MEMORANDUM

To: Linda Church Ciocci, Jeff Leahey, National Hydropower Association

From: Donna Flynn, Washington Council Ernst & Young

Re: Summary of Senate Finance Staff Discussion Draft on Cost Recovery and Accounting Issues

Senate Finance Committee Chairman Max Baucus (D-MT) on November 21, 2013, released a staff discussion draft of provisions to reform cost recovery and accounting rules as part of a potential comprehensive business tax reform plan. While a revenue estimate was not specified in the Committee's release, Finance staff has indicated that the changes would raise roughly $700 billion over 10 years – enough to reduce the corporate rate to roughly 28%. Because the draft proposal would change the method for depreciating assets used in the hydropower industry, we wanted to bring this information to your attention and suggest that you may want to transmit these materials to your members.

Chairman Baucus's staff released statutory language reflecting the draft proposals, along with a JCT technical explanation and Finance staff summaries, all of which are attached. Feedback on the discussion draft is requested by January 17, 2014.

Among other things, the draft proposes to repeal the current MACRS and ADS rules and replace such rules with a pooling cost recovery system designed to better approximate the decline in the economic value of assets. The new system would be comprised of four asset pools: three designated for short- to mid-term property and one designated for mixed-use structures and other longer-term personal property.

Pooled assets would be depreciated at prescribed rates using a 100% declining balance method, meaning that each year a business can deduct an amount equal to the pool's year-end balance, multiplied by the depreciable percentage for that pool.

Real property (e.g., real estate and certain other property) would be recovered using the straight-line recovery method over 43 years. A transition rule would apply to real property placed in service prior to January 1, 2015. Under this rule, the adjusted basis of the property would be depreciated over a term of 43 years reduced by the number of taxable years for which the property has already been depreciated.

The draft contemplates that taxpayers would create asset pools and assign the adjusted basis of each asset held by the taxpayer as of the first day of January 1, 2015 to the appropriate asset pool. ***This is significant, as the draft does not provide for transition relief for existing tangible personal property. Thus, if the draft were to be enacted, personal property placed in service prior to January 1, 2015 with an expectation that the property would be depreciated using MACRS cost recovery methods and recovery periods would instead be depreciated under the new pooling system – i.e., over longer periods of time approximating economic depreciation.***

Calculation of annual depreciation deductions. For the first taxable year beginning after December 31, 2014, each asset pool balanced would be determined by adding the adjusted

basis of any property held by the taxpayer on the first day of such taxable year assigned to each asset pool. The cost basis of property acquired during the taxable year would be added to the appropriate pool, as well as the cost of any additions or improvements to existing pooled property. The gross proceeds from the disposition or transfer of any pooled property during the taxable year would be subtracted from the pool balance. (See pp. 21- 24 of the JCT technical explanation for examples of how the pooling concept would operate.)

The annual depreciation deduction for each pool would be calculated by multiplying the applicable recovery rate for each pool by the associated pool balance at year's end. The applicable rates of the four pools are: Pool 1, 38%; Pool 2, 18%; Pool 3, 12%; and Pool 4, 5%.

Assets are assigned to the pools based on the asset class categorizations provided in Revenue Procedure 87-56. The draft would grant the Treasury Department authority to issue guidance to: (1) reclassify assets (or categories of assets) as real property or as pooled property; (2) reclassify assets (or categories of assets) to different pools; and (3) modify asset classes described in Revenue Procedure 87-56 or create new categories of assets.

It appears that water utilities property (Classification 49.3 under Rev. Proc. 87-56) would be placed in Pool 4. Pool 4 is the category to which most (if not all) electricity generation and distribution plant property (including wind and solar) has been assigned.

The draft would also repeal (as deadwood) certain expired or expiring specialized expensing provisions for the energy industry, including the:

- Section 179A provision for qualified clean-fuel property (expired)
- Section 179B small-business refiner provision (expired)
- Section 179C provision for qualified refiner property (expired)
- Section 179D deduction for energy-efficient commercial building property expenditures (expires 12/31/2013)
- Section 179E qualified advanced mine safety equipment property (expired)

Chairman Baucus's staff requested comments on all aspects of the staff discussion draft, as well as other areas of cost recovery and accounting. Additional issues under consideration by the Chairman's staff include, among others:

- Whether and how tax incentives — such as the research credit, the Section 199 deduction for manufacturing, and credits for clean energy — should be adjusted in light of the proposals in the staff discussion draft
- Whether the corporate AMT should be repealed and, if so, how to treat unused alternative minimum tax credits
- Appropriate transition rules and effective dates (e.g., the provisions are generally effective for taxable years after December 31, 2014, but comments are requested regarding whether more time would be necessary to effectively implement any provisions of the staff discussion draft)

Cost Recovery and Accounting Tax Reform Discussion Draft

Chairman Max Baucus
U.S. Senate Committee on Finance

11/21/13

As part of his work towards tax reform, Chairman Max Baucus is releasing a staff discussion draft today of proposed reforms to the cost recovery and tax accounting rules. These rules, which determine when businesses can deduct the cost of investments and how they account for their income, were created in 1986 before technologies like cell phones and the internet existed. They are outdated, overly complex, reward specific industries to the detriment of others, and make it difficult for businesses to plan for the future through temporary, and sometimes retroactive, provisions.

To address these issues, the staff discussion draft proposes a modernized set of cost recovery and accounting rules that is simpler, fairer, more accurately measures business income, and lessens tax burdens on small businesses. These reforms would also raise enough revenue from corporations in the long-term to finance a significant reduction in the corporate tax rate. The staff discussion draft extensively draws from proposals of a number of Senators, including Committee members Brown, Cardin, Casey, Menendez, Nelson, Portman, Rockefeller, Schumer, and Wyden. It does not address a number of other important areas of business tax reform, such as incentives for innovation, manufacturing and energy production, which may need to be adjusted in light of these proposals. Some of the significant proposals in the staff discussion draft include:

Depreciation of Tangible Assets.

- Replace the current rules with a system that better approximates economic depreciation based on estimates from the Congressional Budget Office.
- Reduce the number of major depreciation rates from more than 40 to 5.
- Eliminate the need for businesses to calculate depreciation separately for each of their assets, other than real property.

Amortization of Intangible Assets.

- Require businesses to deduct the cost of R&D, natural resource extraction, and 50% of advertising expenses over 5 years.

Tax Accounting. Repeal LIFO accounting and the like-kind exchange rules.

Simplify and Reduce Tax Burdens for Small Businesses.

- Permanently increase Section 179 expensing to $1 million and expand the definition of qualifying expenses.
- Allow all companies with gross receipts under $10 million to use cash accounting and expense inventory costs.

Summary of Staff Discussion Draft: Cost Recovery and Accounting

Chairman Max Baucus
U.S. Senate Committee on Finance

11/21/13

Overview

As part of his work towards tax reform, Chairman Max Baucus is releasing a staff discussion draft today on certain aspects of business tax reform. The Chairman and his staff are grateful to the Joint Committee on Taxation (JCT), Senate Legislative Counsel and the Congressional Budget Office (CBO) for their assistance with this draft. This staff discussion draft covers the following topics:

- Cost recovery, including:
  - Depreciation of tangible property
  - Section 179 expensing
  - Amortization of intangible property
- Tax accounting, including:
  - Cash method of accounting
  - Uniform capitalization
  - Last in, first out (LIFO) inventory method
  - Lower of cost or market inventory valuation
  - Completed contract method of accounting

The last major overhaul of our country's tax code occurred in 1986. Since then, there have been more than 15,000 changes to the tax code, and the tax law has become increasingly complex. Individuals and businesses now spend an estimated $168 billion annually on income tax compliance. As more and more special provisions have been added to the tax laws, large disparities have resulted in the tax treatment of different types of business investment. Such disparities distort business investment choices, and inhibit the efficient allocation of resources within the economy. In addition, the number of temporary provisions has increased from 25 in 1985 to close to 100 in 2013, which creates uncertainty and added costs for businesses trying to comply with the tax law. All of these issues drive up the cost of doing business in the United States and serve as a drag on economic growth and employment.

In recent years, the Finance Committee has held a number of hearings related to cost recovery and accounting provisions, and issued a paper on tax reform options under consideration in these areas. These efforts highlighted the following problems and opportunities for reform:

- Current tax law prevents U.S. corporations from competing effectively in a global economy and diminishes our ability to attract more foreign investment. The U.S. statutory corporate tax rate is the highest rate in the developed world. Many tax policy experts believe that lowering the statutory corporate tax rate will result in more investment in the United States by both U.S. and foreign multinational companies, leading to a stronger economy and more jobs. As a result, many support the idea of broadening the U.S. business tax base, including cost recovery and tax accounting reforms, as a way to create a more efficient and fair tax system while also paying for a lower statutory corporate tax rate. As part of this effort, however, the larger business community needs to be considered since passthrough businesses will not benefit from a corporate tax rate reduction but could suffer increased tax burdens from broadening the business tax base.

- Current law is riddled with provisions that encourage companies to make business decisions based to a large extent on tax, rather than business, considerations. Such provisions create large tax disparities among different industries and often inefficiently and unfairly encourage investment in one industry over another.

- Current law is unnecessarily complex. Frequent, sometimes temporary, and occasionally retroactive changes to the law create uncertainty and complicate strategic planning for U.S. businesses. The high compliance and administrative costs of our tax system siphon off business resources that could be invested much more productively.

Cost Recovery

The accounting concept of depreciation was introduced in the 1800's as capital intensive business activities grew and investors demanded a more sophisticated measure of business income. Depreciation contains two elements, useful life and salvage value, which are based on estimates and, accordingly, have been a source of disagreement between taxpayers and the IRS since the beginning of our income tax system. Prior to 1981, taxpayers could select how to depreciate their assets. In 1981, Congress made tax depreciation a more objective exercise with the introduction of the Accelerated Cost Recovery System (ACRS), which prescribed how companies had to depreciate different classes of assets. ACRS reduced the number of controversies and permitted companies to write off their assets at very accelerated rates, in part to help offset the effects of rampant inflation. However, the significantly accelerated depreciation deductions permitted under ACRS, and the wide differences in effective tax rates

that it applied to assets in different industries, led to excessive tax shelter activity and other perceived abuses.

As part of the Tax Reform Act of 1986 (the 1986 Act), the Modified Accelerated Cost Recovery System (MACRS) was adopted to address these abuses. Under MACRS, a ten class cost recovery system was designed to more closely approximate the economic depreciation of assets. Nonetheless, the MACRS system did retain a significant amount of acceleration in excess of economic depreciation but was less accelerated than ACRS. The 1986 Act also established the Alternative Depreciation System (ADS), which applies a straight-line method of depreciation and which taxpayers can elect instead of MACRS. Under current law, businesses that elect MACRS are often required to also re-compute depreciation under the ADS rules for a number of purposes. The result is a complex system that requires companies to compute depreciation using multiple methods for income tax purposes.

The 1986 Act also instructed the Treasury Department to establish a new office to study the depreciation of assets and granted Treasury the authority to adjust existing asset classifications or class lives and to prescribe class lives for assets that had no class lives in order to keep the depreciation schedules up to date. Pursuant to this authority, Treasury issued Revenue Procedures 87-56 and 88-22, detailing the recovery periods for numerous different asset and industry classes. However, Congress repealed this authority in 1988. Since that time, there have been no significant revisions of the asset classifications or class lives to reflect technological change and the emergence of new industries. As a result, many new industries lack rationally developed depreciation rules. In addition, no adjustments have been made to reflect the significant decline in inflation since 1986 when the MACRS rules were adopted.

Over the last quarter century, the MACRS rules have grown ever more complex as Congress has introduced numerous special rules for a variety of assets. Congress has also introduced temporary bonus depreciation and certain expensing rules for smaller businesses at various rates and points in time. In response to granting more accelerated depreciation, Congress has also passed various anti-abuse rules that, in turn, slow that same accelerated depreciation down under certain circumstances. To make things even more complex for companies, bonus depreciation and expensing have led many states (that previously followed the federal depreciation rules for simplicity) to de-couple from the federal tax rules to avoid a significant loss of revenue. As a result, companies are now forced to re-compute depreciation separately by state in most of the 50 states.

Prior to 1993, another area of tax controversies surrounded how taxpayers allocated the purchase price for businesses among intangible assets they acquired (e.g., goodwill, patents, copyrights, and customer lists). Since goodwill was not deductible, taxpayers went to great lengths to identify and assign value to intangible assets, other than goodwill, that could be

amortized. The Omnibus Budget Reconciliation Act of 1993 (the "1993 Act") eliminated this controversy by permitting acquired goodwill to be amortized over 15 years and requiring (with some limited exceptions) other intangibles acquired in the same transaction to also be amortized over 15 years.

Even with the changes made in the 1986 Act and the 1993 Act, significant concerns remain about the treatment of expenses to create or purchase intangible or tangible assets. In some cases, taxpayers are allowed to deduct expenditures as they are incurred regardless of the fact that economic benefits have been created that last well beyond a single tax period. In other cases, an expenditure incurred in one industry can be treated substantially differently than an arguably equivalent expenditure in another industry. Sometimes, the tax treatment of a particular expenditure will depend on some measure of the taxpayer's size or organizational structure.

Our current system of cost recovery violates the principles of neutrality, fairness, and simplicity. The tax code today rewards specific industries to the detriment of others, creates uncertainty with provisions that are temporary, and adds unnecessary complexity to business tax compliance. At the same time, there is no mechanism in place to improve and update the underlying economic assumptions of the cost recovery rules, or to account for technological change and the emergence of new technologies.

Tax Accounting

Under current law, businesses must navigate a maze of tax accounting rules to determine their taxable income. Similarly situated businesses are often subject to substantially different tax accounting rules. For example, the ability to adopt the cash method of accounting hinges on a myriad of factors, such as whether the business is a corporation or a partnership with a corporate partner, the business is a farming or personal service business, inventory is a material income producing factor in the business, average annual gross revenues meet certain thresholds, or the business is considered a tax shelter. Even assuming the business owner is able to qualify for the cash method of accounting, there are lots of exceptions to the general rules.

Inventory accounting is another particularly complex area of tax accounting. If the production, purchase, or sale of goods is a material income-producing factor for a business, then the business generally is required to use inventory accounting for the goods. The rules for deducting inventory costs vary depending on the type of cost (e.g., direct material costs, overhead costs) and whether such costs already are capitalized for other purposes such as for financial statement purposes. While the tax law generally requires the capitalization of direct and certain indirect costs, the so-called UNICAP rules go further and require the capitalization

of additional costs, such as overhead. Businesses can deduct the costs of inventory that are required to be capitalized when the inventory is sold. The UNICAP rules do not apply to all taxpayers. In particular, taxpayers that purchase goods for resale and have average annual gross receipts of $10 million or less are not subject to the UNICAP rules, whereas taxpayers that produce their own goods have no such exception.

Our current tax accounting rules are thus highly complex and force taxpayers, and especially small businesses, to spending precious capital on outside advisors to help with their tax compliance challenges.

Goals of the Staff Discussion Draft

This staff discussion draft proposes a modern, simpler, and fairer cost recovery and tax accounting system that promotes tax neutrality when it comes to business decisions. Specifically, it is intended to promote the following objectives:

Cost Recovery

- Establish a system of cost recovery that better approximates the decline in the economic value of assets. This includes establishing a process to update the cost recovery system to take into account technological changes and the emergence of new industries.
- Provide a stable set of cost recovery rules that allow companies to plan better for the future.
- Treat similar investments similarly so that companies make investment decisions based on the needs of the business, rather than on tax planning.
- Simplify the cost recovery system to reduce the costs of tax compliance and enforcement.

Tax Accounting

- Simplify the tax accounting rules to lessen the costs of tax compliance and enforcement, which fall disproportionately on smaller businesses.
- Improve tax neutrality by eliminating the use of certain accounting methods that allow taxpayers in some industries to significantly defer or otherwise distort income measurement.

Summary of the Staff Discussion Draft

The staff discussion draft advances these goals through the reforms described below. While the Chairman believes tax reform as a whole should raise significant revenue for deficit reduction, the package of reforms in this staff discussion draft is intended to be coupled with a significant reduction in the corporate tax rate that, on net, is revenue-neutral in the long-term (i.e., in a steady state). The Chairman's staff believes that the revenue raised in the long-term from corporations by the proposals in this draft could finance a significant cut to the corporate tax rate. These proposals are meant to be considered as a package and not as stand-alone proposals.

Cost Recovery

Depreciation of Tangible Assets. The staff discussion draft repeals the current MACRS and ADS rules and replaces them with the following simplified cost recovery system that better approximates economic depreciation. The new system results in a single set of depreciation rules that apply to all business taxpayers. It also eliminates the need for businesses to calculate depreciation separately for each of their individual assets. This proposal draws upon S. 727 (112th Congress), the Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich, which proposes moving closer to economic depreciation, and S. 2100 (109th Congress), Tax Depreciation and Modernization, and Simplification Act of 2005, sponsored by Sens. Smith and Kerry, which proposes a mass asset approach.

- The new depreciation system for tangible personal property (other than personal use automobiles) and computer software is comprised of 4 pools, with 3 designated for short to mid-term property and 1 designated for mixed-use structures and other longer-term personal property. These pooled assets are depreciated at prescribed rates using a 100% declining balance method, meaning that each year a business can deduct an amount equal to the pool balance multiplied by the depreciable percentage for that pool.
    - Generally, at year-end each pool balance for determining depreciation equals: the prior year's ending pool balance, increased by the current year's asset purchases (including additions and improvements), and decreased by proceeds from the current year's asset sales and other dispositions. Ordinary income is recognized to the extent, if any, that a pool balance is driven negative at year-end by asset dispositions.

- Real property is depreciated, as under current law, on a straight-line basis, but over 43 years.

- The pools and their depreciable percentages were determined based on data from the Bureau of Economic Analysis (BEA) on the decline in value for different types of assets, in consultation with the Congressional Budget Office (CBO) and JCT staff. JCT assisted CBO in mapping this data based on the asset classifications in current law. CBO and JCT then used the BEA data to group these asset classes into pools based on their estimated economic rate of decline and, in limited circumstances, asset type.[1] Finally, CBO calculated a weighted average depreciable percentage for each pool and a weighted average recovery period for real property based upon the BEA data. For real property, CBO calculated a straight line recovery period with a present value equal to the economic rate of decline. The Chairman's staff has requested that CBO produce a letter detailing their analysis, which is forthcoming.

- Treasury is authorized, subject to Congressional review, to reassign assets to different pools (or to reassign as real property) and to create new asset classes to account for technological changes and the emergence of new industries.

- Certain taxpayers are eligible to elect to use their financial accounting placed-in-service date for tax depreciation.

- The like-kind exchange rules are repealed. For pooled assets, the like-kind exchange rules are replaced by the inherent deferral mechanism of the pooling regime.

- The involuntary conversion rules are revised to provide that, in cases where an involuntary conversion would otherwise trigger a gain as a result of a negative balance in a pool, a taxpayer may defer the recognition of the gain to the end of the second tax year after the year of the involuntary conversion.

- The current depreciation recapture rules are repealed with respect to pooled assets. For pooled property, the new recapture rules treat all gains (including those associated with depreciation recapture) as ordinary income.

- For real property, the recapture rules are revised to recapture all depreciation claimed through the date of disposition at ordinary income tax rates.

[1] There are two cases in which the Chairman's staff asked CBO not to assign assets with a class life to a pool based on their estimated economic rate of decline. These exceptions were for asset classes 44 (assets other than vessels used in water transportation and related land improvements) and 49.14 (assets used in electricity transmission and distribution), which were instead assigned to the pool that included all other land improvement and transmission property.

- The maximum amount that can be depreciated for personal-use automobiles is limited to $45,000, recovered ratably over 5 years. Automobiles used entirely for business purposes are pooled assets and not subject to this limitation.

Cost Recovery for Certain Taxpayer-Created Intangible Assets.[2]

- Expensing for research and experimental expenditures under Section 174 is repealed. Research and experimental expenditures are capitalized and amortized ratably over 5 years.

- Half of advertising expenses may be expensed immediately. The remaining 50% must be capitalized and amortized ratably over 5 years.

- "Qualified extraction expenditures" are treated in the same manner as research and experimental expenditures. "Qualified extraction expenditures" are defined as tertiary injectant expenses, geological and geophysical expenses paid or incurred for the development of oil or gas, intangible drilling and development costs related to oil and gas wells and geothermal wells, mining development expenditures, and mining exploration expenditures. This proposal is based, in part, on S. 258 (112th Congress), Close Big Oil Tax Loopholes Act, sponsored by Sens. Menendez, Boxer, Durbin, Lautenberg, Leahy, Merkley, Nelson, Reed, Rockefeller, Sanders, Schumer, and Whitehouse.

Miscellaneous Other Cost Recovery Provisions.

- The percentage depletion rules of Section 613 are repealed and all taxpayers are permitted to use cost depletion. This proposal draws upon S. 307 (113th Congress), Close Big Oil Tax Loopholes Act, sponsored by Sens. Menendez, Boxer, Brown, Cardin, Durbin, Franken, Gillibrand, Klobuchar, Lautenberg, Leahy, McCaskill, Merkley, Nelson, Reed, Schumer, Shaheen, Stabenow, and Whitehouse.

- The rules for expensing start-up expenditures and organizational costs are consolidated into a single rule. The combined amount that can be immediately expensed is increased from $5,000 to $10,000, phased out for expenses in excess of $60,000. Any costs that are not expensed must be amortized over a period of not less than 20 years.

[2] The 5-year recovery periods and the 50% figure for advertising expenses in this section are intended to reflect empirical evidence on the decline in value over time of expenditures for research, advertising, and natural resource extraction. See Corrado, Hulten and Sichel, Intangible Capital and Economic Growth, Finance and Economics Discussion Series 2006-24, Federal Reserve Board, Washington DC. The Chairman's staff requests comments on whether and how these amounts should be adjusted.

Section 179 Expensing. The staff discussion draft permanently expands and modifies Section 179 to reduce tax burdens and compliance costs for small businesses. This proposal draws upon S. 727 (112th Congress), Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich, S. 1085 (113th Congress), Small Business Tax Certainty and Growth Act of 2013, sponsored by Sens. Collins and Casey, and S. 12 (112th Congress), Job Creation Act of 2011, sponsored by Sen. Portman.

- For years beginning after 2014, the maximum amount that may be expensed is increased to $1,000,000, phasing out for qualifying property exceeding $2,000,000, with both thresholds indexed for inflation.
- The definition of qualifying property is greatly expanded to include all pooled assets (including off-the-shelf computer software), research and experimental expenditures, advertising costs that are required to be capitalized and amortized, and qualified extraction expenditures.
- The special rules for qualified disaster assistance property are repealed.

Amortization of Intangibles. The staff discussion draft modifies the current rules governing expensing and amortization of intangible assets to better reflect the decline in their economic value.[3]

- The amortization period for Section 197 intangible assets is increased from 15 years to 20 years.
- Mortgage servicing rights are classified as Section 197 intangibles subject to the new 20 year amortization period.
- Treasury is directed to revise their safe-harbor regulations with respect to certain intangible assets such that qualifying intangible assets may not be recovered over a period of less than 20 years.
- The anti-churning rules of Section 197(f)(9) are repealed.
- The income forecast method of amortization is modified to increase the recovery period to be 15 years with the 5th and 10th years being re-computation years.
- Facilitative amounts related to tax-free acquisitions can be amortized ratably over 20 years.

[3] The 20-year recovery periods in this section are intended to reflect changes in the real rate of return since the 15-year period was established in 1993. The Chairman's staff requests comments on whether and how these periods should be adjusted.

Tax Accounting

Cash Method of Accounting.

- All businesses (other than tax shelters) with average annual gross receipts of $10 million or less based upon the prior three years (the "gross receipts threshold") may:
    - Elect to adopt either the cash method or accrual method of accounting, regardless of whether inventory is a material income producing factor in the business, and
    - Immediately deduct the cost of inventory even if it is a material income producing factor in the business if the cash method of accounting is adopted.

  This proposal draws upon S. 1085 (113th Congress), Small Business Tax Certainty and Growth Act of 2013, sponsored by Sens. Collins and Casey.
- All businesses that do not meet the gross receipts threshold must adopt the accrual method of accounting, including those engaged in farming and personal service businesses.
    - Businesses that do not satisfy the gross receipts threshold may not change their method of accounting (from cash to accrual or vice versa) without the permission of the Secretary of Treasury more frequently than every five years.
- The special method of accounting for farming businesses under Section 447 is repealed.
- The gross receipts threshold is indexed for inflation in $1 million increments.

Uniform Capitalization Rules.

- Businesses below the gross receipts threshold are exempt from the requirements to capitalize direct and indirect costs of inventory acquired or produced by the taxpayer.

LIFO.

- The LIFO method of accounting for inventory is repealed.
- Taxable income resulting from this change in accounting method is included in income at the new tax rate ratably over 8 years.

Other Accounting Provisions.

- The lower of cost or market rule for inventory is repealed. This proposal comes from S. 727 (112th Congress), Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich.
- The completed contract method of accounting is repealed, except for small construction contracts.

Unaddressed Issues and Request for Comments

Comments are requested on all aspects of the staff discussion draft as well as other areas of cost recovery and accounting. Comments on the additional issues listed below that the Chairman's staff is considering are of particular interest. All comments should be submitted to tax_reform@finance.senate.gov. While comments will be accepted at any time, the staff requests comments by January 17, 2014 in order to be able to give them full consideration.

The additional issues that the Chairman's staff is considering are listed below:

- The staff discussion draft focuses on developing a set of cost recovery and accounting rules that more accurately reflects economic income. It is not intended to address incentives in other areas of the tax code for activities such as innovation, energy production, and manufacturing. For example, while the staff discussion draft proposes capitalization and amortization of research and experimental expenditures, the Chairman's staff is considering expanding and making permanent the research and development credit, which is otherwise set to expire at the end of 2013. Similarly, while the staff discussion draft slows down the cost recovery of certain energy assets, the Chairman's staff is considering improving and making permanent certain energy tax credits set to expire in 2013. Comments are requested on whether and how tax incentives – such as the research and development credit, the Section 199 deduction for manufacturing, and credits for clean energy – should be adjusted in light of the proposals in the staff discussion draft.
- The staff discussion draft does not address whether the corporate alternative minimum tax (AMT) should be repealed. The new cost recovery and accounting provisions in the staff discussion draft eliminate many of the items that cause taxpayers to be subject to the corporate AMT. Comments are requested regarding whether the corporate AMT should be repealed and, if so, how unused alternative minimum tax credits should be treated.

- Businesses have made significant decisions based on current law. Comments are requested regarding appropriate transition rules and effective dates. For example, the provisions are generally effective for taxable years after December 31, 2014, but comments are requested regarding whether more time would be necessary to effectively implement any provisions of the staff discussion draft.

- The staff discussion draft proposes to repeal the like-kind exchange rules. For pooled assets, the like-kind exchange rules are replaced by the inherent deferral mechanism of the pooling regime, but no such analog exists for real property or intangible property in the draft. Comments are requested regarding whether the like-kind rules should be retained in some fashion for real property and intangible property and whether, if retained, the rules should be revised to require a "similar use" concept (such as in the involuntary conversion rules) in place of the "like-kind" concept.

- The staff discussion draft proposes a single method of depreciation for each class of assets and no longer permits taxpayers to choose between different methods of computing depreciation. As a result, normalization rules provided for in current law are no longer operable. Comments are requested regarding whether new normalization rules should be included and, if so, how such rules could work.

- Comments are requested regarding whether small producers should continue to be eligible for percentage depletion (limited to cost basis) and, if so, how small producer eligibility should be determined and to what extent, if any, depletion rates should vary among resources.

- The staff discussion draft proposes that the conversion of a real property asset from more than 50% business use to a principal residence is exempted from the rule that otherwise would require the asset to be deemed sold at fair market value but does not provide any exemption for a business-use property converted into a vacation home. Comments are requested for whether such an exemption should be included and how such an exemption would be designed.

- Other opportunities for simplifying the cost recovery and accounting rules consistent with the proposed changes.

TECHNICAL EXPLANATION OF THE SENATE COMMITTEE ON FINANCE CHAIRMAN'S STAFF DISCUSSION DRAFT TO REFORM CERTAIN BUSINESS PROVISIONS

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



November 21, 2013
JCX-19-13

CONTENTS

Page

TITLE ___ BUSINESS PROVISIONS 1

A. Rules Relating to Deductions for Capital Expenditures 2

1. Modification and permanent extension of section 179 rules (sec. 01 of the discussion draft and sec. 179 of the Code) 2
2. Repeal of certain specialized expensing provisions (sec. 02 of the discussion draft and secs. 179A-179E of the Code) 5
3. Repeal of certain other deductions (sec. 03 of the discussion draft and secs. 180, 190, and 194 of the Code) 7
4. Pooled asset cost recovery system and depreciation of real property (sec. 11 of the discussion draft and sec. 168 of the Code) 10
5. Rules related to treatment of gains from depreciable property (sec. 12 of the discussion draft and secs. 1245 and 1250 of the Code) 29
6. Limitation on depreciation of personal use passenger automobiles (sec. 13 of the discussion draft and sec. 280F of the Code) 31
7. Limitation on depreciation to property predominantly used in a trade or business (sec. 14 of the discussion draft and sec. 167 of the Code) 32
8. Repeal of like-kind exchanges (sec. 15 of the discussion draft and sec. 1031 of the Code) 34
9. Election to use financial statement placed in service date (sec. 16 of the discussion draft and sec. 7701 of the Code) 35
10. Repeal of special amortization rules for pollution control facilities (sec. 17 of the discussion draft and sec. 169 of the Code) 37
11. Intangible property (sec. 21 of the discussion draft and secs. 167 and 197 of the Code) 38
12. Amortization of research and experimental expenditures (sec. 22 of the discussion draft and sec. 174 of the Code) 44
13. Treatment of advertising expenditures (sec. 23 of the discussion draft and new sec. 177 of the Code) 46
14. Amortization of certain oil, gas, and mining expenditures (sec. 24 of the discussion draft and secs. 167(h), 193, 263(c), 291, 616, and 617 of the Code) 47
15. Termination of percentage depletion (sec. 25 of the discussion draft and secs. 613 and 613A of the Code) 54
16. Amortization of soil and water conservation expenditures and endangered species recovery expenditures (sec. 26 of the discussion draft and sec. 175of the Code) 58

B. Accounting Provisions 60

1. Limitation on use of cash method of accounting (sec. 51 of the discussion draft and secs. 448 and 471 of the Code) 60

2. Repeal of special rules for method of accounting for corporations engaged in farming (sec. 52 of the discussion draft and sec. 447 of the Code) 62
3. Modification of rules for capitalization and inclusion in inventory costs of certain expenses (sec. 53 of the discussion draft and sec. 263A of the Code)..... 63
4. Unification of deduction for start-up and organizational expenditures (sec. 54 of the discussion draft and secs. 195, 248, and 709 of the Code) 64
5. Certain methods of determining inventories not treated as clearly reflecting income (sec. 55 of the discussion draft and secs. 471, 472, 473, and 474 of the Code)..... 65
6. Application of percentage of completion method to certain long-term contracts (sec. 56 of the discussion draft and sec. 460 of the Code) 67

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the Senate Committee on Finance Chairman's staff discussion draft (MCG13833) to reform certain business provisions. This document is prepared at the request of Senate Committee on Finance Chairman Max Baucus.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft to Reform Certain Business Provisions* (JCX-19-13), November 21, 2013. This document can also be found on our website at www.jct.gov.

TITLE ___ BUSINESS PROVISIONS

A. Rules Relating to Deductions for Capital Expenditures

1. Modification and permanent extension of section 179 rules (sec. 01 of the discussion draft and sec. 179 of the Code)

Present Law

A taxpayer may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation.[2] For taxable years beginning in 2013, the maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2 million.[3] The $500,000 and $2 million amounts are not indexed for inflation.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.[4] For taxable years beginning before 2014, qualifying property also includes off-the-shelf computer software[5] and qualified real property[6] (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[7] Of the $500,000 expense amount available under section 179, the maximum amount available with respect to qualified real property is $250,000 for each taxable year.

For taxable years beginning in 2014 and thereafter, a taxpayer may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property (not including off-the-shelf computer software or qualified real property) that is purchased for use in the active conduct of a trade or business.

---

[2] Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), the New York Liberty Zone (sec. 1400L(f)), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

[3] Sec. 179(b)(2).

[4] Qualifying property does not include any property described in section 50(b) or air conditioning or heating units. Sec. 179(d)(1).

[5] Off-the-shelf computer software has been eligible for section 179 since 2003.

[6] Qualified real property has been eligible for section 179 since 2010.

[7] Sec. 179(f).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property.[8] Thus, if a taxpayer's section 179 deduction for 2012 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2013. Any such carryover amounts that are not used in 2013 are treated as property placed in service in 2013 for purposes of computing depreciation. That is, the unused carryover amount in 2013 from 2012 is considered placed in service on the first day of the 2013 taxable year.[9]

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[10] In general, any election or specification made with respect to any property may not be revoked except with the consent of the Secretary. However, an election or specification under section 179 may be revoked by the taxpayer without consent of the Secretary for taxable years beginning after 2002 and before 2014.[11]

Explanation of Provision

Temporary one-year extension

The provision extends present-law treatment for an additional year. That is, for taxable years beginning in 2014, the maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2 million. The $500,000 and $2 million amounts are not indexed for inflation.

---

[8] Section 179(f)(4) details the special rules that apply to disallowed amounts.

[9] For example, assume that during 2012, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2012, and has a taxable income limitation of $150,000. The maximum section 179 deduction the company can claim for 2012 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2013 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.

Assume further that in 2013, the company had no asset purchases and had taxable income of $-0-. The $100,000 carryover from 2012 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2013 taxable year. The $50,000 carryover allocated to equipment is carried over to 2013 under section 179(b)(3)(B).

[10] Sec. 179(c)(1).

[11] Sec. 179(c)(2).

Under the provision, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Qualifying property also includes off-the-shelf computer software. However, the definition of qualifying property does not include qualified disaster assistance property or qualified real property.

The provision makes permanent the ability for a taxpayer to revoke an election under section 179. Specifically, an election or specification under section 179 may be revoked by the taxpayer without consent of the Commissioner for taxable years beginning after 2002.

Modifications and permanent extension

For taxable years beginning after 2014, the provision states that the maximum amount a taxpayer may expense is $1 million of the cost of qualifying property placed in service for the taxable year. The $1 million amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2 million. The $1 million and $2 million amounts are indexed for inflation for taxable years beginning after 2015.

The provision broadens the scope of the expensing provision to refer to section 179 expenditures as well as to the cost of section 179 property. A section 179 expenditure means: (1) the cost of any section 179 property; (2) research and experimentation expenditures (within the meaning of section 174, as modified by this provision); (3) advertising expenditures (as defined in new section 177), but only to the extent such expenditures are not otherwise deductible; and (4) qualified extraction expenditures (as defined in section 193, as modified by this provision). Section 179 property is defined as tangible property (to which section 168 applies) or computer software (as described in section 168(b)(2)(B), as modified by this provision) which is section 1245 property (as defined in section 1245(a)(3), as modified by this provision) that is purchased for use in the active conduct of a trade or business. Expenditures that may be amortized under other provisions are required to be reduced by the amount that is expensed under this provision with respect to such expenditure.

The provision also strikes the exclusion of any property described in section 50(b) as well as air conditioning and heating units from the definition of qualifying property.

Effective Date

The temporary one-year extension, including the permanent provision related to revoking an election under section 179 and the repeal of a taxpayer's the ability to elect section 179 for qualified disaster assistance property and qualified real property, is effective for taxable years beginning after December 31, 2013.

The modifications and permanent extension are effective for taxable years beginning after December 31, 2014.

2. Repeal of certain specialized expensing provisions (sec. 02 of the discussion draft and secs. 179A-179E of the Code)

Present Law

Section 179A

For property placed in service prior to December 31, 2005, certain costs of qualified clean-fuel property (*i.e.*, qualified clean-fuel vehicle property[12] and qualified clean-fuel vehicle refueling property[13]) are allowed to be expensed when such property is placed in service.[14]

Section 179B

A small business refiner[15] is allowed to elect to expense 75 percent of qualified capital costs[16] related to compliance with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA") which are paid or incurred by the taxpayer during the taxable year during the period beginning on January 1, 2003 and ending on the earlier of (1) the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or (2) December 31, 2009.[17]

Section 179C

Section 179C provides a temporary election to expense 50 percent of qualified refinery property; the remaining 50 percent is recovered as under present law.[18] Qualified refinery property includes assets, located in the United States, used in the refining of liquid fuels: (1) with respect to the construction of which there is a binding construction contract before January 1, 2010; (2) which are placed in service before January 1, 2014; (3) which increase the capacity of an existing refinery by at least five percent or increase the percentage of total throughput attributable to qualified fuels[19] such that it equals or exceeds 25 percent; and (4) which meet all applicable environmental laws in effect when the property is placed in service.

---

[12] Sec. 179A(b)(1).

[13] Sec. 179A(b)(2).

[14] Sec. 179A.

[15] Sec. 45H(c)(1).

[16] Sec. 45H(c)(2).

[17] Secs. 179B and 45H(c)(4).

[18] See sec. 168.

[19] Sec. 45K(c).

Section 179D

Section 179D provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer.[20] The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service. The deduction is effective for property placed in service after December 31, 2005, and prior to January 1, 2014.

Section 179E

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.[21] "Qualified advanced mine safety equipment property" means any advanced mine safety equipment property[22] for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service after December 20, 2006, and before January 1, 2014.[23]

Explanation of Provision

The provision repeals, as deadwood, sections 179A, 179B, 179C, 179D, and 179E.

Effective Date

For section 179A, the provision takes effect on the date of the enactment. For section 179B, the provision applies to expenses paid or incurred after the date of the enactment. For sections 179C, 179D, and 179E, the provision applies to property placed in service after December 31, 2013.

---

[20] Energy-efficient commercial building property is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003).

[21] Sec. 179E(a).

[22] Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine. Sec. 179E(d).

[23] Secs. 179E(c) and (g).

3. Repeal of certain other deductions (sec. 03 of the discussion draft and secs. 180, 190, and 194 of the Code)

Present Law

Deduction for expenditures by farmers for fertilizer, etc.

A taxpayer engaged in the business of farming may elect to deduct expenses (otherwise chargeable to capital account) which are paid or incurred during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming.[24]

Deduction for qualifying film and television productions

Under section 181, taxpayers may elect[25] to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2014, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[26] Taxpayers may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section.[27] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[28]

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[29] The term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)).[30] With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes

---

[24] Sec. 180.

[25] See Temp. Treas. Reg. section 1.181-2T for rules on making an election under this section.

[26] For this purpose, a production is treated as commencing on the first date of principal photography.

[27] Sec. 181(a)(2)(A).

[28] Sec. 181(a)(2)(B).

[29] Sec. 181(d)(3)(A).

[30] Sec. 181(d)(3)(B).

qualify under the provision.[31] Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.[32]

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.[33]

Expenditures to remove architectural and transportation barriers to the handicapped and elderly

Under present law, a taxpayer may elect to deduct certain architectural and transportation barrier removal expenses for the taxable year in which paid or incurred rather than capitalizing such expenses. Architectural and transportation barrier removal expenses are defined for this purpose as expenditures that are paid or incurred by a taxpayer in order to make facilities or public transportation vehicles owned or leased in connection with the taxpayer's business more accessible to handicapped and elderly individuals. The amount of the deduction allowed under this provision for any taxable year is limited to $15,000.

Treatment of reforestation expenditures

A taxpayer may elect to expense up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property.[34] The remaining expenditures are amortized over 84 months (seven years) subject to a mandatory half-year convention.[35] In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (*i.e.*, an "above-the-line deduction") rather than as an itemized deduction.[36]

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity.[37] Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been

[31] Sec. 181(d)(2)(B).

[32] Sec. 181(d)(2)(C).

[33] Sec. 1245(a)(2)(C).

[34] Sec. 194.

[35] Sec. 194(a).

[36] Sec. 62(a)(11).

[37] Sec. 194(c)(3).

reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer's gross income.

Qualifying timber property means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.[38]

Reforestation amortization is subject to recapture as ordinary income on sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.[39]

Explanation of Provision

The provision repeals section 180 such that amounts paid or incurred during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming are subject to the general capitalization principles.[40]

The provision repeals, as deadwood, section 181.

The provision repeals section 190 such that a taxpayer generally must capitalize architectural and transportation barrier removal expenses for the taxable year in which paid or incurred.

The provision repeals section 194, the special rule for reforestation expenditures, such that the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and including costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity are included in basis and recovered through depletion.

Effective Date

For sections 180, 190, and 194, the provision applies to expenses paid or incurred after December 31, 2014. For section 181, the provision applies to qualified film and television productions commencing after December 31, 2013.

---

[38] Sec. 194(c)(1).

[39] Sec. 1245(b)(7).

[40] See, *e.g.*, sections 471 and 263A.

4. Pooled asset cost recovery system and depreciation of real property (sec. 11 of the discussion draft and sec. 168 of the Code)

Present Law

Cost recovery

Overview

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. Under the modified accelerated cost recovery system ("MACRS"), adopted in 1986, the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[41]

Recovery periods and depreciation methods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[42] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[43] switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for

---

[41] The Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 201 (1986).

[42] Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56 (1987-2 C.B. 674), laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22 (1988-1 C.B. 785). In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[43] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight-line method.

Recovery method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
200-percent declining balance	285.71	204.08	145.77	104.12	86.77	86.77	86.77	1,000.00
150-percent declining balance	214.29	168.37	132.29	121.26	121.26	121.26	121.26	1,000.00
Straight-line	142.86	142.86	142.86	142.86	142.86	142.86	142.86	1,000.00

residential rental property. The straight-line depreciation method is required for the aforementioned real property. Table 1 provides general rules for class lives and recovery periods as provided in section 168(e).

Table 1.−General Rules for Class Lives and Recovery Periods

Type of Property	General Rule-Class Life	MACRS Applicable Recovery Period
3-year property	4 years or less	3 years
5-year property	More than 4 but less than 10 years	5 years
7-year property	10 or more but less than 16 years; also, property (other than real property) without a class life	7 years
10-year property	16 or more but less than 20 years	10 years
15-year property	20 or more but less than 25 years	15 years
20-year property	25 or more years	20 years
Water utility property	50 years	25 years
Residential rental property	40 years	27.5 years
Nonresidential real property	40 years	39 years
Any railroad grading or tunnel bore	50 years	50 years

Placed-in-service conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention. Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month. All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year to reflect the assumption that assets are placed in service ratably throughout the year. However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter

convention,[44] designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

Alternative depreciation system

The alternative depreciation system ("ADS") is required to be used for property used predominantly outside the United States, tax-exempt bond financed property, and certain tax-exempt use property.[45] An election to use ADS is available to taxpayers for any class of property for any taxable year.[46] Under ADS, all property is depreciated using the straight-line method, over recovery periods which generally are equal to the class life of the property, with certain exceptions.

Like-kind exchanges

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment if exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment.[47] If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange. In general, section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[48]

Involuntary conversions

Although gain or loss realized from the sale or other disposition of property must generally be recognized, section 1033 provides an exception to this rule in the case of certain involuntary conversions of property. Section 1033 applies if property is involuntarily or compulsorily converted into similar property or money. Such a conversion may occur as a result of the property's destruction (in whole or in part), theft, seizure, requisition or condemnation, or a sale made under the threat of requisition or condemnation.[49]

---

[44] The mid-quarter convention treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter.

[45] Sec. 168(g).

[46] Sec. 168(g)(7).

[47] Sec. 1031(a)(1).

[48] Sec. 1031(a)(2).

[49] Sec. 1033(a).

For purposes of section 1033, condemnation refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation.[50] Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or a threat of imminence thereof), and the divestiture is not eligible for deferral under this provision.[51]

If property is involuntarily converted into property that is similar or related in service or use to the property so converted, no gain is recognized. This treatment is not elective. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. If the taxpayer receives money (for instance, insurance payments or condemnation awards), or other dissimilar property for the involuntarily converted property, and acquires qualified replacement property within the prescribed time period, nonrecognition of the gain is optional.[52] As a general matter, the prescribed time period begins on the date of the disposition of the converted property (or threat or imminence of a threat of condemnation begins) and ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.[53]

The taxpayer's basis in the replacement property is the same as the taxpayer's basis in the converted property, decreased by the amount of any money received or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.[54]

Explanation of Provision

In general

The provision repeals present-law depreciation rules under section 168 and replaces such rules with a pooling cost recovery system for "pooled property" (*e.g.*, most tangible property and computer software) and a straight-line cost recovery system for "straight-line property" (*i.e.*, real property and personal-use passenger automobiles) (collectively, "section 168 property"). The term "section 168 property" does not include motion picture films, video tapes, or sound recordings.[55]

---

[50] Rev. Rul. 58-11, 1958-1 C.B. 273.

[51] *Ibid*. If the replacement property is stock of a corporation and if the stock basis is decreased under this rule, the aggregate basis of the corporation's assets is likewise decreased by the same amount (but not below that stock basis as so decreased). Sec. 1033(b)(3).

[52] Sec. 1033(a)(2)(A).

[53] Sec. 1033(a)(2)(B).

[54] Sec. 1033(b).

[55] "Sound recordings" are any works resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material (*e.g.*, discs, tapes, or other phonorecordings) in which such sounds are embodied.

Pooled property

In general

In the case of pooled property, costs are recovered by multiplying the applicable recovery rate for each pool by the associated pool balance at year-end. "Pooled property" is defined as any tangible property (other than any personal-use passenger automobile) and any computer software (as defined in section 197(e)(3)(B) that is not an amortizable section 197 intangible) assigned to any one of the four pools (detailed in Table 2 below).

Table 2.−Pooled Property by Pool

Property	Classification[56]
POOL 1	
Information systems	00.12
Data handling equipment, except computers	00.13
Automobiles, taxis	00.22
Electric utility nuclear fuel assemblies	49.121
Computer software	Section 168(b)(2)(B)[57]
POOL 2	
Buses	00.23
Light general purpose trucks	00.241
Heavy general purpose trucks	00.242
Tractor units for use over-the-road	00.26
Trailers and trailer-mounted containers	00.27
Agriculture	01.1
Cotton ginning assets	01.11

[56] Except where noted, the classification is based on the asset class categorization provided in Rev. Proc. 87-56, 1987-2 C.B. 674. Any reference to Rev. Proc. 87-56 shall include any amendment to such revenue procedure (*e.g.*, Rev. Proc. 88-22, 1988-1 C.B. 785). The assignment of asset classes based on the categorization provider in Rev. Proc. 87-56 is not intended to disrupt IRS guidance (*e.g.*, Rev. Proc. 2011-22, 2011 I.R.B. 737).

[57] The section number refers to computer software described in such section of the discussion draft.

Property	Classification[56]
Cattle, breeding or dairy	01.21
Any breeding or work horse that is 12 years old or less at the time it is placed in service	01.221
Any breeding or work horse that is more than 12 years old at the time it is placed in service	01.222
Any race horse that is more than two years old at the time it is placed in service	01.223
Any horse that is more than 12 years old at the time it is placed in service and that is neither a race horse nor a horse described in class 01.222	01.224
Any horse not described in classes 01.221, 01.222, 01.223, or 01.224	01.225
Hogs, breeding	01.23
Sheep and goats, breeding	01.24
Construction	15.0
Manufacture of medical and dental supplies	22.3
Cutting of timber	24.1
Sawing of dimensional stock from logs (permanent)	24.2
Sawing of dimensional stock from logs (temporary)	24.3
Manufacture of wood products and furniture	24.4
Manufacture of rubber products	30.1
Manufacture of finished plastic products	30.2
Manufacture of electronic components, products and systems	36.0
Manufacture of semiconductors	36.1
Manufacture of motor vehicles	37.11
Railroad machinery and equipment	40.1
Motor transport−Passengers	41.0

Property	Classification[56]
Motor transport−Freight	42.0
Telephone central office equipment	48.12
Computer-based telephone central office switching equipment	48.121
Telephone station equipment	48.13
Radio and television broadcastings	48.2
TOCSC[58]−High frequency radio and microwave system	48.32
TOCSC−Central office control equipment	48.34
TOCSC−Computerized switching, channeling, and associated control equipment	48.35
TOCSC−Satellite space segment property	48.37
TOCSC−Equipment installed on customer's premises	48.38
TOCSC−Support and service equipment	48.39
Distributive trades and services	57.0
Recreation	79.0
Qualified rent to own property	Section 168(i)(14)[59]
Tree or vine bearing fruit or nuts	Section 168(e)(3)(D)(ii)[60]

[58] "TOCSC" stands for telegraph, ocean cable, and satellite communications.

[59] The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

[60] The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

Property	Classification[56]
POOL 3	
Office Furniture, fixtures and equipment	00.11
Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters	00.21
Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction	00.28
Mining	10.0
Offshore drilling	13.0
Drilling of oil and gas wells	13.1
Exploration for and production of petroleum and natural gas deposits	13.2
Petroleum refining	13.3
Manufacture of grain and grain mill products	20.1
Manufacture of sugar and sugar products	20.2
Manufacture of vegetable oils and vegetable oil products	20.3
Manufacture of other food and kindred products	20.4
Manufacture of food and beverages−Special handling devices	20.5
Manufacture of tobacco and tobacco products	21.0
Manufacture of knitted goods	22.1
Manufacture of yarn, thread, and woven fabric	22.2
Manufacture of carpets, and dyeing, finishing, and packaging of textile products	22.3
Manufacture of textured yarns	22.4
Manufacture of nonwoven fabrics	22.5
Manufacture of apparel and other finished products	23.0

Property	Classification[56]
Manufacture of pulp and paper	26.1
Manufacture of converted paper, paperboard, and pulp products	26.2
Printing, publishing, and allied industries	27.0
Manufacture of chemicals and allied products	28.0
Manufacture of rubber products−Special tools and devices	30.11
Manufacture of finished plastic products−Special tools	30.21
Manufacture of leather and leather products	31.0
Manufacture of glass products	32.1
Manufacture of glass products−Special tools	32.11
Manufacture of cement	32.2
Manufacture of other stone and clay products	32.3
Manufacture of primary nonferrous metals	33.2
Manufacture of primary nonferrous metals−Special tools	33.21
Manufacture of foundry products	33.3
Manufacture of primary steel mill products	33.4
Manufacture of fabricated metal products	34.0
Manufacture of fabricated metal products − Special tools	34.01
Manufacture of electrical and non-electrical machinery and other mechanical products	35.0
Manufacture of motor vehicles−Special tools	37.12
Manufacture of aerospace products	37.2
Ship and boat building machinery and equipment	37.31

Property	Classification[56]
Ship and boat building −Special tools	37.33
Manufacture of locomotives	37.41
Manufacture of railroad cars	37.42
Manufacture of athletic, jewelry and other goods	39.0
Air transport	45.0
Air transport (restricted)	45.1
CATV[61]−Program origination	48.43
CATV−Service and test	48.44
CATV−Microwave systems	48.45
Personal property not assigned a class life	
POOL 4	
Railroad cars and locomotives, except those owned by railroad transportation companies	00.25
Land improvements	00.3
Industrial steam and electric generation and/or distribution systems	00.4
Ship and boat building dry docks and land improvements	37.32
Railroad wharves and docks	40.3
Railroad track	40.4
Railroad hydraulic electric generating equipment	40.51
Railroad nuclear electric generating equipment	40.52
Railroad steam electric generating equipment	40.53

[61] "CATV" stands for cable television.

Property	Classification[56]
Railroad steam, compressed air, and other power plant equipment	40.54
Water transportation	44.0
Pipeline transportation	46.0
Telephone distribution plant	48.14
TOCSC−Electric power generating and distribution systems	48.31
TOCSC−Cable and long-line systems	48.33
TOCSC−Satellite ground segment property	48.36
CATV−Headend	48.41
CATV−Subscriber connection and distribution systems	48.42
Electric utility transmission and distribution plant	49.14
Gas utility distribution facilities	49.21
Gas utility trunk pipelines and related storage facilities	49.24
Water utilities	49.3
Central steam utility production and distribution	49.4
Municipal sewer	51.0
Distributive trades and services−Billboard, service station buildings and petroleum marketing land improvements	57.1
Theme and amusement parks	80.0
Real property that is section 1245 property[62] not assigned a class life	

[62] "Section 1245 property" refers to an asset defined under such section as in effect for taxable years beginning in 2014.

Property	Classification[56]
Solar and wind energy	Section 168(e)(3)(B)(vi)[63]

Applicable rates

The applicable recovery rates for the four pools are:

- Pool 1: 38 percent;
- Pool 2: 18 percent;
- Pool 3: 12 percent; and
- Pool 4: five percent.

Foreign assets

In instances where assets used predominantly outside the United States ("foreign assets") and assets used predominantly inside the United States ("domestic assets") are owned by (and used in) the same trade or business, the foreign assets must be pooled separately from the domestic assets in order to permit necessary foreign sourcing calculations and any other necessary allocations with respect to foreign assets. Thus, a trade or business with both foreign assets and domestic assets may have two of each pool.

Pool balances

In general

To determine an asset pool balance as of the close of the taxable year, a taxpayer generally must take in to account additions to and subtractions from the pool as well as any depreciation deduction or negative pool balance adjustment (discussed below).

First taxable year.−For the first taxable year beginning after December 31, 2014, each asset pool balance is determined by:

(1) adding the adjusted basis of (A) any pooled property held by the taxpayer on the first day of such taxable year assigned to such asset pool;[64] (B) any pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and (C) to the extent not already included by reason of (B), any capitalizable addition or improvement made to pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and

[63] The section number refers to an asset described in such section as in effect for taxable years beginning in 2014.

[64] The term "any pooled property held by the taxpayer" includes pooled property with zero adjusted basis.

(2) subtracting (A) the amount of any reduction pursuant to a discharge of indebtedness;[65] (B) except as provided in (C), the gross proceeds from the disposition or transfer during the taxable year of any asset assigned to such pool; and (C) in the case of any pooled property disposed of or transferred to a related person or tax shelter or any other pooled property which the taxpayer continues to use after its disposition, the recomputed basis (discussed below).

Subsequent taxable years.−For each subsequent taxable year, a taxpayer must first compute each asset pool's adjusted balance. The adjusted balance of an asset pool is the prior year's ending pool balance decreased by the amount of any depreciation deduction claimed with respect to such pool and increased by the amount of any gain recognized with respect to a negative pool balance for such pool. To determine the pool balance as of the close of the taxable year, a taxpayer begins with the adjusted balance then:

(1) adds the adjusted basis of: (A) any pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and (B) to the extent not already included by reason of (A), any capitalizable addition or improvement made to pooled property placed in service by the taxpayer during the taxable year assigned to such asset pool; and

(2) subtracts: (A) the amount of any reduction pursuant to a discharge of indebtedness;[66] (B) except as provided in (C), the gross proceeds from the disposition or transfer during the taxable year of any asset assigned to such pool; and (C) in the case of any pooled property disposed of or transferred to a related person or tax shelter or any other pooled property which the taxpayer continues to use after its disposition, the recomputed basis (discussed below).

Pooling example

Suppose a calendar year taxpayer offers music lessons at a studio. The taxpayer owns the following assets on January 1, 2015, each with an adjusted basis as indicated: (1) $1,000 computers (asset class 00.12 under Revenue Procedure 87-56); (2) $1,000 light truck (asset class 0.241 under Revenue Procedure 87-56) used 100 percent for business use; (3) $1,000 violin (personal property not assigned a class life under Revenue Procedure 87-56); and (4) $1,000 sidewalks and other land improvements around the studio (asset class 00.3 under Revenue Procedure 87-56). As of January 1, 2015, the taxpayer has a pool balance of $1,000 in each of pools one through four.

On February 1, 2015, the taxpayer acquires a new computer for $2,000. On March 1, 2015, the taxpayer sells the violin to an unrelated party for $1,500. On March 2, 2015, the taxpayer acquires a viola for $1,700. On April 1, 2015, the taxpayer sells the light truck for $500 and acquires a new light truck for $1,500. The taxpayer makes no improvements to the land

[65] For this purpose, the relevant subsections are (b)(2)(E), (b)(5), and (c)(1) of section 108, as amended by the discussion draft.

[66] For this purpose, the relevant subsections are (b)(2)(E), (b)(5), and (c)(1) of section 108, as amended by the discussion draft.

around the studio or to the building in 2015. The following describes the depreciation deductions allowable to the taxpayer.

Pool 1: The beginning balance of pool 1 is $1,000. The taxpayer acquired a new computer for $2,000 and added it to the pool for a balance of $3,000. The applicable rate of depreciation for assets in pool 1 is 38 percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 1 of $1,140 (0.38 multiplied by $3,000). The $1,140 of depreciation for 2015 is deducted from the balance of pool 1, resulting in a balance of $1,860 for the beginning of 2016.

Pool 2: The beginning balance of pool 2 is $1000. During 2015, the taxpayer sells the light truck for $500 and acquires another for $1500, to be used 100 percent for business use. The balance of pool 2 is reduced by the proceeds of the sale of the old truck and is increased by the basis of the new truck. The pool balance before depreciation is $2000 ($1000 - $500 + $1500). The applicable rate of depreciation for assets in pool 2 is 18 percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 2 of $360 (0.18 multiplied by $2000). The taxpayer recognizes no loss on the sale of the old truck. However, the taxpayer is permitted to continue to recover the remaining basis in the old truck, thus recognizing the loss over time. The $360 of depreciation is deducted from the balance of pool 2, resulting in a balance of $1,640 for the beginning of 2016.

Pool 3: The beginning balance of pool 3 is $1,000. In 2015, the taxpayer sold a violin to an unrelated party for $1,500 and acquired a viola for $1,700. The balance of pool 3 is reduced by the proceeds of the sale of the violin but is increased by the basis of the viola. The pool balance before depreciation is $1,200 ($1,000 - $1,500 + $1,700). The applicable rate of depreciation for assets in pool 3 is 12 percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 3 of $144 (0.12 multiplied by $1,200). The taxpayer recognizes no gain on the sale of the violin. However, the taxpayer is only permitted to depreciate $1,200 of the cost of the viola, rather than $1,700. The $144 of depreciation for 2015 is deducted from the balance of pool 3, resulting in a balance of $1,056 for the beginning of 2016.

Pool 4: The beginning balance of pool 4 is $1,000. The taxpayer has no additions to the pool for 2015. The applicable rate of depreciation for assets in pool 4 is five percent. For 2015, the taxpayer is allowed a deduction for depreciation with respect to pool 4 of $50 (0.04 multiplied by $1,000). The $50 of depreciation for 2015 is deducted from the balance of pool 4, resulting in a balance of $950 for 2016.

The taxpayer is allowed a total deduction for depreciation in 2016 with respect to his trade or business of $1,694 ($1,140 + $360 + $144 + $50).

Special rules

In general, pool balances that are less than zero at year-end ("negative pool balances") give rise to section 1245 gain. As previously discussed, the amount of section 1245 gain recognized is added to the pool balance to restore such pool balance to zero. For example, suppose that the taxpayer in the above example above had not purchased a viola in 2015. The proceeds from the sale of the violin are still subtracted from the balance of pool 3, resulting in a

balance before depreciation of -$500 ($1,000 - $1,500). The $500 negative balance is treated as gain from the disposition of section 168 property for purposes of section 1245. Thus, the taxpayer recognizes $500 of gain as ordinary income. The balance of pool 3 is increased by the amount of gain recognized, restoring the taxpayer's pool balance to zero for the subsequent year's calculation.

Similarly, if there are no assets remaining in a pool at year-end, any positive year-end balance in the pool may be deducted as a terminal loss with respect to that pool. Additionally, a taxpayer may deduct any pool balance at year-end of $1,000 or less ("de minimis balance"). Any amount deducted as a terminal loss or de minimis balance with respect to a pool is an ordinary loss and is subtracted from the pool balance to restore the taxpayer's pool balance to zero for the subsequent year's calculation.

Leasebacks and dispositions to related parties and tax shelters

In the case of pooled property disposed of or transferred to a related person or to a tax shelter, the pool balance is reduced by the lesser of the recomputed basis or the gross proceeds from the sale. The recomputed basis of any pooled property is determined by calculating the pool balance as if such property (including any additions or improvements to such property) had been the only property assigned to such pool since acquisition. A "related person" is related to any other person if the related person bears a relationship to such other person described in section 267(b) or 707(b)(1) or the related person and such other person are engaged in a trade or business under common control (within the meaning of sections 41(f)(1)(A) and (B)).[67] A tax shelter has the meaning given such term in section 461(i)(3).

If a taxpayer continues to use pooled property after its disposition (*e.g.*, sale-lease-back transaction), the pool balance is reduced by the lesser of the recomputed basis (as defined above) or gross proceeds from the sale.

The excess of the fair market value of the property disposed of or transferred over the recomputed basis is treated as section 1245 gain.[68] The purchaser (or transferee) adds the asset to the appropriate pool at its purchase price.

Straight-line property

In the case of straight-line property, costs are recovered ratably (without regard to salvage value) over the applicable recovery period, beginning with the midpoint of the month in which the asset is placed in service. "Straight-line property" is comprised of tangible property classified as real property and any personal-use automobile.

[67] A person is treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the property involved.

[68] For a discussion of section 1245 gain, see Section _12, Rules related to treatment of gains from depreciable property.

Real property

"Real property" is defined as (1) any residential rental property (as defined in section 168(e)(2)(A) prior to the enactment of this provision); (2) any nonresidential real property (as defined in section 168(e)(2)(B) prior to the enactment of this provision); (3) any qualified second generation biofuel plant property (as defined in section in 168(l) prior to enactment of this provision); and any asset treated under Revenue Procedure 87-56[69] as belonging to one of the asset classes in the below. Table 3 includes all assets classified as "real property."

Table 3.−Real Property

Property	Classification[70]
Farm building except structures include in class 01.4	01.3
Single purpose agricultural or horticultural structures	01.4
Railroad structures and similar improvements	40.2
Telephone central office buildings	48.11
Electric utility hydraulic production plant	49.11
Electric utility nuclear production plant	49.12
Electric utility steam production plant	49.13
Electric utility combustion turbine production plant	49.15
Gas utility manufactured gas production plants	49.221
Gas utility substitute natural gas (SNG) production plant (naphtha or lighter hydrocarbon feed stocks)	49.222
Substitute natural gas-coal gasification	49.223
Natural gas production plant	49.23
Liquefied natural gas plant	49.25
Waste reduction and resource recovery plants	49.5

[69] Rev. Proc. 87-56, 1987-2 C.B. 674. Any reference to Rev. Proc. 87-56 shall include any amendment to such revenue procedure (*e.g.*, Rev. Proc. 88-22, 1988-1 C.B. 785).

[70] Except where noted, the classification is based on the asset class categorization provided in Rev. Proc. 87-56, 1987-2 C.B. 674. Any reference to Rev. Proc. 87-56 shall include any amendment to such revenue procedure (*e.g.*, Rev. Proc. 88-22, 1988-1 C.B. 785).

Property	Classification[70]
Municipal wastewater treatment plant	50.0
Residential rental property	Section 168(e)(2)(A)[71]
Nonresidential real property	Section 168(e)(2)(B)[72]
Qualified second generation biofuel plant property	Section 168(l)(2)[73]

The applicable recovery period for real property is 43 years.

A transition rule applicable to all straight-line property (including real property) placed in service in a taxable year beginning before January 1, 2015, provides that the adjusted basis of such real property is depreciated over a term of 43 years reduced by the number of taxable years for which the property has already been depreciated.[74] For example, assume a taxpayer purchased residential rental property for $907,500 and placed such property in service on June 15, 2005. Under the transition rule, for taxable years beginning on or after January 1, 2015, the taxpayer recovers the remaining basis of $594,000[75] over 33 years (43 years minus the 10 years the property has already been depreciated). Thus, the taxpayer is allowed depreciation deductions of $18,000 per year for 33 years (instead of $33,000 for the remaining 17.5 years) for the remaining basis.[76]

[71] The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

[72] The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

[73] The section number refers to an asset defined in such section as in effect for taxable years beginning in 2014.

[74] The first year the real property is placed in service is considered an entire year for purposes of the transition rule. For example, assume a calendar-year taxpayer places real property in service in June of 2012 and begins depreciating such amount. For purposes of the transition, the taxpayer is deemed to have amortized the intangible for four years as of January 1, 2015. Therefore, the remaining basis of the real property as of January 1, 2015 is depreciated over 39 years (43 years minus four years for which the real property had already been depreciated).

[75] Prior to enactment of this provision, the taxpayer would have taken $16,500 (half of $907,500 divided by 27.5 years) of depreciation for the first year and $33,000 of depreciation ($907,500 divided by 27.5 years) for the subsequent nine years (January 1, 2006 to December 31, 2014).

[76] For purposes of this transition rule only, the computation is made as if the remaining basis of the property was placed in service on the first day of the taxable year for which the proposal is effective and disposed of on the last day of the final taxable year in question. If the property is disposed of prior to being fully depreciated, the mid-month convention for determining the depreciation for the year of disposition applies.

Personal-use passenger automobiles

A "personal-use passenger automobile" is defined as any passenger automobile that is used for business less than 100 percent of the time. A passenger automobile for this purpose is any four-wheeled vehicle that is (1) manufactured primarily for use on public streets, roads, and highways and (2) rated at 6,000 pounds unloaded gross vehicle weight or less.[77] Excluded from the definition of a passenger automobile is (1) any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in their trade or business and (2) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire. The applicable recovery period for personal-use passenger automobiles is five years. The amount of depreciation with respect to any personal-use passenger automobile may not exceed $45,000 in total.[78]

The transition rule applicable to all straight-line property (including any personal-use passenger automobile) placed in service in a taxable year beginning before January 1, 2015, provides that the adjusted basis of the personal-use passenger automobile[79] is depreciated over a term of five years reduced by the number of taxable years for which the automobile had already been depreciated.[80]

Assignments, classifications, and modifications

The provision grants the Secretary[81] authority to issue guidance to: (1) reclassify assets (or categories of assets) as real property or as pooled property; (2) reclassify assets (or categories of assets) to different pools; and (3) modify asset classes described in Revenue Procedure 87-56 or create new categories of assets. Any reclassifications or reassignments must be made based on the anticipated useful life and the anticipated decline in value over time of the asset and after taking into account when the asset is technologically or functionally obsolete. Further, in any case where the Secretary makes a modification, the Secretary must publish a schedule reflecting all classifications and assignments (including the modification(s) to such classifications and assignments) for all section 168 property. Such publication is treated as a major rule for purposes of applying chapter 8 of title 5 of the United States Code, the Congressional review of agency rulemaking.

---

[77] In the case of a truck or van, "gross vehicle weight" is replaced with "unloaded gross vehicle weight."

[78] The $45,000 limitation is provided in section 13 of the discussion draft, Limitation on depreciation of personal use passenger automobiles, modifying section 280F.

[79] See section 13 of the discussion draft, Limitation on depreciation of personal use passenger automobiles, for a further discussion of personal-use automobiles.

[80] The first year the personal-use passenger automobile is placed in service is considered an entire year for purposes of the transition rule.

[81] Unless otherwise noted, any reference to the "Secretary" means the Secretary of the Treasury.

Additionally, at least every 10 years, the Secretary in consultation with the Secretary of Commerce (*i.e.*, the Bureau of Economic Analysis),[82] must submit a report to Congress analyzing the classification and assignment of all section 168 property, including the classification of assets as pooled property or real property, assignments of assets to pools, the number of asset pools, the applicable rates for such pools, and the recovery periods for straight-line property.

Business use

Business use percentage

In general, property used in a trade or business less than 50 percent of the time ("personal-use property") is not eligible for depreciation.[83] For property used less than 100 percent of the time (but more than 50 percent of the time), the taxpayer is required to prorate the amount eligible for depreciation (*e.g.*, amount placed in service, amount added to the appropriate pool).[84]

Conversion to personal use

In the case of any property used in a trade or business more than 50 percent of the time ("business-use property") which is converted to personal-use property, the business-use property is treated as disposed of by the taxpayer at fair market value on the day of the conversion. A conversion to personal use results in the recapture of depreciation and gain, to the extent fair market value exceeds basis.[85] The provision provides an exception to the general rule for any conversion to use as a principal residence.

Involuntary conversions

Under the provision, if an involuntary conversion (as defined in section 1033) gives rise to gain (*e.g.*, negative pool balance), a taxpayer may defer the recognition of the gain to the end of the second tax year after the year of the involuntary conversion. Special transition rules apply for involuntary conversions where qualifying replacement property has not been placed in service as of the effective date.

---

[82] It is expected that the Secretary of the Treasury will consult with the Bureau of Economic Analysis within the Commerce Department, which estimates economic depreciation for purposes of the National Income and Product Accounts. The purpose of these estimates is to measure the consumption of fixed capital for purposes of accurately measuring the components of gross domestic product.

[83] See section _14 of the discussion draft, Limitation on depreciation to property predominantly used in a trade or business, for new section 167(i).

[84] *Ibid.*

[85] For pooled property, it is intended that the related party rules requiring the computation of a recomputed basis for the converted personal-use property apply. Authority is granted to the Secretary to provide rules for changes in the business use percentage between 50 percent and 100 percent.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

5. Rules related to treatment of gains from depreciable property (sec. 12 of the discussion draft and secs. 1245 and 1250 of the Code)

Present Law

In general

Upon disposition of most property used in a business with respect to which depreciation or amortization deductions were taken, the treatment of the resulting gain or loss as ordinary or capital depends on whether there is a net gain or a net loss under section 1231. If the netting of gains and losses results in a net gain, then, subject to the depreciation recapture rules, long-term capital gain treatment results.[86] If the netting of gains and losses results in a loss, the loss is fully deductible against ordinary income.[87]

The depreciation recapture rules require taxpayers to recognize ordinary income in an amount equal to all or a portion of the gain realized as a result of the disposition of property. The purpose of the rules is to limit a taxpayer's ability to reduce ordinary income via depreciation deductions and then receive capital gain treatment for the portion of any gain on the disposition of the depreciated property that resulted from the taking of depreciation deductions. There are two regimes that dictate depreciation recapture, sections 1245 and 1250.[88]

Section 1245 property

Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed of at a gain are known as section 1245 property.[89] When a taxpayer disposes of section 1245 property, the taxpayer must recapture the gain on disposition of the property as ordinary income to the extent of earlier depreciation or amortization deductions taken with respect to the asset.[90] Any remaining gain recognized upon the sale of section 1245 property is treated as section 1231 gain.

---

[86] Sec. 1231(a)(1).

[87] Sec. 1231(a)(2).

[88] Cost recovery deductions taken under the Accelerated Cost Recovery System ("ACRS") (for property placed in service after 1980 and before 1987 (before August 31, 1986, if the taxpayer so elected)) generally are subject to recapture; however, properties are not necessarily classified as section 1245 or 1250 property in the same manner as similar properties placed in service before or after ACRS.

[89] Sec. 1245(a)(3).

[90] Sec. 1245(a)(1).

Section 1250 property

Depreciable real property, other than that included within the definition of section 1245 property, disposed of at a gain is known as section 1250 property.[91] Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess of post-1969 depreciation allowances over the depreciation that would have been available under the straight-line method.[92] However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight-line method. Special rules phase out the recapture for certain types of property held over a specified period of time.[93]

For corporations, the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property.[94] For individuals, any capital gain that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property is taxed at a maximum rate of 25 percent.

Additional recapture rules

Recapture rules apply under other cost recovery provisions, including sections 179 and 197. For recapture purposes, an amortizable section 197 intangible is considered section 1245 property and is subject to section 1245 recapture rules.[95]

Recapture rules also apply to certain business credits. For example, if property eligible for an investment tax credit is disposed of, or otherwise ceases to be investment tax credit property (*e.g.*, casualty loss), before the close of the recapture period (five years), the tax for the year is increased by a recapture percentage.[96] Advance rehabilitation and certain energy credits and credits related to certain energy property also are subject to recapture provisions. In addition, in determining the amount of gain that is recaptured as ordinary income under section 1245 or section 1250, the amount of an investment credit downward basis adjustment also is treated as a deduction allowed for depreciation.[97]

---

[91] Sec. 1250(c).

[92] Sec. 1250(a)(1).

[93] Sec. 1250(a)(1)(B). The special phase-out rule applies to residential rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k).

[94] Sec. 291(a)(1).

[95] Sec. 197(f)(7).

[96] Sec. 50(a).

[97] Sec. 50(c)(4).

Explanation of Provision

With respect to pooled property and personal-use passenger automobiles, the provision requires all section 1245 gain (*e.g.*, from sales to related parties, or related to negative pool balances) to be treated as ordinary income. With respect to other section 1245 property (*e.g.*, intangible assets), the provision requires gain to the extent of previously claimed depreciation or amortization to be treated as ordinary income.

With respect to real property, the provision requires gain to the extent of previously claimed depreciation or amortization to be treated as ordinary income.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

6. Limitation on depreciation of personal use passenger automobiles (sec. 13 of the discussion draft and sec. 280F of the Code)

Present Law

Section 280F(a) limits the annual cost recovery deduction with respect to certain passenger automobiles. This limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles placed in service in 2013, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period.[98] This limitation is indexed for inflation and applies to the aggregate deduction provided under present law for depreciation and section 179 expensing.

Basis not recovered in the recovery period of a passenger automobile is allowable as an expense in subsequent taxable years.[99] The expensed amount is limited in each such subsequent taxable year to the amount of the limitation in the fourth year in the recovery period.

The limitation does not apply to the cost of qualified clean burning vehicle property (as defined in section 179A(c)(1)(A)).[100] In the case of a purpose built passenger vehicle (as defined in section 4001(a)(2)(C)(ii)), each annual limitation is tripled.[101]

The special limitation for passenger automobiles is applied before the special depreciation rules for listed property, and before any other reduction in the amount of the deduction allowable under section 168.

---

[98] Rev. Proc. 2013-21, Table 3, 2013-12 I.R.B. 660.

[99] Sec. 280F(a)(1)(B).

[100] Sec. 280F(a)(1)(C)(i).

[101] Sec. 280F(a)(1)(C)(ii).

Explanation of Provision

The provision limits the amount of depreciation that can be claimed related to any personal use passenger automobile. For any automobile used in a trade or business less than 100 percent of the time (but more than 50 percent of the time), the amount placed in service related to such vehicle cannot exceed $45,000.[102] The $45,000 amount must be prorated to reflect only business use of the automobile. For example, assume a taxpayer purchases a new car for $60,000 and will use it in the trade or business 80 percent of the time. The amount placed in service (and deducted ratably over the subsequent five-year period) is $36,000 ($45,000 multiplied by 80 percent).

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

7. Limitation on depreciation to property predominantly used in a trade or business (sec. 14 of the discussion draft and sec. 167 of the Code)

Present Law

In general

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[103] Such a deduction includes recovery of the cost of assets used in a taxpayer's business (*e.g.*, depreciation).[104] However, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use.[105]

Listed property

In the case of certain listed property, special depreciation rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation;[106] (3) any property of a type generally used for purposes of entertainment,

[102] The $45,000 depreciation limit includes any depreciation claimed by a related person with respect to such personal-use passenger automobile.

[103] Sec. 162(a).

[104] See, *e.g.*, section 167.

[105] See, *e.g.*, section 280A.

[106] Property substantially all of the use of which is in a trade or business of providing transportation to unrelated persons for hire is not considered other property used as a means of transportation. Sec. 280F(d)(4)(C).

recreation, or amusement; (4) any computer or peripheral equipment;[107] and (5) any other property of a type specified in Treasury regulations.[108]

First, if for the taxable year in which the property is placed in service, the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.[109] The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.[110] Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.[111] Both limitations apply for purposes of section 179 expensing.

Explanation of Provision

The provision disallows a depreciation deduction for any property used in a trade or business less than 50 percent of the time ("personal-use property"). Further, for property used less than 100 percent of the time (but more than 50 percent of the time), the taxpayer is required to prorate the amount eligible for depreciation (*e.g.*, amount placed in service, amount added to the appropriate pool).

The majority of the general rules for listed property are not changed by this provision. However, the exception for certain computers is modified such that any computer or peripheral equipment used exclusively in the taxpayer's trade or business and owned or leased by the person operating such trade or business is not listed property.[112]

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

---

[107] Computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating such establishment, however, is not listed property. Sec. 280F(d)(4)(B).

[108] Sec. 280F(d)(4)(A).

[109] Sec. 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (*i.e.*, included in gross income) for such taxable year.

[110] Sec. 168(g).

[111] Sec. 280F(d)(3).

[112] For purposes of this sentence, a computer used in a dwelling unit is not treated as used exclusively in a taxpayer's trade or business unless the requirements of section 280A(c)(1) are met with respect to the portion of such dwelling unit in which the computer is located.

8. Repeal of like-kind exchanges (sec. 15 of the discussion draft and sec. 1031 of the Code)

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment if exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment.[113] In general, section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[114]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other property or money, then the gain to the recipient of the other property or money is to be recognized, but not in an amount exceeding the fair market value of such other property or money. Additionally, any gain realized on a section 1031 exchange must be recognized to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250. No losses may be recognized from a like-kind exchange.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred. The basis is increased to the extent of any gain recognized due to the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer. The holding period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.

Explanation of Provision

The provision repeals section 1031, which provides for nonrecognition of gain in the case of like-kind exchanges. However, limited deferral for pooled property is achieved by operation of the pooling regime.[115]

Effective Date

The provision applies to exchanges made in taxable years beginning after December 31, 2014.

---

[113] Sec. 1031(a)(1).

[114] Sec. 1031(a)(2).

[115] For a discussion of the pooling regime, see section _11 of the discussion draft, Pooled asset cost recovery system and depreciation of real property.

9. Election to use financial statement placed in service date (sec. 16 of the discussion draft and sec. 7701 of the Code)

Present Law

Depreciation deduction

The period for depreciation under section 167 begins when the asset is placed in service by the taxpayer.[116] For depreciation based on class lives, property is first placed in service by the taxpayer when "first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity."[117]

In general, an asset is ready and available when the taxpayer needs to take no further steps to realize the intended economic benefit of the asset. For example, where an airport runway was still under construction, but some airplanes were able to take off and land on the unpaved surface, the runway was not placed into service because the unpaved surface could not be used on a permanent basis in the taxpayer's trade or business.[118] In another example, where the taxpayer intended to profit from the sale of electricity generated from incinerating landfill waste, the court held that the relevant inquiry was the plant's operation as a power plant (regardless of whether the power plant reached its expected production capabilities).[119] The actual economic benefit realized does not need to rise to the anticipated economic benefit for an asset to be placed in service.[120]

For assets with multiple component parts, the placed in service determination is made with respect to the facility as a whole. In Revenue Ruling 73-518,[121] the Secretary concluded that a power line, completed in 1970, was not placed in service until 1971 because the "substations, which were necessary parts of the system for the transmission of electricity, were not completed and made available for service until 1971." Conversely, the court concluded in *Madison Newspapers*[122] that where three out of eight planned printing presses were installed and

---

[116] Treas. Reg. sec. 1.167(a)-10(b).

[117] Treas. Reg. sec. 1.167(a)-11(e)(1)(i). However, applicable conventions must be used when determining depreciation under section 168. For example, for property depreciated under section 168 (other than real property), the half-year conventional generally is required. The half-year convention treats all property placed in service during the year as placed in service on the midpoint of such year. For real property, the applicable convention is the mid-month convention whereby all property placed in service during the month is treated as placed in service on the midpoint of such month. Sec. 168(d).

[118] *Noell v. Commissioner*, 66 T.C. 718, 728 (1976).

[119] *Sealy Power, Ltd. v. Commissioner*, 46 F.3d 382 (5th Cir. 1995), nonacq., 1995-2 C.B. 1 (1995).

[120] *Ibid.*

[121] 1973-2 C.B. 54.

[122] *Madison Newspapers, Inc. v. Commissioner*, 47 T.C. 630, 636-37 (1967) ("Madison Newspapers").

"ready for commercial operation," such three printing presses were placed into service. There, the court noted that "there is a marked difference between a half-completed building and a half-completed machine."[123]

Assets the purpose of which is to be ready and available "should the occasion arise" are considered placed in service at acquisition and even if the property is not in fact in use.[124] Treasury regulations give the following examples: [125]

- Taxpayer acquires parts and sets them aside during the taxable year for use as replacements in order to avoid operational time loss.
- Taxpayer acquires operational farm equipment but it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following taxable year.
- Taxpayer acquires operational equipment for a specified assigned function but is undergoing testing to eliminate defects.[126]

In general, property improvements are placed in service when their cost is paid or incurred.[127]

Expenditures paid or incurred to repair property, the cost or other basis of which is eligible to be deducted as an expense, are not treated as placed in service.[128]

Investment credit

For the purposes of the credits allowable under section 38 (for example, the investment credit), an asset is placed in service during the earlier of the taxable year during which depreciation with respect to such property begins, or the "taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity."[129]

---

[123] *Ibid.*

[124] *Connecticut Yankee Atomic Power Co. v. United States*, 38 Fed.Cl. 721, 729 (1997).

[125] Treas. Reg. sec. 1.167(a)-11(e)(1)(i) (citing Treas. Reg. sec. 1.46-3(d)(2)).

[126] But where a Federal regulatory agency required certain "preoperational testing," a hydroelectric plant was not placed in service, even though it was producing electricity throughout the testing. *Consumers Power Company v. Commissioner*, 89 T.C. No. 49 (1987).

[127] Treas. Reg. sec. 1.167(a)-11(e)(1)(iii).

[128] Treas. Reg. sec. 1.167(a)-11(e)(1)(ii).

[129] Treas. Reg. sec. 1.46-3(d)(1)(ii). Although the definition of placed in service is very similar to such definition for the purposes of class life depreciation, the period for depreciation may be different if the taxpayer

Explanation of Provision

The provision provides an election whereby taxpayers may treat property as placed in service on the date it is considered placed in service for purposes of an audited financial statement rather than when first placed in a condition or state of readiness and availability for a specifically assigned function under the tax rules. Such audited financial statement must be certified as being prepared in accordance with generally accepted accounting principles, and must be used for the purposes of a statement or report (1) to shareholders, partners, or other proprietors; (2) to beneficiaries; or (3) for credit purposes.

The election is made on an asset-by-asset basis at a time and in a manner which the Secretary may specify. Once made, the election with respect to an asset is irrevocable.

Effective Date

The provision applies to property placed in service in taxable years beginning after December 31, 2014.

10. Repeal of special amortization rules for pollution control facilities (sec. 17 of the discussion draft and sec. 169 of the Code)

Present Law

In general, a taxpayer may elect to recover the cost of any certified pollution control facility over a period of 60 months.[130] A certified pollution control facility is defined as a new, identifiable treatment facility which (1) is used in connection with a plant in operation before January 1, 1976, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat; and (2) does not lead to a significant increase in output or capacity, a significant extension of useful life, a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility.[131] A certified air pollution control facility placed in service after April 11, 2005 used in connection with an electric generation plant which is primarily coal fired is eligible for 84-month amortization if the associated plant or other property was not in operation prior to January 1, 1976.

For a pollution control facility with a useful life greater than 15 years, only the portion of the basis attributable to the first 15 years is eligible to be amortized over a 60-month or 84-month

---

uses, for example, an averaging convention, the completed contract method, the unit of production method, or the retirement method.

[130] Sec. 169. For purposes of computing alternative minimum taxable income, the depreciation deduction is determined using the straight-line method over the applicable regular tax recovery period.

[131] Sec. 169(d).

period.[132] In addition, a corporation must reduce the amount of basis otherwise eligible for the 60-month or 84-month recovery by 20 percent.[133] The amount of basis not eligible for 60-month or 84-month amortization is depreciable under the regular tax rules for depreciation.

Explanation of Provision

The provision repeals section 169 such that pollution control facilities must be capitalized and amortized in accordance with the general cost recovery provisions under sections 167 and 168.

Effective Date

The provision applies to property placed in service after December 31, 2014.

11. Intangible property (sec. 21 of the discussion draft and secs. 167 and 197 of the Code)

Present Law

In general

Section 167, in general, allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. While section 168[134] provides the specific cost recovery (*i.e.*, depreciation) rules for most tangible assets, section 197 governs the cost recovery (*i.e.*, amortization) for many intangible assets. Cost recovery for tangible and intangible assets not covered by the aforementioned sections is provided by other sections of the Code.[135]

Section 197 intangibles

Under section 197, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years.[136] Such intangibles include goodwill; going concern value; workforce in place including its composition and terms and conditions (contractual or otherwise)

---

[132] The amount attributable to the first 15 years is equal to an amount which bears the same ratio to the portion of the adjusted basis of the facility, which would be eligible for amortization but for the application of this rule, as 15 bears to the number of years of useful life of the facility.

[133] Sec. 291(a)(5).

[134] See section _11 of the discussion draft, Pooled asset cost recovery system and depreciation of real property, for a detailed discussion of section 168.

[135] See, *e.g.*, sections 167 and 195.

[136] Secs. 197(d)(1)(F) and 197(f)(4). A franchise is included in the definition of a section 197 intangible. A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

of its employment; business books and records, operating systems, or other information base; any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item; customer based intangibles; supplier based intangibles; and any other similar item. The definition of a section 197 intangible also includes any license, permit, or other rights granted by governmental units (even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely);[137] any covenant not to compete; and any franchise, trademark, or trade name.

However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not be amortized over the 15-year period provided in section 197, but instead must be amortized over the period of the grant of the right.[138] Certain financial interests,[139] certain computer software readily available for purchase by the general public,[140] and certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof)[141] are not subject to the 15-year amortization. Certain interests under leases and debt instruments,[142] any right to service indebtedness which is secured by residential real property (unless such right is acquired as part of the acquisition of a trade or business, or substantial portion thereof) ("mortgage servicing rights"),[143] and certain transaction costs[144] are not section 197 intangibles. In addition, self-created assets, such as goodwill created through advertising and other expenses, are not subject to section 197.

While mortgage servicing rights are explicitly excluded from section 197, section 167 provides that mortgage servicing rights are depreciated using the straight-line method over a 108-month period.[145]

---

[137] Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197-2(b)(8). A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197-2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197-2(c)(13).

[138] Sec. 197(e)(2). Treas. Reg. sec. 1.197-2(c)(3). An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. Treas. Reg. Sec. 1.197-2(c)(3).

[139] Sec. 197(e)(1).

[140] Sec. 197(e)(3).

[141] Sec. 197(e)(4).

[142] Sec. 197(e)(5).

[143] Sec. 197(e)(6)

[144] Sec. 197(e)(7).

[145] Sec. 167(f)(3).

If there is a disposition of one or more section 197 intangibles acquired in a transaction or series of related transactions (or any such intangible becomes worthless), and one or more other section 197 intangibles acquired in such transaction or series of related transactions are retained, no loss is allowable until all such section 197 intangibles are disposed of, and the basis of those assets are adjusted for any loss not recognized.[146]

Section 197 contains anti-churning rules that apply to prevent pre-section 197 goodwill, going concern value, or any other intangible that would not have been amortizable but for section 197 from being transferred among related parties and becoming eligible for the 15-year amortization.[147]

Other cost recovery provisions

In general

Section 167 provides special rules for some tangible and intangible assets. Specifically, section 167 provides rules with respect to computer software,[148] certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof) that are not governed under section 197, mortgage servicing rights,[149] and geological and geophysical expenditures.[150] The cost of motion picture films, sound recordings, copyrights, books, and patents also are depreciated using the income forecast method (discussed below) under section 167.[151]

Income forecast method

The cost of motion picture films or video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.[152] Under the income forecast method, a property's depreciation deduction for a taxable year is determined

[146] Sec. 197(f)(1).

[147] Sec. 197(f)(9).

[148] Section 167(f)(1) provides that costs of computer software shall be recovered ratably over 36 months.

[149] Section 167(f)(3) provides that costs incurred to obtain mortgage servicing rights shall be recovered ratably over 108 months.

[150] Section 167(h) provides that geological and geophysical ("G&G") expenditures shall be recovered ratably over 24 months. However, major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007.

[151] Section 167(g).

[152] Sec. 167(g)(6). An election under section 167(g)(8) was available for taxable years beginning after December 31, 2005 and before January 1, 2011 which provided a 5-year amortization period (beginning with the month in which the property was placed in service) for certain musical works and copyrights with respect to musical compositions.

by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service.[153] Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in that year.[154]

In general, the adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). An exception to this rule applies to participations and residuals.[155] Solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service (even if economic performance has not yet occurred) if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service. For this purpose, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property.

The inclusion of participations and residuals in adjusted basis beginning in the year the property is placed in service applies only for purposes of calculating the allowable depreciation deduction under the income forecast method. For all other purposes, the general basis rules of sections 1011 and 1016 apply. Thus, in calculating the adjusted basis for determining gain or loss on the sale of income forecast property, participations and residuals are treated as increasing the taxpayer's basis only when such items are properly taken into account under the taxpayer's method of accounting.[156]

Alternatively, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid, consistent with the Associated Patentees[157] decision. This may be done on a property-by-property basis and must be applied consistently with respect to a given property thereafter.

---

[153] Sec. 167(g)(1).

[154] Sec. 167(g)(1)(C).

[155] Sec. 167(g)(7). For property placed in service after October 22, 2004, taxpayers may choose to include participations and residuals in the adjusted basis of the property for the taxable year the property is placed in service.

[156] For example, in the case of participations or residuals to which sections 404(a)(5) or 404(b)(1) apply, such participations or residuals would not increase the taxpayer's basis until the amount is included in the gross income of the participant.

[157] *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.[158]

The look-back method is applied in any recomputation year by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

Certain interests or rights acquired separately

The recovery period for certain interests or rights (*e.g.*, patent or copyright), not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof,[159] is determined by the useful life of the asset to the taxpayer. To the extent a certain interest or right is known to be of use for only a limited period of time, the length of which can be estimated with reasonable accuracy, such an intangible asset may be recovered over the useful life of the asset.[160] For certain interests or rights, a 15-year safe harbor amortization period may be available.

A taxpayer may rely on the 15-year safe harbor amortization period if the length of the useful life cannot be estimated with reasonable accuracy and the amortization period or useful life of the intangible asset is not prescribed or prohibited by any other section of the Code, regulations, or other published guidance.[161] The safe harbor is not available for certain acquired intangibles or created financial interests (whether or not traded on an established market).[162] The safe harbor also is not available for amounts required to be capitalized by Treasury Regulation section 1.263(a)-5 (relating to amounts paid to facilitate the acquisition of a trade or business, a change in the capital structure of a business entity, or similar transactions).[163] A 25-year safe harbor amortization period is available for the intangible benefit arising from the provision,

[158] Sec. 167(g)(2). An exception is allowed under section 167(g)(3) for any property with a cost basis of $100,000 or less.

[159] Secs. 167(f)(2) and 197(e)(4)(B), (C), and (D).

[160] Treas. Reg. sec. 1.167(a)-3(a).

[161] Treas. Reg. sec. 1.167(a)-3(b).

[162] Treas. Reg. sec. 1.167(a)-3(b)(1)(ii).

[163] Treas. Reg. sec. 1.167(a)-3(b)(2).

production, or improvement of real property owned by another.[164] A taxpayer who relies on a safe harbor amortization period amortizes basis in the intangible ratably over such safe harbor period.[165] No amortization is allowable simply because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life.

Explanation of Provision

The provision provides that section 197 intangibles are amortized ratably over a 20-year period beginning with the month in which such intangible was acquired. Under the provision, the exception to the definition of section 197 intangibles for mortgage servicing rights is repealed and mortgage servicing rights are explicitly included in the definition of a section 197 intangible. The provision repeals the section 197 anti-churning rules.

Similar to the transition rule for real property and personal-use passenger automobiles, the adjusted basis of a section 197 intangible placed in service prior to the enactment of this provision is depreciated over a term of 20 years reduced by the number of taxable years for which the intangible had already been amortized.[166]

This provision extends the income forecast recovery from 10 years to 15 years and modifies the recomputation years to be the fifth, tenth, and fifteenth (previously, the third and tenth).

The provision repeals, as deadwood, present-law section 167(g)(8).

The provision also provides direction to the Secretary regarding any safe harbor period provided for certain intangible assets with a limited useful life. Specifically, the provision prevents the Secretary from providing a useful life of less than 20 years. Additionally, the provision directs the Secretary to allow the safe-harbor for amounts paid to facilitate an acquisition of a trade or business, a change in capital structure of a business entity, and other transactions required to be capitalized pursuant to Treas. Reg. section 1.263(a)-5.

Effective Date

With respect to amendments related to the income forecast method, the provision applies to property placed in service after December 31, 2014. For all other amendments, the provision applies to taxable years beginning after December 31, 2014.

---

[164] Treas. Reg. sec. 1.167(a)-3(b)(1)(iv).

[165] Treas. Reg. sec. 1.167(a)-3(b)(3).

[166] The first year the section 197 intangible asset is placed in service is considered an entire year for purposes of the transition rule. For example, assume a calendar-year taxpayer places an amount paid for goodwill in service in March of 2011 and begins amortizing such amount. For purposes of the transition, the taxpayer is deemed to have amortized the intangible for four years as of January 1, 2015. Therefore, the remaining basis of the goodwill as of January 1, 2015 is amortized over 16 years (20 years minus four years for which the intangible had already been amortized).

12. Amortization of research and experimental expenditures (sec. 22 of the discussion draft and sec. 174 of the Code)

Present Law

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[167] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[168] Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[169] Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years.[170]

Amounts defined as research and experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to development or improvement of a product.[171] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[172] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[173] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include

---

[167] Sec. 263(a).

[168] Sec. 174.

[169] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures either are not deductible or are amortizable over a period of not less than 180 days once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize the section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

[170] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime.

[171] Treas. Reg. sec. 1.174-2(a)(1) and (2). Product is defined to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

[172] Treas. Reg. sec. 1.174-2(a)(1).

[173] Treas. Reg. sec. 1.174-2(a)(1).

salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[174] In addition, under administrative guidance, the costs of developing computer software have been accorded similar treatment to research expenditures.[175]

However, generally no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[176] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[177]

Explanation of Provision

Under the provision, amounts defined as research and experimental expenditures are required to be capitalized and amortized over a five-year period, beginning with the midpoint of the taxable year in which the research and experimental expenditures were paid or incurred. Research and experimental expenditures subject to capitalization include expenditures for software development. In the case of retired, abandoned, or disposed property with respect to which research and experimental expenditures are paid or incurred, remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining applicable amortization period.

Under the provision, taxpayers may no longer elect to amortize their research expenditures over a period of 10 years.

Effective Date

The provision applies to expenditures paid or incurred in taxable years beginning after December 31, 2014.

---

[174] Treas. Reg. sec. 1.174-2(a)(1). The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent.

[175] Rev. Proc. 2000-50, 2000-2 C.B. 601.

[176] Sec. 174(c).

[177] Sec. 174(d).

13. Treatment of advertising expenditures (sec. 23 of the discussion draft and new sec. 177 of the Code)

Present Law

Advertising expenses generally are deductible as ordinary and necessary business expenses in the year in which they are paid or incurred.[178] Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and recovered over such useful life.[179]

Explanation of Provision

Under the provision, a taxpayer is required to capitalize and amortize 50 percent of its advertizing expenditures over a five-year period, beginning with the midpoint of the year in which the expenses are paid or incurred. The remaining 50 percent of a taxpayer's advertising expenditures may continue to be deducted in the year paid or incurred (as under present law).

An "advertising expenditure" is defined as any expenditure paid or incurred for the development, creation, or placement of advertising, or for any similar activity with respect to advertising. "Advertising" is defined as any message or other programming material which is broadcast or otherwise transmitted, published, displayed, or distributed, and which promotes or markets any trade or business, service, facility, or product. The term includes messages containing qualitative or comparative language, price information (or other indications of savings or value), an endorsement, or an inducement to purchase, sell, or use any company, service, facility, or product. A single message that contains both advertising and an acknowledgment or other message is advertising. Advertising expenditures include only amounts that would (but for this section) be deductible by the taxpayer for the taxable year under other provisions of the Code. Thus, the determination of amounts that are required to be capitalized under section 263 or other Code sections is not affected by this provision.

The provision provides certain exceptions from the definition of advertising expenditures: (1) any amount paid or incurred with respect to section 168 property (as defined in section 168(b), as modified by this provision) or any intangible asset the costs of which are amortizable over a period of five years or more;[180] (2) any amounts paid to employees and contractors for performing sales functions; (3) any purchase price adjustments, including discounts, promotional pricing, and rebates; and (4) any goods sold or otherwise disposed of by the taxpayer in the ordinary course of business, including sample-sized goods.

---

[178] See sec. 162 and Rev. Rul. 92-80, 1992-2 C.B. 57, September 11, 1992.

[179] See secs. 263, 167, and 168.

[180] It is intended that amortization expenses allowable under other provisions of the Code (*e.g.*, section 167) for periods less than five years are not part of this exception. For example, a taxpayer who pays an amount upfront for a three-year contract to receive advertising services and capitalizes such amount pursuant to section 263(a), includes the amortization of the amount as an advertising expenditure for purposes of this provision.

In the case of retired, abandoned, or disposed property with respect to which advertising expenditures are paid or incurred, remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining applicable amortization period.

Effective Date

The provision applies to expenditures paid or incurred in taxable years beginning after December 31, 2014.

14. Amortization of certain oil, gas, and mining expenditures (sec. 24 of the discussion draft and secs. 167(h), 193, 263(c), 291, 616, and 617 of the Code)

Present Law

In general

A taxpayer generally must capitalize costs that benefit future periods, including certain direct and indirect costs of producing inventory or property used in the taxpayer's business.[181] Capitalized costs may be recovered through depreciation, depletion, cost of goods sold, or upon abandonment or other disposition. However, special rules apply with respect to geological and geophysical costs,[182] qualified tertiary injectant expenses,[183] intangible drilling costs,[184] and mining exploration and development costs.[185]

Amortization period for geological and geophysical costs[186]

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.[187] G&G costs incurred

[181] Secs. 263 and 263A.

[182] Sec. 167(h).

[183] Sec. 193.

[184] Sec. 263(c).

[185] Secs. 616 and 617.

[186] Sec. 167(h).

[187] G&G costs include expenditures for geologists, seismic surveys, gravity meter surveys, and magnetic surveys.

by independent producers and smaller integrated oil companies[188] in connection with oil and gas exploration in the United States generally may be amortized over 24 months.[189]

Major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007 (the date of enactment of the Energy Independence and Security Act of 2007).[190] A major integrated oil company[191] is an integrated oil company which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment, but instead must continue to be amortized over the remaining applicable amortization period.[192]

Expensing of qualified tertiary injectant expenses[193]

Taxpayers engaged in petroleum extraction activities generally may deduct qualified tertiary injectant expenses paid or incurred in connection with a tertiary recovery method, including carbon dioxide augmented waterflooding and immiscible carbon dioxide displacement.[194] The deduction is available even if such costs are otherwise subject to capitalization. The deduction is permitted for the later of: (1) the tax year in which the injectant is injected or (2) the tax year in which the expenses are paid or incurred.[195] No deduction is permitted for expenditures for which a taxpayer has elected to deduct such costs under section

---

[188] Smaller integrated oil companies are those that do not meet the definition of a "major integrated oil company" under section 167(h)(5)(B). Major integrated oil companies are discussed in more detail below.

[189] This amortization rule applies to G&G costs incurred in taxable years beginning after August 8, 2005, the date of enactment of the Energy Policy Act of 2005, Pub. L. No. 109-58. Prior to the effective date, G&G costs associated with productive properties generally were deductible over the life of such properties, and G&G costs associated with abandoned properties generally were deductible in the year of abandonment.

[190] Pub. L. No. 110-140. Prior to the enactment of the Energy Independence and Security Act of 2007, major integrated oil companies were required to amortize G&G costs paid or incurred after May 17, 2006 over five years, as provided in the Energy Tax Incentives Act of 2005, Pub. L. No. 109-222.

[191] Sec. 167(h)(5)(B).

[192] Sec. 167(h)(4).

[193] Sec. 193.

[194] Sec. 193. Prior to the enactment of section 193, the income tax treatment of tertiary injectant costs was unclear. In enacting section 193, Congress sought to clarify the tax treatment and encourage the use of qualified tertiary injectants. See, *e.g.*, Joint Committee on Taxation, *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980* (JCS-1-81), January 29, 1981, pp. 114-115.

[195] Treas. Reg. sec. 1.193-1.

263(c) (intangible drilling costs, discussed below) or if a deduction is allowed for such amounts under any other income tax provision.[196]

A qualified tertiary injectant expense is any cost paid or incurred for any tertiary injectant (other than a recoverable hydrocarbon injectant) that is used as part of a tertiary recovery method.[197] The cost of a recoverable hydrocarbon injectant (which includes natural gas, crude oil, and any other injectant with more than an insignificant amount of natural gas or crude oil) is not a qualified tertiary injectant expense unless the amount of the recoverable hydrocarbon injectant in the qualified tertiary injectant is insignificant.[198]

Expensing of intangible drilling costs[199]

The Code provides special rules for the treatment of intangible drilling and development costs ("IDCs"). Under these special rules, an operator or working interest owner[200] that pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs.[201]

IDCs include all expenditures made by an operator including for wages, fuel, repairs, hauling, and supplies, incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Such work includes labor, fuel, repairs, hauling, and supplies which are used (1) in the drilling, shooting, and cleaning of wells; (2) in the clearing of ground, draining, road making, surveying, and geological works necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items that have a salvage value (such as pipes and casings) or items that are part of the acquisition price of an interest in the property.[202] IDCs also

---

[196] Sec. 193(c).

[197] Sec. 193(b). A tertiary recovery method is any of the nine methods described in section 212.78(c)(1) - (9) of the June 1979 energy regulations, as defined in former section 4996(b)(8)(C), or any other method approved by the IRS.

[198] Sec. 193(b)(2). Treas. Reg. sec. 1.193-1(c)(3) provides that an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

[199] Sec. 263(c).

[200] An operator or working interest owner is defined as a person that holds an operating or working interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting operating or working rights.

[201] Sec. 263(c).

[202] Treas. Reg. sec. 1.612-4(a).

do not include (1) the cost to operators payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and (2) amounts properly allocable to the cost of depreciable property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. In instances where the taxpayer capitalizes its IDCs, any IDCs associated with a nonproductive well ("dry hole") may be deducted at the election of the operator.[203] For an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.[204]

Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred.[205] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. The election also allows a taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax ("AMT").

The election to deduct IDCs applies only to those IDCs associated with domestic properties.[206] For this purpose, the United States includes certain wells drilled offshore.[207]

Pursuant to a special exception, the uniform capitalization rules do not apply to IDCs incurred with respect to oil or gas wells that are otherwise deductible under the Code.[208]

---

[203] Treas. Reg. sec. 1.612-4(b)(4).

[204] Sec. 291(b)(1)(A). The IRS has ruled that, if a company that has capitalized and begun to amortize IDCs over a 60-month period pursuant to section 291 ceases to be an integrated oil company, it may not immediately write off the unamortized portion of the capitalized IDCs, but instead must continue to amortize the IDCs so capitalized over the 60-month amortization period. Rev. Rul. 93-26, 1993-1 C.B. 50.

[205] Sec. 59(e)(1).

[206] In the case of IDCs paid or incurred with respect to an oil or gas well located outside of the United States, the costs, at the election of the taxpayer, are either (1) included in adjusted basis for purposes of computing the amount of any deduction allowable for cost depletion or (2) capitalized and amortized ratably over a 10-year period beginning with the taxable year such costs were paid or incurred. Sec. 263(i).

[207] The term "United States" for this purpose includes the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources (*i.e.*, the Continental Shelf area). Sec. 638.

[208] Sec. 263A(c)(3).

Expensing of mining exploration and development costs[209]

Exploration costs

Taxpayers generally may elect to deduct amounts paid or incurred during the tax year in ascertaining the existence, location, extent, or quality of any deposit of ore, provided the amounts are paid or incurred prior to the beginning of the development stage of the mine.[210] The development stage of a mine typically begins when, based on all relevant facts and circumstances, deposits of ore or other minerals are demonstrated to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.[211] Generally, if mining exploration costs are not expensed, but are capitalized, they may be recovered through depletion or deducted as a loss if the exploration does not result in the acquisition of productive property. For a corporation that has elected to expense mining exploration costs, 30 percent of the exploration costs must be capitalized and amortized over a 60-month period.[212]

Expenditures for the acquisition or improvement of depreciable property may not be deducted under the election; however, depreciation is considered an eligible expenditure. The election may not be made with respect to any oil or gas deposit or any mineral deposit for which a deduction for percentage depletion is not permitted under section 613.[213] Expenditures paid or incurred with respect to mineral deposits located outside of the United States are not eligible for the election, but may, at the election of the taxpayer, be included in depletable basis or, if no such election is made, be deducted ratably over the 10-year period beginning with the taxable year in which the expenditures are paid or incurred.[214]

Expenditures expensed pursuant to the election are subject to recapture when the mine reaches the producing stage.[215] The recapture generally is accomplished through the disallowance of depletion with respect to the mining property that contains the mine until the expensed amounts are recaptured. A taxpayer may instead elect to include in gross income adjusted exploration expenditures for all mines reaching the producing stage during the taxable year.[216] Adjusted exploration expenditures are the amounts for which the taxpayer claimed a

---

[209] Secs. 616 and 617.

[210] Sec. 617(a).

[211] Treas. Reg. sec. 1.617-1(a).

[212] Sec. 291(b)(1)(B).

[213] Sec. 617(a).

[214] Sec. 617(h). For these purposes, the United States includes the 50 states and the District of Columbia, as well as the Continental Shelf Areas adjacent to U.S. territorial waters and over which the United States has exclusive rights regarding exploration and exploitation of natural resources. See, S. Rep. No. 313, 99th Cong., 2d Sess. 282 (1986).

[215] Sec. 617(b).

[216] Sec. 617(b)(1).

deduction under section 617 that would have been included in the basis of the property reduced by the excess of the percentage depletion over the depletion allowable under section 611 had the amounts been capitalized.[217]

Notwithstanding the fact that a taxpayer has made the election to deduct mining exploration costs, the taxpayer is allowed to capitalize and amortize such costs over a 10-year period beginning with the month the expenditure was paid or incurred.[218] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its mining exploration costs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the mining exploration adjustments or preferences under the AMT.

The uniform capitalization rules under section 263A do not apply to mining exploration costs otherwise deductible under section 617.[219]

Development costs

In general, expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) are expensed if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.[220] Development expenditures are amounts paid or incurred after deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.[221]

A taxpayer may elect to treat mining development expenditures paid or incurred during the taxable year as deferred expenses and recognize such amounts ratably as the units of produced ore or minerals benefited by such expenditures are sold. Special rules apply in the case of expenditures paid or incurred during the development stage of the mine that limit the election to the excess of the expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from the mine.

Depreciable property may not be expensed or treated as a deferred expense under section 616, but depreciation may be considered a development expenditure.[222] Expenditures with respect to the development of a mine or other natural deposit (other than an oil, gas, or

---

[217] Sec. 617(f).

[218] Sec. 59(e)(1). See also, section 56(a)(2), which provides that mining exploration and development costs generally are capitalized and amortized ratably over 10 years beginning in the year the costs are paid or incurred for AMT purposes.

[219] Sec. 263A(c)(3).

[220] Sec. 616(a).

[221] Treas. Reg. sec. 1.616-1(a).

[222] Sec. 616(a).

geothermal well) located outside of the United States are deducted ratably over the 10-taxable-year period beginning with the year the expenditures are paid or incurred unless the taxpayer elects to include the expenditures in the depletable basis of the property.[223]

Rules similar to those discussed above with respect to exploration costs apply to limit the deduction for development expenditures for corporations. Thus, a corporation that expenses mining development costs must capitalize 30 percent of the costs and amortize the capitalized costs over a 60-month period.[224] Like mining exploration costs, mining development costs deductible under section 616 are not subject to the uniform capitalization rules under section 263A.[225] Additionally, the special 10-year election under section 59(e) is available for mining development costs to mitigate or eliminate the effect of the AMT preference or adjustment.[226]

Explanation of Provision

The provision repeals present-law expensing for G&G costs, tertiary injectants, IDCs, and mining exploration and development costs by significantly modifying section 193, repealing sections 167(h) and 263(c), and terminating sections 616 and 617.

Specifically, the provision modifies section 193 requiring qualified extraction expenditures to be capitalized and amortized over five years, beginning with the midpoint of the taxable year in which such costs were paid or incurred. "Qualified extraction expenditures" are defined to include G&G costs, tertiary injectants, IDCs, and mining exploration and development costs. In the case of retired, abandoned, or disposed property with respect to which qualified extraction expenditures are paid or incurred, remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining applicable amortization period.

Under the provision, taxpayers may no longer elect to amortize their qualified extraction expenditures over a period other than five years.

Effective Date

The provision applies to expenditures paid or incurred in taxable years beginning after December 31, 2014.

---

[223] Sec. 616(d).

[224] Sec. 291(b)(1)(B).

[225] Sec. 263A(c)(3).

[226] Sec. 59(e)(1). See also, section 56(a)(2), which provides that mining exploration and development costs generally are capitalized and amortized ratably over 10 years beginning in the year the costs are paid or incurred for AMT purposes.

15. Termination of percentage depletion (sec. 25 of the discussion draft and secs. 613 and 613A of the Code)

Present Law

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income. Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction. These include the cost of acquiring the lease or other interest in the property. In certain instances, the cost of land used in production also is recovered through the depletion deduction.

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital. Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit, however, does not acquire an economic interest merely by possessing an economic or pecuniary advantage derived from production through a contractual relation.[227]

Two methods of depletion currently are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[228] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, a percentage, varying from five percent to 22 percent, of the taxpayer's gross income from a producing property is allowed as a deduction in each taxable year.[229] The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[230] Such producers and royalty owners generally may claim percentage depletion at a rate of 15 percent. [231]

---

[227] Treas. Reg. sec. 1.611-1(b).

[228] Secs. 611 - 613.

[229] Sec. 613.

[230] Sec. 613A(c).

[231] Sec. 613A(c)(1).

The amount deducted generally may not exceed 50 percent (100 percent in the case of oil and gas properties) of the taxable income from the property in any taxable year.[232] Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).[233] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire and/or develop the property.[234]

A taxpayer is required to determine the depletion deduction for each property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question.[235]

Limitation on oil and gas percentage depletion to independent producers and royalty owners

As previously stated, percentage depletion of oil and gas properties generally is not permitted, except for independent producers and royalty owners, certain fixed-price gas contracts, and natural gas from geopressured brine. For purposes of the percentage depletion allowance, an independent producer is any producer that is not a retailer or refiner. A retailer is any person that directly, or through a related person, sells oil or natural gas (or a derivative thereof): (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or a derivative thereof) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person.[236]

Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales. Further, if the combined gross receipts of the taxpayer and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year, the taxpayer will not be treated as a retailer.

---

[232] Sec. 613(a).

[233] Sec. 613A(d)(1).

[234] In the case of iron ore and coal (including lignite), a corporate preference reduces the amount of percentage depletion calculated by 20 percent of the amount of percentage depletion in excess of the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Sec. 291(a)(2).

[235] Sec. 613(a).

[236] Sec. 613A(d)(2).

A refiner is any person that directly or through a related person engages in the refining of crude oil in excess of an average daily refinery run of 75,000 barrels during the taxable year.[237]

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.[238] For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated;[239] each group then is treated as one producer in applying the 1,000-barrel limitation.

In addition to independent producers and royalty owners, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), if an interest in a proven oil or gas property was transferred (subject to certain exceptions), the production from such interest did not qualify for percentage depletion.[240] The 1990 Act repealed the limitation on claiming percentage depletion on transferred properties effective for property transfers occurring after October 11, 1990.

Percentage depletion on marginal production

The 1990 Act also created a special percentage depletion provision for oil and gas production from so-called marginal properties held by independent producers or royalty owners.[241] Under this provision, the statutory percentage depletion rate is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than $20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The increased rate applies for the taxpayer's taxable year that immediately follows a calendar year for which the average crude oil price falls below the $20 floor. To illustrate the application of this provision, the average price of a barrel of crude oil for calendar year 1999 was $15.56. Thus, the percentage depletion rate for production from marginal wells was increased to 19 percent for taxable years beginning in 2000. Since the price of oil currently is above the $20 floor, there is no increase in the statutory depletion rate for marginal production.

---

[237] Sec. 613A(d)(4).

[238] Sec. 613A(c).

[239] Sec. 613A(c)(8).

[240] Pub. L. No. 101-508.

[241] Sec. 613A(c)(6).

The Code defines the term "marginal production" for this purpose as domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (*i.e.*, oil that has a weighted average gravity of 20 degrees API or less, corrected to 60 degrees Fahrenheit).[242] A stripper well property is any oil or gas property that produces a daily average of 15 or fewer equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.[243]

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, a taxpayer makes the stripper well property determination for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's interest. If the property satisfies the requirements of a stripper well property, then the benefits of this provision apply with respect to the taxpayer's allocable share of the production from the property. The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

Percentage depletion for hard mineral fossil fuel properties

Percentage depletion is available for taxpayers with an economic interest in a coal mine or other hard mineral fossil fuel property such as lignite or oil shale properties. The depletion rate for coal and lignite is 10 percent.[244] For oil shale, the rate generally is 15 percent, but the

[242] Sec. 613A(c)(6)(D).

[243] Sec. 613A(c)(6)(E).

[244] Sec. 613(b)(4).

rate drops to 7.5 percent for shale used or sold for use in the manufacture of sewer pipe or brick or as sintered or burned lightweight aggregates.[245]

As noted above, the percentage depletion deduction is limited to 50 percent of the taxable income from the property (determined before depletion and the deduction under section 199). Additionally, a corporation's percentage depletion deduction with respect to coal or lignite properties is reduced by 20 percent of the excess of the percentage depletion deduction over the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year).[246]

The excess of percentage depletion over cost depletion is a tax preference in computing a taxpayer's alternative minimum taxable income.[247]

Explanation of Provision

The provision repeals percentage depletion under sections 613 and 613A. Cost depletion, however, remains available under section 611.

Effective Date

Under the provision, section 613 does not apply to mines, wells, and natural deposits placed in service after December 31, 2014; section 613A does not apply to oil and gas wells placed in service after December 31, 2014.

16. Amortization of soil and water conservation expenditures and endangered species recovery expenditures (sec. 26 of the discussion draft and sec. 175 of the Code)

Present Law

Under present law, a taxpayer engaged in the business of farming may treat expenditures that are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, for the prevention of erosion of land used in farming, or made pursuant to a recovery plan under the Endangered Species Act of 1973[248] as expenses that are not chargeable to capital account. Such expenditures are allowed as a deduction, not to exceed 25 percent of the gross income derived from farming during the taxable year.[249] Any excess above such percentage is deductible for succeeding taxable years, not to exceed 25 percent of the gross income derived from farming during each succeeding taxable year.

---

[245] Sec. 613(b)(2)(B) and (5).

[246] Sec. 291(a)(2).

[247] Sec. 57(a)(1).

[248] 16 U.S.C. sec. 1533(f)(B).

[249] Sec. 175.

Explanation of Provision

Under the provision, soil and water conservation expenditures and endangered species recovery expenditures are required to be capitalized and amortized over a 28-year period, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred.

The provision requires gain to the extent of previously claimed amortization to be treated as ordinary income.

Effective Date

The provision applies to expenditures paid or incurred in taxable years beginning after December 31, 2014.

B. Accounting Provisions

1. Limitation on use of cash method of accounting (sec. 51 of the discussion draft and secs. 448 and 471 of the Code)

Present Law

Taxpayers using the cash receipts and disbursements method of accounting (the "cash method") generally recognize items of income when actually or constructively received and items of expense when paid. Taxpayers using an accrual method of accounting generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[250] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the right to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[251] An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.[252]

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust with unrelated business income generally may not use the cash method of accounting. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the "gross receipts test"). The cash method of accounting may not be used by any tax shelter. In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.[253] Such taxpayers generally are required to keep inventories and use an accrual method of accounting with respect to inventory items.[254]

A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees.[255] Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.[256]

---

[250] See, *e.g.*, section 451.

[251] See, *e.g.*, section 461.

[252] See, *e.g.*, section 166.

[253] Treas. Reg. sec. 1.446-1(c)(2).

[254] Sec. 471.

[255] Sec. 448(d)(1).

[256] However, section 447 requires certain farming business to use an accrual method of accounting. For farmers, nurserymen, and florists not required by section 447 to capitalize preproductive period expenses, section

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

Accrual method taxpayers are not required to include in income that portion of any amounts to be received for the performance of services in the fields of health, law, engineering, architecture, accounting actuarial science, performing arts, or consulting, that, on the basis of experience, will not be collected (the "nonaccrual experience method").[257] The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Explanation of Provision

The provision both expands and restricts the universe of taxpayers that may use the cash method of accounting.

Under the provision, the cash method of accounting may only be used by taxpayers that satisfy the gross receipts test, other than tax shelters. In the case of a partnership, S corporation, trust, estate, or other passthrough entity, the gross receipts test applies at the entity level as well as the partner, shareholder, beneficiary, or similar level. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed the applicable dollar amount of $10 million for the three prior taxable-year period to use the cash receipts and disbursements method. This applicable dollar amount is adjusted for inflation in taxable years beginning after 2015.

The provision eliminates the exceptions for farming businesses[258] and qualified personal service corporations. Thus, farming businesses and personal service corporations generally are precluded from using the cash method unless such farming business or personal service corporation satisfies the gross receipts test.

In the case of any taxpayer required by the provision to change its method of accounting for any taxable year, such change is treated as initiated by the taxpayer and made with the consent of the Secretary. If a taxpayer is required to change its method of accounting for any taxable year from the cash method because the taxpayer did not meet the gross receipts test, the taxpayer may not elect to change its method back to the cash method for any of the four taxable years immediately following the taxable year for which such change was first required.

---

352 of the Revenue Act of 1978 (Pub. L. No. 95-600) provides that such taxpayers are not required to inventory growing crops.

[257] Sec. 448(d)(5).

[258] As a conforming amendment, the provision also repeals the exception from the requirement to inventory growing crops provided in section 352 of the Revenue Act of 1978 (Pub. L. No. 95-600).

The provision exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the gross receipts test and that properly elect to use the cash method are not required to keep inventories.[259]

Under the provision, the rules for the nonaccrual experience method are retained and are moved from section 448 to new subsection (j) of section 451.

Effective Date

The provision applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

2. Repeal of special rules for method of accounting for corporations engaged in farming (sec. 52 of the discussion draft and sec. 447 of the Code)

Present Law

A corporation or a partnership with a corporate partner engaged in the trade or business of farming (other than the trade or business of operating a nursery or sod farm or the raising or harvesting of trees (other than fruit and nut trees)) must use an accrual method of accounting for such activities unless such corporation or partnership, for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million.[260] If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change.

Special rules apply for family farm corporations. A provision of the Revenue Act of 1987[261] ("1987 Act") requires a family corporation or a partnership with a family corporation as a partner to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change. The amount of the

[259] Thus, such taxpayers will not be required to use an accrual method by reason of Treas. Reg. sec. 1.446-1(c)(2).

[260] Sec. 447.

[261] Pub. L. No. 100-203.

suspense account is required to be included in gross income if the corporation ceases to be a family corporation.

Explanation of Provision

The provision repeals the special method of accounting rules for corporations and partnerships with a corporate partner engaged in farming under section 447. Thus, taxpayers engaged in the trade or business of farming are subject to the generally applicable rules for methods of accounting.[262]

Effective Date

The provision applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

3. Modification of rules for capitalization and inclusion in inventory costs of certain expenses (sec. 53 of the discussion draft and sec. 263A of the Code)

Present Law

The uniform capitalization rules, which were enacted as part of the Tax Reform Act of 1986,[263] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[264] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

Section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts;[265] such taxpayers are not required to include additional section 263A costs in inventory.

Explanation of Provision

The provision expands the exception from the uniform capitalization rules for certain small taxpayers. Under this provision, a taxpayer that produces real or tangible personal

[262] See, *e.g.*, sections 446 and 448. For a discussion of a provision concerning section 448, see section 51, Limitation on use of cash method of accounting.

[263] Sec. 803(a) of Pub. L. No. 99-514 (1986).

[264] Sec. 263A.

[265] Sec. 263A(b)(2)(B).

property and has $10 million or less of average annual gross receipts[266] is not subject to section 263A.

Effective Date

The provision applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

4. Unification of deduction for start-up and organizational expenditures (sec. 54 of the discussion draft and secs. 195, 248, and 709 of the Code)

Present Law

A taxpayer may elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[267] A corporation or a partnership may elect to deduct up to $5,000 of organizational expenditures in the taxable year in which the active trade or business begins.[268] However, in each case, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000.[269] Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins. Absent an election to deduct and amortize start-up or organizational expenditures, such amounts are properly chargeable to capital and recovered when the business is sold, exchanged, or otherwise disposed.

Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation or the organization of a partnership, are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Explanation of Provision

Under the provision, the rules for start-up expenditures (section 195) and organizational expenditures (sections 248 and 709) are consolidated into a single provision.[270] A taxpayer may

---

[266] The determination of average annual gross receipts for purposes of section 263A is the same as such determination under section 448 (discussed above).

[267] Sec. 195(b)(1)(A).

[268] Secs. 248(a)(1), and 709(b)(1)(A)(ii).

[269] Secs. 248(a)(1)(B), and 709(b)(1)(A). However, for taxable years beginning in 2010, the Small Business Jobs Act of 2010, Pub. L. No. 111-240, increased the amount of start-up expenditures a taxpayer could elect to deduct to $10,000, with a phase-out threshold of $60,000.

[270] The definitions of start-up and organizational expenditures are unchanged by the provision.

elect to deduct up to $10,000 of the sum of start-up and organizational expenditures in the taxable year in which the active trade or business begins. The $10,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of the sum of start-up and organizational expenditures exceeds $60,000. Pursuant to this election, the remainder of start-up and organizational expenditures may be amortized over a period of not less than 20 years, beginning with the midpoint of the taxable year in which the trade or business begins.

Effective Date

The provision applies to expenditures paid or incurred after December 31, 2014.

5. Certain methods of determining inventories not treated as clearly reflecting income (sec. 55 of the discussion draft and secs. 471, 472, 473, and 474 of the Code)

Present Law

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[271] In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the first-in, first-out ("FIFO") method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the last-in, first-out ("LIFO") method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

LIFO

In general

Under the LIFO method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[272] Compared to FIFO, LIFO produces net income that more closely reflects the

[271] Sec. 471(a) and Treas. Reg. sec. 1.471-1.

[272] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year. Sec. 472(b).

difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory generally is not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which the quantity of items sold exceeds purchases.[273]

Dollar-value LIFO

Under a variation of the LIFO method, known as dollar-value LIFO, inventory is measured not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the pooling of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer's method for defining an item, LIFO may be applied to a taxpayer's entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.[274] In doing so, Congress acknowledged that the LIFO method generally is considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.[275]

To qualify for the simplified method, a taxpayer must have average annual gross receipts of $5 million or less for the three preceding taxable years.[276] Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

---

[273] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (an inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

[274] Sec. 474(a).

[275] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514),* (JCS-10-87), May 4, 1987, p. 482.

[276] Sec. 474(c).

Special rules for qualified liquidations of LIFO inventories

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

Lower of cost or market

Treasury regulations provide that taxpayers that maintain inventories under section 471 may determine the value of ending inventory under the cost method or the lower-of-cost-or-market ("LCM") method.[277] Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, subnormal goods, defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to bona fide net selling price, under either the cost or LCM method.

Explanation of Provision

The provision repeals the LIFO inventory accounting method. The provision also repeals the LCM method and prohibits any write down for subnormal goods. Thus, taxpayers valuing their inventory under section 471 generally are not permitted to value their inventory below cost.

Effective Date

The provision applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. Any resulting increase in income may be taken into account ratably over eight taxable years beginning with the first taxable year beginning after December 31, 2014.

6. Application of percentage of completion method to certain long-term contracts (sec. 56 of the discussion draft and sec. 460 of the Code)

Present Law

Percentage-of-completion method

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[278] Under this method, the percentage of

[277] Treas. Reg. sec. 1.471-2(c). Taxpayers valuing their inventory under section 472 (using the LIFO method) must maintain such inventories at cost.

[278] Sec. 460(a).

completion is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs. Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities. The allocation of costs to a contract is made in accordance with regulations.[279]

Upon the completion of a long-term contract, a taxpayer must pay (or receive as a refund) interest computed under the look-back method to the extent that taxes in a prior contract year were underpaid (or overpaid) due to the use of estimated contract price and costs rather than the actual contract price and costs.[280]

A "long-term contract" is defined as any contract for the manufacture, building, installation, or construction of property when such contract is not completed within the same taxable year in which the contract was entered into.[281] However, a contract for the manufacture of property is not considered a long-term contract unless the contract involves the manufacture of (1) any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or (2) any item which normally requires more than 12 calendar months to complete.[282]

Exceptions to the percentage-of-completion method

There are a number of types of long-term contracts excepted from the requirement to use the percentage-of-completion method to compute taxable income: (1) home and residential construction contracts; (2) small construction contracts; and (3) ship construction contracts. For the portion of the long-term contract income excluded from the percentage-of-completion method, taxable income is determined under the taxpayer's exempt contract method. Permissible exempt contract methods include the completed contract method, the exempt-contract percentage-of-completion method, and the percentage-of-completion method.[283]

Home and residential construction contracts

One exception from the requirement to use the percentage-of-completion method is provided for home construction contracts.[284] For this purpose, a "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to

[279] Treas. Reg. sec. 1.460-5.

[280] Sec. 460(b)(2).

[281] Sec. 460(f)(1).

[282] Sec. 460(f)(2).

[283] Treas. Reg. sec. 1.460-4(c)(1).

[284] Secs. 460(e)(1)(A) and (e)(5).

be attributable to the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property with respect to dwelling units and improvements to real property directly related to (and located on the site of) such dwelling units.[285] Thus, long-term contract income must be reported consistently using the taxpayer's exempt contract method.

A partial exception is provided which allows residential construction contracts to use 70/30 percentage-of-completion/capitalized cost method ("PCCM").[286] "Residential construction contracts" are home construction contracts, as defined above, except that the building or buildings being constructed contain more than four dwelling units. Under the 70/30 PCCM, 70 percent of a taxpayer's long-term contract income is required to be computed using the percentage-of-completion method while the remaining 30 percent is exempt from the requirement. The exempt 30 percent of long-term contract income must be reported by consistently using the taxpayer's exempt contract method.

Small construction contracts

Another exception from the requirement to use the percentage-of-completion method is provided for certain construction contracts ("small construction contracts"). Contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer whose average annual gross receipts for the prior three taxable years do not exceed $10 million.[287] Thus, long-term contract income must be reported consistently using the taxpayer's exempt contract method.

Ship construction contracts

Additional exceptions from the requirement to use the percentage-of-completion method are provided for qualified ship construction contracts and qualified naval ship contracts, as defined below. The taxable income from those contracts are allowed to be determined using the 40/60 PCCM. Under the 40/60 PCCM, 40 percent of a taxpayer's long-term contract income is required to be computed using the percentage-of-completion method while the remaining 60 percent is exempt from the requirement.[288] The exempt 60 percent of long-term contract income must be reported consistently using the taxpayer's exempt contract method.

"Qualified ship construction contracts" are defined as any contract for the construction in the United States of not more than five ships if such ships will not be constructed (directly or

[285] Sec. 460(e)(6).

[286] Sec. 460(e)(5).

[287] Sec. 460(e)(1)(B).

[288] Sec. 10203(b)(2)(B) of the Revenue Act of 1987, Pub. L. No. 100-203 (1987) and sec. 708 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

indirectly) for the Federal government and the taxpayer reasonably expects to complete such contract within five years of the contract commencement date.[289]

"Qualified naval ship contracts" are defined as any contract or portion thereof that is for the construction in the United States of one ship or submarine for the Federal government if the taxpayer reasonably expects the acceptance date will occur no later than nine years after the construction commencement date (the date on which the physical fabrication of any section or component of the ship or submarine begins in the taxpayer's shipyard).[290]

Explanation of Provision

The provision repeals the exception from the use of the percentage-of-completion method for determining taxable income from home construction contracts. However, the exception for certain small construction contracts is retained. Thus, taxable income for home contracts generally must be accounted for using the percentage-of-completion method, unless the taxpayer meets the present-law exception for small construction contracts.

The provision amends the small construction contract exception. Specifically, the $10 million average annual gross receipts amount is adjusted for inflation in taxable years beginning after 2015.

The provision also repeals the 40/60 PCCM exception for qualified ship construction contracts and qualified naval ship contracts. Thus, the taxable income under these contracts generally must be accounted for using the percentage-of-completion method.

Effective Date

The provision applies to contracts entered into after December 31, 2014.

[289] Sec. 10203(b)(2)(B) of the Revenue Act of 1987, Pub. L. No. 100-203 (1987).

[290] Sec. 708 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004). Qualified naval ship contracts may only be accounted for using the 40/60 PCCM during the five taxable year period beginning with the taxable year in which construction commences. The cumulative reduction in tax resulting from the provision over the five-year period is recaptured and included in the taxpayer's tax liability in the sixth year.