depending on whether the property is disposed of in the first, second, third, or fourth quarter, respectively.

2. 20% bonus depreciation will generally be available for qualified new and used property placed in service in 2026 [IRC Sec. 168(k)].

3. 30% bonus depreciation was generally available for qualified new personal property and certain leasehold improvements acquired after September 10, 2001, and before January 1, 2005, and will be available for assets purchased prior to September 28, 2017, but not placed in service until 2019 [IRC Sec. 168(k)(8)(C)].

4. 40% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2025 [IRC Sec. 168(k)] and for assets purchased prior to September 28, 2017, but not placed in service until 2018 [IRC Sec. 168(k)(8)(B)].

5. 50% bonus depreciation is generally available for:

a. Qualified new personal property acquired and placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property placed in service in 2010 after September 8), as well as during 2012 through September 27, 2017, and was available after May 5, 2003, and before January 1, 2005.

b. Qualified improvement property placed in service after December 31, 2015, and before September 28, 2017.

c. Qualified leasehold improvement property placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property place in service in 2010 after September 8), as well as during 2012–2015 and was available after May 5, 2003, and before January 1, 2005.

d. Qualified disaster assistance property purchased and placed in service after December 31, 2007, for disasters declared after 2007 and occurring before January 1, 2010.

e. Qualified reuse and recycling property purchased and placed in service after August 31, 2008.

f. Qualified Gulf Opportunity Zone new personal property and certain leasehold improvements placed in service after August 27, 2005, and before January 1, 2008 (January 1, 2009, for qualifying nonresidential real property and residential rental property).

g. Qualified cellulosic biomass ethanol plant property placed in service after December 20, 2006, and before January 3, 2013, and qualified second generation biofuel plant property placed in service before January 1, 2021.

6. 60% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2024 [IRC Sec. 168(k)].

7. 80% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2023 [IRC Sec. 168(k)].

8. 100% bonus depreciation is generally available for qualified new and used property, including qualified improvement property, acquired and placed in service after September 27, 2017, and before January 1, 2023 [IRC Sec. 168(k)] and was available for qualified new property after September 8, 2010, and before January 1, 2012. 100% bonus depreciation is generally available for property with a recovery period of 20 years or less; certain computer software; water utility property; and qualified film, television or live theatrical productions placed in service after September 27, 2017, and before January 1, 2023.

4. 40% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2025 [IRC Sec. 168(k)] and for assets purchased prior to September 28, 2017, but not placed in service until 2018 [IRC Sec. 168(k)(8)(B)].

5. 50% bonus depreciation is generally available for:

   a. Qualified new personal property acquired and placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property placed in service in 2010 after September 8), as well as during 2012 through September 27, 2017, and was available after May 5, 2003, and before January 1, 2005.

   b. Qualified improvement property placed in service after December 31, 2015, and before September 28, 2017.

   c. Qualified leasehold improvement property placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property place in service in 2010 after September 8), as well as during 2012–2015 and was available after May 5, 2003, and before January 1, 2005.

   d. Qualified disaster assistance property purchased and placed in service after December 31, 2007, for disasters declared after 2007 and occurring before January 1, 2010.

   e. Qualified reuse and recycling property purchased and placed in service after August 31, 2008.

   f. Qualified Gulf Opportunity Zone new personal property and certain leasehold improvements placed in service after August 27, 2005, and before January 1, 2008 (January 1, 2009, for qualifying nonresidential real property and residential rental property).

   g. Qualified cellulosic biomass ethanol plant property placed in service after December 20, 2006, and before January 3, 2013, and qualified second generation biofuel plant property placed in service before January 1, 2021.

6. 60% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2024 [IRC Sec. 168(k)].

7. 80% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2023 [IRC Sec. 168(k)].

8. 100% bonus depreciation is generally available for qualified new and used property, including qualified improvement property, acquired and placed in service after September 27, 2017, and before January 1, 2023 [IRC Sec. 168(k)] and was available for qualified new property after September 8, 2010, and before January 1, 2012. 100% bonus depreciation is generally available for property with a recovery period of 20 years or less; certain computer software; water utility property; and qualified film, television or live theatrical productions placed in service after September 27, 2017, and before January 1, 2023.

TABLE T304

MACRS Personal Property, Midquarter Convention—3rd Quarter

APPLY TO: Tangible personal property placed in service during the third quarter of a year subsequent to 1986 if midquarter convention is required. (Note that this table is generally *not* used for farm property acquired before January 1, 2018, because 150% DB is normally required for such property.)

METHOD: Declining balance (DB) switching to straight-line (SL) (200% for 3-, 5-, 7-, and 10-year classes, 150% for 15- and 20-year classes).

	Depreciation Rate for Recovery Period					
Year	3-year	5-year	7-year	10-year	15--year	20-year
1	25.00	15.00	10.71	7.50	3.75	2.813
2	50.00	34.00	25.51	18.50	9.63	7.289
3	16.67	20.40	18.22	14.80	8.66	6.742
4	8.33	12.24	13.02	11.84	7.80	6.237
5		11.30	9.30	9.47	7.02	5.769
6		7.06	8.85	7.58	6.31	5.336
7			8.86	6.55	5.90	4.936
8			5.53	6.55	5.90	4.566
9				6.56	5.91	4.460
10				6.55	5.90	4.460
11				4.10	5.91	4.460
12					5.90	4.460
13					5.91	4.461
14					5.90	4.460
15					5.91	4.461
16					3.69	4.460
17						4.461
18						4.460
19						4.461
20						4.460
21						2.788

	Depreciation Rate If 30% First-year Bonus Depreciation Was Claimed					
Year	3-year	5-year	7-year	10-year	15-year	20-year
1	47.50	40.50	37.50	35.25	32.63	31.969
2	35.00	23.80	17.86	12.95	6.74	5.102
3	11.67	14.28	12.75	10.36	6.06	4.719
4	5.83	8.57	9.11	8.29	5.46	4.366
5		7.91	6.51	6.63	4.91	4.038
6		4.94	6.20	5.31	4.42	3.735
7			6.20	4.59	4.13	3.455
8			3.87	4.58	4.13	3.196
9				4.59	4.14	3.122
10				4.58	4.13	3.122
11				2.87	4.14	3.122
12					4.13	3.122
13					4.14	3.123
14					4.13	3.122
15					4.13	3.123
16					2.58	3.122
17						3.123
18						3.122
19						3.123
20						3.122
21						1.952

Year	Depreciation Rate If 40% First-year Bonus Depreciation Was Claimed					
	3-year	5-year	7-year	10-year	15-year	20-year
1	55.000	49.000	46.426	44.500	42.250	41.688
2	30.000	20.400	15.306	11.100	5.778	4.373
3	10.002	12.240	10.932	8.880	5.196	4.045
4	4.998	7.344	7.812	7.104	4.680	3.742
5		6.780	5.580	5.682	4.212	3.461
6		4.236	5.310	4.548	3.786	3.202
7			5.316	3.930	3.540	2.962
8			3.318	3.930	3.540	2.740
9				3.936	3.546	2.676
10				3.930	3.540	2.676
11				2.460	3.546	2.676
12					3.540	2.676
13					3.546	2.677
14					3.540	2.676
15					3.546	2.676
16					2.214	2.676
17						2.677
18						2.676
19						2.676
20						2.676
21						1.673
Year	**Depreciation Rate if 50% First-year Bonus Depreciation Was Claimed**					
	3-year	5-year	7-year	10-year	15-year	20-year
1	62.500	57.500	55.355	53.750	51.875	51.4065
2	25.000	17.000	12.755	9.250	4.815	3.6445
3	8.335	10.200	9.110	7.400	4.330	3.3710
4	4.165	6.120	6.510	5.920	3.900	3.1185
5		5.650	4.650	4.735	3.510	2.8845
6		3.530	4.425	3.790	3.155	2.6680
7			4.430	3.275	2.950	2.4680
8			2.765	3.275	2.950	2.2830
9				3.280	2.955	2.2300
10				3.275	2.950	2.2300
11				2.050	2.955	2.2300
12					2.950	2.2300
13					2.955	2.2305
14					2.950	2.2300
15					2.955	2.2305
16					1.845	2.2300
17						2.2305
18						2.2300
19						2.2305
20						2.2300
21						1.3940

Notes:

1. In the year of disposition, multiply the depreciation obtained from these tables by $^{1.5}/_{12}$, $^{4.5}/_{12}$, $^{7.5}/_{12}$, or $^{10.5}/_{12}$, depending on whether the property is disposed of in the first, second, third, or fourth quarter, respectively.

2. 20% bonus depreciation will generally be available for qualified new and used property placed in service in 2026 [IRC Sec. 168(k)].

3. 30% bonus depreciation was generally available for qualified new personal property and certain leasehold improvements acquired after September 10, 2001, and before January 1, 2005, and will be available for assets purchased prior to September 28, 2017, but not placed in service until 2019 [IRC Sec. 168(k)(8)(C)].

4. 40% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2025 [IRC Sec. 168(k)] and for assets purchased prior to September 28, 2017, but not placed in service until 2018 [IRC Sec. 168(k)(8)(B)].

5. 50% bonus depreciation is generally available for:

   a. Qualified new personal property acquired and placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property placed in service in 2010 after September 8), as well as during 2012 through September 27, 2017, and was available after May 5, 2003, and before January 1, 2005.

   b. Qualified improvement property placed in service after December 31, 2015, and before September 28, 2017.

   c. Qualified leasehold improvement property placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property place in service in 2010 after September 8), as well as during 2012–2015 and was available after May 5, 2003, and before January 1, 2005.

   d. Qualified disaster assistance property purchased and placed in service after December 31, 2007, for disasters declared after 2007 and occurring before January 1, 2010.

   e. Qualified reuse and recycling property purchased and placed in service after August 31, 2008.

   f. Qualified Gulf Opportunity Zone new personal property and certain leasehold improvements placed in service after August 27, 2005, and before January 1, 2008 (January 1, 2009, for qualifying nonresidential real property and residential rental property).

   g. Qualified cellulosic biomass ethanol plant property placed in service after December 20, 2006, and before January 3, 2013, and qualified second generation biofuel plant property placed in service before January 1, 2021.

6. 60% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2024 [IRC Sec. 168(k)].

7. 80% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2023 [IRC Sec. 168(k)].

8. 100% bonus depreciation is generally available for qualified new and used property, including qualified improvement property, acquired and placed in service after September 27, 2017, and before January 1, 2023 [IRC Sec. 168(k)] and was available for qualified new property after September 8, 2010, and before January 1, 2012. 100% bonus depreciation is generally available for property with a recovery period of 20 years or less; certain computer software; water utility property; and qualified film, television or live theatrical productions placed in service after September 27, 2017, and before January 1, 2023.

5. 50% bonus depreciation is generally available for:

   a. Qualified new personal property acquired and placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property placed in service in 2010 after September 8), as well as during 2012 through September 27, 2017, and was available after May 5, 2003, and before January 1, 2005.

   b. Qualified improvement property placed in service after December 31, 2015, and before September 28, 2017.

   c. Qualified leasehold improvement property placed in service after December 31, 2007, and before September 9, 2010 (and if elected, for qualified property place in service in 2010 after September 8), as well as during 2012–2015 and was available after May 5, 2003, and before January 1, 2005.

   d. Qualified disaster assistance property purchased and placed in service after December 31, 2007, for disasters declared after 2007 and occurring before January 1, 2010.

   e. Qualified reuse and recycling property purchased and placed in service after August 31, 2008.

   f. Qualified Gulf Opportunity Zone new personal property and certain leasehold improvements placed in service after August 27, 2005, and before January 1, 2008 (January 1, 2009, for qualifying nonresidential real property and residential rental property).

   g. Qualified cellulosic biomass ethanol plant property placed in service after December 20, 2006, and before January 3, 2013, and qualified second generation biofuel plant property placed in service before January 1, 2021.

6. 60% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2024 [IRC Sec. 168(k)].

7. 80% bonus depreciation will generally be available for qualified new and used property acquired and placed in service in 2023 [IRC Sec. 168(k)].

8. 100% bonus depreciation is generally available for qualified new and used property, including qualified improvement property acquired and placed in service after September 27, 2017, and before January 1, 2023 [IRC Sec. 168(k)] and was available for qualified new property after September 8, 2010, and before January 1, 2012. 100% bonus depreciation is generally available for property with a recovery period of 20 years or less; certain computer software; water utility property; and qualified film, television or live theatrical productions placed in service after September 27, 2017, and before January 1, 2023.

TABLE T401

MACRS Residential Rental Property and AMT Residential Rental Property (27.5-year Property)

APPLY TO: Any real property placed in service after 12/31/86 that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from dwelling units.

METHOD: Straight-line, midmonth convention.

If the Recovery Year Is	and the Month in the First Recovery Year the Property Is Placed in Service Is:											
	1	2	3	4	5	6	7	8	9	10	11	12
	the Percentage Depreciation Rate Is:											
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152
2–9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10–26 (even years)	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11–27 (odd years)	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
28	1.970	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29	0.000	0.000	0.000	0.000	0.000	0.000	0.152	0.455	0.758	1.061	1.364	1.667

If the Recovery Year Is	and the asset was placed in service after December 31, 2017, the ADS is elected, and the Month in the First Recovery Year the Property Is Placed in Service Is:											
	1	2	3	4	5	6	7	8	9	10	11	12
	the Percentage Depreciation Rate Is:											
1	3.204	2.926	2.649	2.371	2.093	1.815	1.528	1.250	.972	.694	.417	.139
2–30	3.333	3.333	3.333	3.333	3.333	3.333	3.333	3.333	3.333	3.333	3.333	3.333
31	.139	.417	.694	.972	1.250	1.528	1.815	2.093	2.371	2.649	2.926	3.204

If the Recovery Year Is	and the asset was placed in service before January 1, 2018, the ADS is elected, and the Month in the First Recovery Year the Property Is Placed in Service Is:											
	1	2	3	4	5	6	7	8	9	10	11	12
	the Percentage Depreciation Rate Is:											
1	2.396	2.188	1.979	1.771	1.563	1.354	1.146	.938	.729	.521	.313	.104
2–40	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500
41	.104	.312	.521	.729	.937	1.146	1.354	1.562	1.771	1.979	2.187	2.396

TABLE T404

MACRS Qualified Leasehold Improvement Property, Qualified Restaurant Property, and Qualified Retail Improvement Property [IRC Sec. 168(e)(3)(E) before Amendment by the 2017 Tax Cuts and Jobs Act] and Qualified Improvement Property [IRC. Sec. 168(e)(3)(vii), as added by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)] (15-year Property)

APPLY TO: Any Qualified Leasehold Improvement Property as defined in former IRC Sec. 168(e)(6) [before the 2017 Tax Cuts and Jobs Act (TCJA)] and placed in service after October 22, 2004, Qualified Restaurant Property as defined in former IRC Sec. 168(e)(7) (before repeal by the TCJA) placed in service after October 22, 2004, or Qualified Retail Improvement Property as defined in former IRC Sec. 168(e)(8) (before repeal by the TCJA) placed in service after December 31, 2008.

Any qualified improvement property as defined in IRC Sec. 168(e)(6) placed in service after December 31, 2017.

METHOD: Straight-line, half year convention.

If the Recovery Year Is	the Percentage Depreciation Rate Is:
1	3.33
2–7	6.67
8–14 (even years)	6.66
9–15 (odd years)	6.67
16	3.33

TABLE T501

Luxury Auto Depreciation Dollar Limits[a]

APPLY TO: The luxury auto depreciation limits reduce depreciation and Section 179 deductions otherwise available. Apply to vehicles weighing 6,000 pounds or less (unloaded) that are manufactured primarily for use on public roads. For 2018 and 2019, the same amounts apply to trucks and vans with loaded gross weights of 6,000 pounds or less. For earlier years, trucks and van may have had a higher amount. Does not apply to certain special-use vehicles or to trucks with a gross vehicle weight (loaded) over 6,000 pounds.

Placed in Service	Depreciation First Year[b, c, d]	Depreciation Later Years[b]
2019—Cars, Trucks, and Vans acquired after September 27, 2017	Regular—$10,100 100% Bonus—$18,100	$16,100 2nd year 9,700 3rd year 5,760[e] 4th year to end
2019—Cars, Trucks, and Vans acquired before September 28, 2017	Regular—$10,100 30% Bonus—$14,900	$16,100 2nd year 9,700 3rd year 5,760[e] 4th year to end
2018—Cars, Trucks, and Vans acquired after September 27, 2017	Regular—$10,000 100% Bonus—$18,000	$16,000 2nd year 9,600 3rd year 5,760[e] 4th year to end
2018—Cars, Trucks, and Vans acquired before September 28, 2017	Regular—$10,000 40% Bonus—$16,400	$16,000 2nd year 9,600 3rd year 5,760[e] 4th year to end
2017—Cars	Regular—$3,160 50% Bonus—$11,160	$5,100 2nd year 3,050 3rd year 1,875[e] 4th year to end
2017—Trucks/Vans	Regular—$3,560 50% Bonus—$11,560	$5,700 2nd year 3,450 3rd year 2,075[e] 4th year to end
2016—Cars	Regular—$3,160 50% Bonus—$11,160	$5,100 2nd year 3,050 3rd year 1,875[e]4th year to end
2016—Trucks/Vans	Regular—$3,560 50% Bonus—$11,560	$5,700 2nd year 3,350 3rd year 2,075[e] 4th year to end
2015—Cars	Regular—$3,160 50% Bonus—$11,160	$5,100 2nd year 3,050 3rd year 1,875[e]4th year to end
2015—Trucks/Vans	Regular—$3,460 50% Bonus—$11,460	$5,600 2nd year 3,350 3rd year 1,975[e] 4th year to end

Preparation Pointer: Apply the Section 179 deduction to fixed asset additions other than autos when the depreciation deduction for autos will reach the maximum allowable without the Section 179 deduction.

Notes:

[a] See Key Issue 15B.

[f] Depending on the date acquired, if qualified small business stock is held more than five years, the taxpayer can exclude up to 100% of the gain when sold. When the 50% exclusion applies (for stock acquired before February 18, 2009), a 28% [31.8% (28% plus 3.8% NIIT) for some high-income taxpayers] maximum capital gains rate applies to this stock, so the effective maximum capital gains rate is 14% [15.9% (14% plus 1.9% NIIT) for some high-income taxpayers]. However, for stock acquired after February 17, 2009, and before September 28, 2010, 75% of the gain is excluded [IRC Sec. 1202(a)(3)], and for stock acquired after September 27, 2010, 100% of the gain is excluded [IRC Sec. 1202(a)(4)].

TABLE T611

Partnership Income and Expense Chart (Form 1065)

Partnership Income and Expense Chart (Form 1065)		
Category	***Description***	***Where to Report***
Business Expenses in General	Nonrental activity expenses paid by partnership deductible under IRC Sec. 162; not specially allocated to partners.	Operating expenses are reported on Form 1065, page 1, lines 9–20. Cost of goods sold (COGS) expenses are reported on Form 1125-A.
Capital Contributions	Cash or property contributed to the partnership by partners in exchange for an interest or additional interest in the partnership.	Schedule M-2, line 2, and Schedule K-1, Part II, Item L.
Capital Gains and Losses	Gains and losses from investments such as stocks and bonds.	Form 8949/Schedule D, Form 1065. Carried to Schedules K and K-1, lines 8 and 9.
Charitable Contributions	Charitable contributions on behalf of partners.	Schedules K and K-1, line 13 (codes A–G).
Depreciation	Property purchased by the partnership.	Form 4562 and Form 1065, page 1, line 16a. Enter on line 16b amount reported elsewhere on return such as in COGS on Form 1125-A. Reconcile any difference between depreciation per books and return on Schedule M-1, line 4a or 7a, or M-3. Books prepared on: book basis (FMV) will yield a difference reported on Schedule M-1/M-3; tax basis should not yield such difference.
	Property contributed to the partnership by the partners, when the fair market value (FMV) of the property is different than its adjusted basis at the time it is contributed.	Form 4562 and Form 1065, page 1, line 16a and, if applicable, line 16b. A separate depreciation schedule must be maintained showing depreciation based on FMV and on adjusted basis. Depreciation for: books based on FMV; return based on adjusted basis. Reconcile difference between depreciation per books and return on Schedule M-1, line 4a or 7a, or M-3. Books prepared on: book basis (FMV) will yield a difference reported on Schedule M-1/M-3; tax basis should not yield such difference.
Distributions to Partners	Cash or property distributions to partners that are not guaranteed payments for services rendered or for use of capital.	Schedule M-2, line 6, Schedule K-1, Part II, Item L, and Schedules K and K-1, line 19.
Excess Business Interest Expense	Business interest expense in excess of current year interest income and 30% of adjusted taxable income for 2019 under IRC Sec. 163(j) for partnerships. Calculated at partnership level and passed through to partner. See *Interest Expense Limitation* in Key Issue 14G.	Partner's distributive share reported on Schedule K-1, Line 13, code K. Partner's distributive share of excess taxable income and excess business interest income reported on Schedule K-1, Line 20, codes AE and AF.
Farm Income and Expenses	Other than from rental activities.	Schedule F, Form 1040, is attached to Form 1065. The net profit (loss) is carried to Form 1065, page 1, line 5.

TABLE T620

Below-market Loans between Partnerships and Their Partners

(See Key Issue 14D)

Purpose: The following table summarizes the different treatment under IRC Sec. 7872 given demand and term loans between partnerships and their partners.

Type of Loan	Deemed Transaction	Date Transfer Recognized	Amount of Transfer	Character to Recipient
Demand	Transfer to borrower	December 31[a]	Forgone interest for the year (demand loans)	Compensation, distribution, or capital contribution, depending on the facts
	Retransfer to lender	December 31[a]	Forgone interest for the year (demand and gift term loans)	Interest income to lender, interest expense to borrower
Term Loans	Transfer to borrower	Date loan made	Excess of amount loaned over the present value of the payments to be received (i.e., imputed transfer)	Compensation, distribution, or capital contribution, depending on the facts
	Transfer to lender	Daily through term of loan	Amount of OID based on amount of imputed transfer	Interest income/ expense

Imputed interest is characterized in accordance with the substance of the transaction and is treated as so characterized for all purposes of the Code [Prop. Regs. 1.7872-1(a) and -11(g)(4)]. The following table lists some of the Code sections to which amounts imputed under the below-market rules may be subject:

Section	**Effect of the Code**
61(a)	Imputed interest, imputed dividends, and imputed compensation are included in gross income.
163(a)	Imputed interest expense is allowed as a deduction.
263A	Imputed interest or imputed compensation allocable to certain inventory may be required to be included as a cost of the inventory.
444	Imputed items of income or deduction enter into the computation of the required payment if the partnership maintains a fiscal year by virtue of a Section 444 election.
731	Below-market interest treated as a partnership distribution would be nontaxable to the extent the distributions do not exceed the partner's basis in the partnership. If the deemed distributions exceed the partners basis, the excess would result in capital gain to the partner.

Note:

[a] In the event of the death or liquidation of the borrower, the transfer and retransfer are deemed to occur (for both the borrower and lender) at the end of the borrower's final tax year. If the loan is repaid, the transfers are deemed to occur on the date of payment [Prop. Reg. 1.7872-6(b)].

TABLE T621

Coordination of Business Interest Expense Limits with Other Tax Provisions

IRC Sec. 163(j) applies before [Prop. Reg. 1.163(j)-3(b)]:

- IRC Sec. 461(l)—excess business loss of noncorporate taxpayers (tax years beginning after 2020).
- IRC Code Sec. 465—at-risk limits.
- IRC Code Sec. 469—passive activity loss limits

IRC Sec. 163(j) applies after provisions that subject interest expense to disallowance, deferral, capitalization or other limitations as listed below.

Disallowance provisions:

- IRC Sec. 163(e)(5)(A)(i)—OID on high-yield OID obligations issued by a C corporation.
- IRC Sec. 163(f)—interest on registration-required obligations not issued in registered form
- IRC Sec. 163(l)—interest on disqualified debt instruments,
- IRC Sec. 163(m)—interest on underpayments attributable to undisclosed tax shelter transactions
- IRC Sec. 264(a)—interest on loans in connection with life insurance, endowment, or annuity contracts
- IRC Sec. 265—interest on borrowings to buy or carry tax-exempt obligations
- IRC Sec. 267A—related party amounts paid or accrued in hybrid transactions or with hybrid entities
- IRC Sec. 279—interest on corporate acquisition indebtedness

Deferral provisions:

- IRC Sec. 163(e)(3)—debt instrument with OID held by related foreign person
- IRC Sec. 163(e)(5)(A)(ii)—OID on high-yield OID obligations
- IRC Sec. 267(a)(2)—accrued interest owed to related taxpayer
- IRC Sec. 267(a)(3)—interest owed to related foreign person
- IRC Sec. 1277—interest attributable to accrued market discount
- IRC Sec. 1282—interest attributable to discounts on short-term obligations

Capitalization provisions:

- IRC Sec. 263A—uniform capitalization rules.
- IRC Sec. 263(g)—interest related to tax straddles.

Other limitations:

- IRC Sec. 246A—reductions in dividends received deduction
- IRC Sec. 381(a)—disallowed business interest expense carryforwards to which an acquiring corporation succeeds.
- IRC Sec. 382—limitation on NOL carryforward and certain built-in losses following ownership changes.
- Other types of interest provisions. Provisions that characterize interest expense as something other than business interest expense under IRC Sec. 163(j), such as investment interest expense under IRC Sec. 163(d), will not be treated as business interest expense.

Notes:

[a] If the partnership is a publicly traded partnership, losses from the partnership cannot be used to offset passive income arising from other sources.

[b] Whether the partner is a general partner or limited partner will determine which liabilities can be included in the partner's basis and whether the partner has income or loss for self-employment (SE) tax purposes. (See Chapters 21 and 25.)

[c] A partner's share of profits, losses, and capital need not necessarily be the same. However, the percentage each partner has of these items is important since it may determine the share of nonrecourse liabilities the partner can include in his partnership basis; and whether a special allocation meets the safe harbor rules under IRC Sec. 704(b). Special allocations can permit certain amounts to be allocated to partners on a basis different from their "regular" partnership interests. The amounts shown here should be the partners' "regular" sharing percentages.

[d] Partners can use their proportionate shares of certain partnership liabilities as part of their at-risk amount. General partners can include both their share of recourse and qualified nonrecourse indebtedness in their amount at-risk. Limited partners, on the other hand, generally can include only qualified nonrecourse debt in their amount at-risk. (See Chapter 29.) Different rules apply to liabilities for computing outside basis. However, to the extent the partnership is on the cash basis, accounts payable and other liabilities generating a deduction in future years cannot be considered as part of the partner's basis. (Chapter 25 has a complete discussion of basis from partnership debt.)

[e] See Chapter 20 for a detailed discussion of what should be reported in the various lines of the Schedule K-1 capital account analysis and a discussion of the interrelationships between Schedules M-1, M-2, M-3, K, and the Schedule K-1 capital account analysis.

[f] Item M on Schedule K-1 requires checking a box and attaching a statement if the partner contributed property with a built-in gain or loss to the partnership. For each such contribution, the required statement should show the contribution date and amount of the built-in gain or loss. If more than 10 properties are contributed on the same date, the statement can show the total number of properties contributed, the total built-in gain amount, and the total built-in loss amount. The contribution of properties with built-in gains or losses will trigger the rules in IRC Sec. 704(c) explained in this chapter. Such contributions can also trigger the rules in IRC Sec. 737 explained in Key Issue 33E. Item N is new for 2019 and requires the partnership to report any unrecognized Section 704(c) built-in gain or loss allocable to the partner for both the beginning and end of the tax year.

[g] If the partnership has grouped multiple activities into a single activity, a schedule showing the items allocable to the activity should be attached. If activities are not grouped, tax information should be shown by activity. (See Illustration 21-5.) If the partner materially participates in all partnership activities, income or loss should be entered directly on Schedule E, Part II. If the partner does not materially participate in partnership activities, income should be reported directly on Schedule E, Part II, and losses should be entered on Form 8582 (Passive Activity Loss Limitations). The income (loss) from the trade or business is also considered to be SE income (loss) for a general partner and included on line 14 of Schedule K-1. Starting in 2019, the Schedule K-1 also includes question 21, that must be checked if there is more than one activity for at-risk purposes and question 22, that must be checked if there is more than one activity for passive activity purposes.

[h] A guaranteed payment is a direct payment made by the partnership to a partner for personal services rendered to the partnership (line 4a) or for the use of capital (line 4b). The amounts entered on line 4 should be reported directly on the partner's Schedule E, Part II. Amounts for services also constitute SE income and should be included on Schedule K-1, line 14 (code A). For general partners, guaranteed payments for capital also constitute SE income and are included on Schedule K-1, line 14 (code A).Guaranteed payments should not run through the Schedule K-1 capital account reconciliation. Medical and dental insurance premiums paid on behalf of partners generally should be treated as guaranteed payments and reported on line 4a and also on line 13 (code M), other deductions, to allow the partner to determine if he or she can benefit from the above-the-line

deduction for self-employed health insurance premiums on Form 1040 (U.S. Individual Income Tax Return). (See Key Issues 21D and 21E.)

i The amounts on lines 5 through 9b and line 11 (code A) generally constitute both portfolio income and investment income and should also be included on line 20 (code A). Such amounts should be entered, even if the partnership has no investment interest expense, since these amounts increase a partner's investment income, thus allowing the deduction of more investment interest expense from other sources at the partner level. Common and preferred dividends received by an individual shareholder from domestic corporations and qualified foreign corporations are taxed at the same rates as adjusted net capital gain. Taxpayers can elect to treat qualified dividend income as investment income. If elected, the dividends considered to be investment income will not qualify for the capital gain rates.

j Lines 8 and 9a are used to determine capital gains subject to 0%, 15%, and 20% rates (depending on the taxpayer's marginal tax bracket) and deductible net capital losses. Collectibles gains subject to 28% maximum rate are reported on line 9b. Unrecaptured Section 1250 gain which is subject to a 25% maximum tax rate should be reported on line 9c.

k Section 1231 gain or loss should be allocated to the activity in which the assets were used. The gain or loss may be passive, nonpassive, or a combination. If gain is passive, it should be entered on Form 4797 (Sales of Business Property) and identified as from a partnership. Losses should be entered on Form 8582. Passive amounts should be labeled as such and broken out by activity on a separate statement. (See Chapter 30.)

l Certain allocations of ordinary gain, gambling gains or losses, recovery of tax benefit items, etc., should be reported on line 11 with an attached schedule explaining the item and amount. (See Key Issues 21D and 21E.) Line 11 should also include specially allocated ordinary income (that would otherwise be included in the amount shown on line 1), Section 743(b) positive adjustments, and Subpart F income other than Sections 951A and 965 income.

m The partner's proportionate share of the partnership's Section 179 expense deduction not only reduces the partner's income, but it also reduces the partner's SE income. The partner's Section 179 expense should be deducted from the amount on line 14 (code A) when completing the individual's Schedule SE. (See Key Issue 15F.)

n If the partnership has made a noncash contribution or a contribution has been made to a charity, a separate schedule should be attached to the return with an explanation of the limitation or the property donated. If noncash charitable contributions in excess of $500 are made, Form 8283 (Noncash Charitable Contributions) must be attached to the partnership's return. If the deduction for a noncash item (or group of similar items) exceeds $5,000, each partner must be furnished a copy of the partnership's Form 8283. A separate schedule should be attached with detailed information regarding the contribution. (See Chapter 19.)

Line 13 is used to report miscellaneous deductions such as contributions on behalf of the partner to a partnership retirement plan (including a Keogh or SEP); medical and dental insurance premiums paid on behalf of a partner, his spouse and/or dependents; and separately stated interest expense attributable to debt-financed distributions. Line 13 should also include specially allocated deductions or losses (that would otherwise be included as part of the amount shown on line 1) and Section 743(b) negative adjustments .

Investment interest expense incurred by the partnership is reported on line 13 (code H). Any partnership investment income and investment expenses are also reported on line 20 (codes A and B). These amounts are entered on the partner's Form 4952 (Investment Interest Expense Deduction). The amount on line 13 (code H) is an additional deduction not included on other lines of Schedule K-1.

A partner can elect under IRC Sec. 59(e) to capitalize and amortize items that would otherwise generate an AMT adjustment or preference of five or ten years. (See Election E904.) The expenditures eligible for such