Tax Law Update

Philip E. Harris
Professor Emeritus
Department of Agricultural and Applied Economics
University of Wisconsin-Madison

Part One: Legislative Update

Part Two: Regulatory Update
Tangible Property Regulations

Part One: Legislative Update

I. Introduction

A. Division Q of H.R. 2029, the Protecting Americans from Tax Hikes Act of 2015, (Pub. L. 114-113, December 18, 2015) (PATH Act) and Division P of H.R. 2029, the Consolidated Appropriations Act, 2016 (Pub. L. 114-113, December 18, 2015) (CAA of 2016) were passed by the House and Senate and signed by the President on December 18, 2015.

B. The legislation extends retroactively for 2015 and makes permanent, at their 2014 levels, numerous taxpayer benefits that had expired at the end of 2014.

C. This outline summarizes selected provisions of the legislation and includes a table of tax provisions that were set to expire before this legislation was enacted. It reports whether those provisions were extended by this legislation, the new expiration date, if any, and whether the provision was modified.

II. Individual Taxpayer Credits

A. Additional Child Tax Credit [I.R.C. § 24; PATH Act § 101]

1. Effective for tax years beginning after December 18, 2015.

2. Taxpayers generally may claim a $1,000 credit for each dependent child under age 17. It is not adjusted for inflation.

3. All or a portion of the child tax credit becomes refundable if the allowable credit exceeds the individual's tax liability and he or she has earned income exceeding $3,000.

4. This provision was set to revert to $10,000 at the end of 2017. The PATH Act makes the $3,000 threshold permanent.

B. Earned Income Credit [I.R.C. § 32; PATH Act § 103]

1. Effective for tax years beginning after December 31, 2015.

2. The EIC provisions that increased the income ranges for phasing out the credit on joint returns and increased the credit amount for three or more qualifying children were set to expire at the end of 2017. The PATH Act makes them permanent.

3. As under prior law, the income phaseout ranges are adjusted for inflation. Figure 1 reports the phaseout ranges for MFJ returns for 2015 and 2016.

FIGURE 1. Earned Income or AGI Phaseout Ranges for MFJ Returns

Qualifying Children	2015 Phaseout Range	2016 Phaseout Range
None	$13,750–$20,330	$13,750–$20,430
One	$23,630–$44,651	$23,630–$44,846
Two	$23,630–$49,974	$23,630–$50,198
Three or more	$23,630–$53,267	$23,630–$53,505

C. Hope Scholarship Credit [I.R.C. § 25A; PATH Act § 102]

1. Effective for tax years beginning after December 18, 2015.

2. The American opportunity credit—an enhanced Hope credit—is permanent.

3. The credit can be up to $2,500, and 40% of it can be refundable.

4. Certain required materials and supplies continue to be eligible expenses.

5. The credit continues to be available with respect to an individual student for 4 years, provided that the student has not completed the first 4 years of post-secondary education before the beginning of the fourth taxable year.

D. Residential Energy Credits

1. Energy Efficiency Building Envelope Component [I.R.C. § 25C; PATH Act § 181]

    a. Effective for property placed in service after December 31, 2014; the modification to the credit applies to property placed in service after December 31, 2015.

    b. The 10% credit for qualified energy efficiency improvements to the taxpayer's main home is limited to $500 for all tax years after 2005, and the credit for windows is limited to $200 for all tax years after 2005.

    c. The PATH Act extends the credit for 2 years, through December 31, 2016. Additionally, it modifies the efficiency standard to require that windows, skylights, and doors meet Energy Star 6.0 standards.

2. Residential Energy Efficient Property Credit for Solar Property [I.R.C. § 25D; CAA of 2016 § 304(a)]

    a. Effective January 1, 2017.

    b. Individual taxpayers are allowed a personal tax credit, known as the residential energy efficient property (REEP) credit, for expenditures for installing certain energy-efficient property in the taxpayer's residence.

c. The CAA of 2016 extends the REEP credit for 5 years, so that it applies to property placed in service before January 1, 2022, but only for qualified solar electric property expenditures and qualified solar water heating property expenditures.

d. It does not extend the REEP credit for fuel cell property, wind energy property, and geothermal heat pump property, which expires for property placed in service after December 31, 2016.

e. The credit rate for qualified solar electric property expenditures and qualified solar water heating property expenditures remains at 30% through 2019, but is then reduced to 26% for 2020 and 22% for 2021.

E. Vehicle-Related Energy Credits [I.R.C. §§ 30C and 30D; PATH Act §§ 182 and 183]

1. Effective for property placed in service in 2015 and 2016.

2. The 30% credit (limited to $1,000 for nondepreciable property and $30,000 for depreciable property) for the cost of non-hydrogen qualified alternative fuel vehicle refueling property is reinstated for 2015 and 2016.

3. The PATH Act reinstates the qualitied plug-in electric vehicles credit for electric motorcycles acquired in 2015 and 2016 (but not 2014). The credit for electric 3-wheeled vehicles is not extended.

III. Individual Taxpayer Deductions and Exclusions

A. Deductions

1. State and Local Sales Taxes [I.R.C. § 164; PATH Act § 106]

a. Effective for tax years beginning after December 31, 2014.

b. Taxpayers who itemize deductions may choose between deducting state and local general sales taxes and deducting state and local income taxes. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have a state income tax, but this option can also benefit some residents of other states.

2. Mortgage Insurance Premiums [I.R.C. § 163(h)(3)(E); PATH Act § 152]

a. Effective for amounts paid or accrued after December 31, 2014.

b. The PATH Act extends the deduction for private mortgage insurance premiums for 2 years (with respect to contracts entered into after December 31, 2006). Thus, the extension applies to amounts paid or accrued in 2015 and 2016 (and not properly allocable to any period after 2016).

3. Qualified Conservation Easements [I.R.C. § 170(b); PATH § 111]

a. Generally effective for contributions made in tax years beginning after December 31, 2014; the modification for contributions by certain Native Corporations is effective for contributions made in tax years beginning after December 31, 2015.

b. Qualified farmers and ranchers who enter into qualified conservation easements continue to be eligible to deduct the easement's value up to 100% of their contribution base (generally, their AGI), with a 15-year carryover period.

i. Other individuals have a 50% limitation, with the same 15-year carryover.

ii. Without the PATH Act changes, all donors would have a 30% limitation and a 5-year carryover period for contributions in 2015 and thereafter.

Example 1. Charitable Contribution Limit

Barb and Guy Wire are married and have $110,000 of AGI on their joint return every year and donate $10,000 to qualified charities every year. During 2016 they also donated a $400,000 qualified conservation easement to their local land trust commission.

If Barb and Guy are qualified farmers, they can claim a $110,000 (100% of $110,000) charitable contribution deduction on their 2016 income tax return and carry the remaining $300,000 ($410,000 – $110,000) forward for 15 years subject to the 100% of AGI limit in those years. Therefore, they can deduct their $10,000 charitable contribution and $100,000 of the carryover in each of the next 3 years.

If Barb and Guy are not qualified farmers, they can claim a $55,000 (50% of $110,000) charitable contribution deduction on their 2016 income tax return and carry the remaining $355,000 ($410,000 – $55,000) forward for 15 years subject to the 50% of AGI limit in those years. Therefore, they can deduct their $10,000 charitable contribution and $45,000 of the carryover in each of the next 7 years and the remaining $40,000 [$355,000 – ($45,000 × 7 years)] in the 8th year.

Without the PATH Act changes, Barb and Guy could claim a $33,000 (30% of $110,000) charitable contribution deduction on their 2016 income tax return and carry the remaining $377,000 ($410,000 – $33,000) forward for 5 years subject to the 0% of AGI limit in those years. Therefore, they could deduct their $10,000 charitable contribution and $23,000 of the carryover in each of the next 5 years. They could never deduct remaining $262,000 [$377,000 – ($23,000 × 5 years)].

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c. The term qualified farmer or rancher for this provision means a taxpayer whose gross income from the trade or business of farming is greater than 50% of the taxpayer's total gross income for the tax year. Farming is defined by reference to the estate tax special-use-valuation election (Notice 2007-50, 2007-25 I.R.B. 1430). It includes

   i. Cultivating the soil, or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm

   ii. Handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity

   iii. Planting, cultivating, caring for, or cutting trees, or the preparation (other than milling) of trees for market [I.R.C. § 2032A(e)(5)]

Example 2. Gross Income from Farming

Hugh and Alice Ryder are married and file a joint return for 2016. Hugh earned a $45,000 off-farm salary, and they have $1,200 of interest income, a $2,500 capital loss on the sale of stock, a $4,000 gain on the sale of a raised mare used for breeding, and a $3,500 ordinary gain on the sale of a used tractor. Their farm income on line 9 of Schedule F (Form 1040) is $40,000 from the sale of crops from their land, and they sold $65,000 of timber. **Figure 2** shows their tax return income, their total gross income, and their gross income from farming.

As indicated in Figure 2, the $2,500 capital loss is not included in gross income. The $3,500 I.R.C. § 1245 depreciation recapture gain from the tractor sale is included in total gross income, but it is not gross income from farming.

If the timber proceeds were not gross income from farming, Hugh and Alice would have only $44,000 of gross farm income [$40,000 from Schedule F (Form 1040) and $4,000 from the sale of the mare], and less than 50% of their total gross income would be from farming. However, I.R.C. § 2032A(e)(5) includes the $65,000 sale of timber as farm income. Therefore, more than 50% of the Ryder's gross income is from farming ($109,000 ÷ $158,700 = 68.7%), and they are qualified farmers for purposes of I.R.C. § 170(b)(1)(E)(iv)(I).

FIGURE 2. TOTAL GROSS INCOME AND GROSS INCOME FROM FARMING

Income Item	Tax Return Income	Total Gross Income	Gross Income from Farming
Off-farm salary	$ 45,000	$ 45,000	
Interest income	1,200	1,200	
Capital loss on stock	(2,500)		
Farm income	40,000	40,000	$ 40,000
Gain on sale of mare	4,000	4,000	4,000
Gain on sale of used tractor	3,500	3,500	
Sale of timber	65,000	65,000	65,000
Total	$156,200	$158,700	$109,000

Example 3. Income from Training Horses

Lew and Chelsea Driver have the same income items that are shown in Figure 2, but their Schedule F (Form 1040) does not include sales of crops on line 11. Instead, Chelsea uses their farm to train horses for other individuals, resulting in $40,000 of gross income in 2016.

Because I.R.C. § 2032A(e)(5) defines farming as including cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including raising, shearing, feeding, caring for, training, and managing animals) on a farm, the $40,000 gross income from training horses is included in gross income from farming. Thus, the Drivers are qualified farmers for using the 100% contribution base for charitable contributions of conservation easements.

d. For contributions made in tax years beginning after December 31, 2015, the PATH Act also includes special rules for qualified conservation contributions by certain Native Corporations.

   i. For this purpose, the term Native Corporation has the meaning given such term by section 3(m) of the Alaska Native Claims Settlement Act.

   ii. In the case of any qualified conservation contribution that is made by a Native Corporation and is a contribution of property that was land conveyed under the Alaska Native Claims Settlement Act, a deduction for the contribution is allowed to the extent that the aggregate amount of such contributions does not exceed the excess of 100% of the taxpayer's taxable income over the amount of all other allowable charitable contributions.

   iii. Any excess may be carried forward for up to 15 years as a contribution subject to the 100% limitation.

   iv. The provision shall not be construed to modify the existing property rights validly conveyed to Native Corporations under the Alaska Native Claims Settlement Act.

4. Qualified Tuition Deduction [I.R.C. § 222; PATH Act § 153]

   a. Effective for tax years beginning after December 31, 2014.

   b. The qualified tuition deduction for up to $4,000 of tuition and fees paid for attendance at any level of post-secondary education is extended to amounts paid before 2017.

B. Exclusions from Gross Income

1. Cancellation of Home Mortgage Debt [I.R.C. § 108; PATH Act § 151]

   a. Generally applies to discharges of indebtedness after December 31, 2014. The provision relating to discharges pursuant to a binding written agreement applies to discharges of indebtedness after December 31, 2015.

   b. The PATH Act extends the exclusion from gross income for discharges of qualified principal residence indebtedness for 2 additional years (through December 31, 2016). It also provides for an exclusion from gross income for taxpayers whose qualified principal residence indebtedness was discharged on or after January 1, 2017, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2017.

2. Charitable Donations from IRAs [I.R.C. § 408(d)(8); PATH Act § 112]

   a. Effective for distributions made in tax years beginning after December 31, 2014.

   b. Otherwise taxable IRA distributions from a traditional or Roth IRA are excluded from gross income to the extent they are qualified charitable distributions. The exclusion may not exceed $100,000 per taxpayer per tax year.

3. Transit Assistance [I.R.C. § 132(f); PATH Act § 105]

   a. Effective for months after December 31, 2014.

   b. The PATH Act reinstates parity in the exclusion for combined employer-provided transit pass and vanpool benefits and for employer-provided parking benefits and makes parity permanent. Thus, for 2015, the monthly limit on the exclusion for combined transit pass and vanpool benefits is $250, the same as the monthly limit on the exclusion for qualified parking benefits. Similarly, for 2016 and later years, the same monthly limit will apply on the exclusion for combined transit pass and vanpool benefits and the exclusion for qualified parking benefits.

   c. In order for the extension to be effective retroactive to January 1, 2015, expenses incurred for months beginning after December 31, 2014, and before December 18, 2015, by an employee for employer-provided vanpool and transit benefits may be reimbursed (under a bona fide reimbursement arrangement) by employers on a tax-free basis to the extent they exceed $130 per month and are no more than $250 per month.

   d. It is intended that the rule that an employer reimbursement is excludible only if vouchers are not available to provide the benefit continues to apply, except in the case of reimbursements for vanpool or transit benefits between $130 and $250 for months beginning after December 31, 2014, and before December 18, 2015.

   e. Further, it is intended that reimbursements of the additional amount for expenses incurred for months beginning after December 31, 2014, and before December 18, 2015, may be made in addition to the provision of benefits or reimbursements of up to the applicable monthly limit for expenses incurred for months beginning after December 18, 2015.

IV. Business Deductions

A. Cost Recovery Deductions

1. I.R.C. § 179 Expensing [I.R.C. § 179; PATH Act § 124]

    a. Generally effective for tax years beginning after December 31, 2014; the modifications apply to tax years beginning after December 31, 2015.

    b. The PATH Act provides that the maximum amount a taxpayer may expense, for tax years beginning after 2014, is $500,000 of the cost of qualifying property placed in service for the tax year.

    c. 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 tax year exceeds $2,000,000.

    d. The $500,000 and $2,000,000 amounts are indexed for inflation for tax years beginning after 2015.

    e. In addition, the PATH Act makes permanent the treatment of off-the-shelf computer software as qualifying property.

    f. It also makes permanent the treatment of qualified real property as eligible section 179 property.

    g. For tax years beginning after 2015, the PATH Act strikes the flush language in I.R.C. § 179(d)(1) that excludes air conditioning and heating units from the definition of qualifying property.

    h. The PATH Act also makes permanent the rule that allows a taxpayer to revoke any election, and any specification of property to be expensed contained therein, made under I.R.C. § 179 without the consent of the Commissioner.

2. Bonus Depreciation [I.R.C. § 168(k); PATH Act § 143]

    a. Generally effective for property placed in service after December 31, 2014. In tax years ending after such date; the modifications relating to bonus depreciation apply to property placed in service after December 31, 2015, in tax years ending after such date; the modifications relating to the election to accelerate AMT credits in lieu of claiming bonus depreciation generally apply to tax years ending after December 31, 2015.

        i. For a tax year beginning before January 1, 2016, and ending after December 31, 2015, a transitional rule applies for purposes of determining the amount eligible for the election to claim additional AMT credits. The transitional rule applies the present-law limitations to property placed in service in 2015 and the revised limitations to property placed in service in 2016.

        ii. The provision relating to certain plants bearing fruits and nuts is effective for specified plants planted or grafted after December 31, 2015.

    b. Additional first-year depreciation

        i. The PATH Act extends and modifies the additional first-year depreciation deduction for 5 years, generally through 2019 (through 2020 for certain longer-lived and transportation property). The percentage is phased down from 50% by 10% per calendar year beginning in 2018 (2019 for certain longer-lived and transportation property). Thus, for qualified property (other than certain longer-lived and transportation property) the percentage for property placed in service in 2018 is 40% and for 2019 is 30%. These percentages apply to certain longer-lived and transportation property placed in service 1 year later.

ii. The $8,000 increase amount in the limitation on the depreciation deductions allowed with respect to certain passenger automobiles is phased down from $8,000 by $1,600 per calendar year beginning in 2018. Thus, the I.R.C. § 280F increase amount for property placed in service in 2018 is $6,400, and for 2019 is $4,800. The increase does not apply to a taxpayer who elects to accelerate AMT credits in lieu of bonus depreciation for a tax year.

iii. After 2015, the PATH Act allows additional first-year depreciation for qualified improvement property without regard to whether the improvements are property subject to a lease, and also removes the requirement that the improvement must be placed in service more than 3 years after the date the building was first placed in service.

iv. The PATH Act also extends the special rule for the allocation of bonus depreciation to a long-term contract for 5 years to property placed in service before January 1, 2020 (January 1, 2021, in the case of certain longer-lived and transportation property).

c. Special rules for certain plants

i. The PATH Act provides an election for certain plants bearing fruits and nuts.

ii. Under the election, the applicable percentage of the adjusted basis of a specified plant that is planted or grafted after December 31, 2015 and before January 1, 2020, is deductible for regular tax and AMT purposes in the year planted or grafted by the taxpayer, and the adjusted basis is reduced by the amount of the deduction.

iii. The percentage is 50% for 2016, and then is phased down by 10% per calendar year beginning in 2018. Thus, the percentage for 2018 is 40%, and for 2019 is 30%.

iv. A specified plant is any tree or vine that bears fruits or nuts, and any other plant that will have more than one yield of fruits or nuts and generally has a preproductive period of more than 2 years from planting or grafting to the time it begins bearing fruits or nuts.

v. The election is revocable only with the consent of the Secretary, and if the election is made with respect to any specified plant, such plant is not treated as qualified property eligible for bonus depreciation in the subsequent tax year in which it is placed in service.

d. Benefits of the New Legislation

i. The new legislation not only allows farmers who elect out of the UNICAP rules to claim bonus depreciation they previously could not claim; it also allows farmers (whether or not they elect out of the UNICAP rules) to claim the bonus depreciation in the year the plants are planted instead of the year the plants are placed in service.

ii. Deducting the bonus depreciation in an earlier year has two benefits.

a) As with any deduction allowed in an earlier year, it allows the taxpayer to reap the benefit of the deduction in an earlier year, which postpones paying taxes in most cases.

b) Deducting bonus depreciation in an earlier year also allows farmers to avoid the phase-out of the bonus depreciation for plants that were planted before 2018 but will not be placed in service until 2018 or a later year.

Example 4. Elected Out of UNICAP

Franny Smith elected out of the UNICAP rules in the first year she planted fruit trees because she did not want to bother with accounting for her preproductive period expenses. Consequently, she must use the ADS to depreciate all of her depreciable assets used in farming. **Figure 3** reports the cost of planting and maintaining fruit trees that she planted in May 2016 and that will be placed in service in October 2018.

FIGURE 3. Costs for New Fruit Trees

Amounts paid in 2016		
Cost of planting trees		
Cost of trees	$32,000	
Cost of support posts	8,000	
Spray and fertilizer	3,000	
Labor for planting	4,000	
Total cost of planting trees		$47,000
Maintenance cost after planting		7,000
2017 maintenance costs		12,000
2018 maintenance costs		
Before trees were placed in service		9,000
After trees were placed in service		3,000

Because Franny elected out of the UNICAP rules, she is required to use the ADS depreciation on all of her depreciable assets and she does not qualify for the general bonus depreciation. She does qualify for the elective bonus depreciation on the cost of planting the trees.

Franny elected to expense the $8,000 cost of the support posts under I.R.C. § 179. Because the posts are necessary for the growing process to begin and were not used for any other purpose in 2016, the entire $8,000 cost recovery for the posts in 2016 must be capitalized into the adjusted basis of the trees as a planting expense (preparatory cost).

Practitioner Note

ADS Depreciation of Posts

If Franny did not elect the section 179 deduction for part or all of the cost of the posts, she must use the ADS to depreciate the remaining basis. The ADS depreciation for 2016 would be capitalized into the adjusted basis of the trees (along with any section 179 deduction) as a planting expense.

ADS depreciation on the posts after 2016 and before October 2018 would be a preproductive period expense that she would deduct because she elected out of capitalizing preproductive period expenses. ADS depreciation after September 2018 would be deducted as an expense incurred while the trees are productive.

Elective Bonus Depreciation

Franny can elect to deduct $23,500 ($47,000 × 50%) of bonus depreciation in 2016 for the trees she planted that year. That election reduces her basis in the trees to $23,500 ($47,000 – $23,500). Because Franny elected out of the UNICAP rules, she deducts her $7,000 cost of maintaining the trees in 2016 after they were planted.

For 2017, Franny deducts the $12,000 cost of maintaining the trees.

In 2018, Franny can expense part or all of the $23,500 remaining basis in the trees under I.R.C. § 179 subject to the limitations for that deduction. After reducing her basis in the trees by her section 179 deduction, Franny must use ADS to depreciate the remaining basis. Franny cannot claim bonus depreciation when her trees are placed in service in 2018 for two reasons. One is that she is required to use ADS (because she elected out of the UNICAP rules). The second reason is that she elected bonus depreciation for the trees when she planted them in 2016. Franny also deducts the $12,000 of maintenance costs in 2018.

No Elective Bonus Depreciation

If Franny forgoes the elective bonus depreciation in 2016, she capitalizes her $47,000 planting costs into the basis of the trees. She deducts her $7,000 cost of maintaining the trees after they were planted.

For 2017, Franny deducts the $12,000 cost of maintaining the trees.

In 2018, Franny can expense part or all of the $47,000 basis in the trees under I.R.C. § 179 subject to the limitations for that deduction. Because Franny elected out of the UNICAP rules, she is required to use the ADS depreciation and she cannot claim bonus depreciation for the trees. Therefore, after reducing her basis in the trees by her section 179 deduction, Franny must use ADS cost recovery on the remaining basis. She also deducts the $12,000 of maintenance costs.

Example 5. Did Not Elect Out of UNICAP

Franny's neighbor, Mabel Delicious, planted exactly the same number of fruit trees in 2016 and incurred the same costs as Franny. However, Mabel likes accounting and did not elect out of the UNICAP rules. Mabel is not required to use ADS depreciation, which allows her to use bonus depreciation on all of her depreciable assets and allows her to choose it for the cost of planting trees either at the time they are planted or when they become productive. She has several options for recovering the cost of her depreciable assets.

Mabel also elected to expense the $8,000 cost of the support posts under I.R.C. § 179. Because the posts are necessary for the growing process to begin and were not used for any other purpose in 2016, the entire $8,000 cost recovery for the posts in 2016 must be capitalized into the adjusted basis of the trees as a planting expense (preparatory cost). (See the Practitioner Note on preparatory costs earlier in this issue.)

Practitioner Note

Depreciation of Posts

If Mabel did not elect the section 179 deduction for the posts or for only part of the cost of the posts, the remaining basis is eligible for bonus and MACRS depreciation. The bonus and/or MACRS depreciation for 2016 would be capitalized to the adjusted basis of the trees along with any section 179 deduction as a planting expense.

Mabel would capitalize MACRS depreciation on the posts in 2017 and through September of 2018 (the end of the preproductive period) because she did not elect out of capitalizing preproductive period expenses. She would add the capitalized MACRS depreciation to the adjusted basis of the trees, and begin depreciating the trees when they are placed in service in October 2018. She would deduct MACRS depreciation on the posts after September 2018 as an expense incurred while the trees are productive.

Elective Bonus Depreciation

Because she is subject to the UNICAP rules, Mabel must capitalize not only the cost of planting her trees but also the cost of maintaining them until they are placed in service in October 2018. However, she elected to deduct $23,500 ($47,000 × 50%) of bonus depreciation in 2016 and reduced her basis in the trees by that amount. She adds her $7,000 cost of maintaining the trees in 2016 after they were planted to the basis of the trees.

In 2017, Mabel cannot deduct any costs for her trees because they are subject to the UNICAP rules. She adds $12,000 of maintenance costs to the adjusted basis of her trees.

Mabel can begin depreciating her trees when they are placed in service in October 2018. She calculates her $51,500 adjusted basis in the trees when they are placed in service as shown in **Figure 4**. The trees do not qualify for bonus depreciation because Mabel elected bonus depreciation when she planted them in 2016. They do qualify for the section 179 deduction and MACRS (10-year 150% DB; 10-year SL; or 20-year SL) depreciation.

She also deducts the $3,000 cost of maintaining the trees after they were placed in service.

FIGURE 4. Basis of Trees with Bonus Depreciation Election

Remaining planting costs	$23,500
2016 maintenance costs	7,000
2017 maintenance costs	12,000
2018 maintenance costs	
Before trees were placed in service	9,000
Adjusted basis in trees	$51,500

No Elective Bonus Depreciation

If Mabel did not elect to deduct bonus depreciation in 2016, she capitalizes her $47,000 cost of planting the trees and the $7,000 spray and fertilizer costs into her adjusted basis in the trees.

In 2017, Mabel cannot deduct any costs for her trees because they are subject to the UNICAP rules. She adds $12,000 of maintenance costs to the adjusted basis of her trees.

Mabel can begin depreciating her trees when they are placed in service in October 2018. She calculates her $71,000 adjusted basis in the trees when they are placed in service as shown in **Figure 5**. The trees qualify for the section 179 deduction, the 40% bonus depreciation, and MACRS (10-year 150% DB; 10-year SL; or 20-year SL) depreciation.

She also deducts the $3,000 cost of maintaining the trees after they were placed in service.

FIGURE 5. Basis of Trees without Bonus Depreciation Election

Planting costs	$47,000
2016 maintenance costs	7,000
2017 maintenance costs	12,000
2018 maintenance costs	
Before trees were placed in service	9,000
Adjusted basis in trees	$75,000

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Planning Pointer

Increasing Adjusted Basis of Plants

As Examples 4 and 5 illustrate, farmers can increase the adjusted basis of plants that are eligible for the elective bonus depreciation by choosing a more rapid cost recovery method for assets that are placed in service in the year the plants are planted and used to plant the plants. Such assets include support posts, trellises, irrigation systems, equipment, and machinery. If the assets are eligible, the famer could choose the section 179 deduction, bonus depreciation, and/or the most rapid MACRS depreciation in the year of planting to increase the cost recovery deductions that are capitalized into the adjusted basis of the plant.

3. MACRS Recovery Periods

   a. 15-Year Property [I.R.C. § 168(e)(3)(E); PATH Act § 123]

      i. Effective for property placed in service after December 31, 2014.

      ii. Buildings and building improvements that are qualified leasehold improvement property, qualified retail improvement property, or qualified restaurant property are 15-year property for the MACRS General Depreciation System (GDS).

      iii. The PATH Act makes the provision permanent.

   b. Motorsports Entertainment Property [I.R.C. § 168(i)(15)(D); PATH Act § 166]

      i. Effective for property placed in service after December 31, 2014.

      ii. Motorsports entertainment facilities are not included in a specific asset class under MACRS, but 2004 legislation temporarily provided a 7-year recovery period. This benefit is extended for qualifying property placed in service through 2016.

   c. Indian Reservation Property [I.R.C. § 168(j); PATH Act § 167]

      i. Generally effective for property placed in service after December 31, 2014; the modification providing an election out of I.R.C. § 168(j) applies to tax years beginning after December 31, 2015.

      ii. Depreciation deductions for certain MACRS property used predominantly in the active conduct of a trade or business property within an Indian reservation are determined using the recovery periods shown in Figure 6.

FIGURE 6. Recovery Periods for Indian Reservation Property

Property Class	Recovery Period
3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

iii. The PATH Act extends the accelerated depreciation for qualified Indian reservation property for 2 years to apply to property placed in service on or before December 31, 2016.

iv. It also provides that a taxpayer may annually make an irrevocable election out of I.R.C. § 168(j) on a class-by-class basis for qualified Indian reservation property placed in service in tax years beginning after December 31, 2015.

4. Biofuel Plant Property [I.R.C. § 168(l); PATH Act § 189]

   a. Effective for property placed in service after December 31, 2014.

   b. References to second generation biofuel replace references to cellulosic biofuel in I.R.C. § 168. Second generation biofuel is defined as liquid fuel derived by or from any qualified feedstocks if the fuel meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under the Clean Air Act (42 U.S.C. 7545).

   c. The allowance of the 50% AFYD and an exemption from an alternative minimum tax depreciation adjustment are extended through 2016.

B. Educator's Expense Deduction [I.R.C. § 62(a)(2)(D); PATH Act § 104]

1. Generally effective for tax years beginning after December 31, 2014; modification is effective for tax years beginning after December 31, 2015.

2. School employees working with children in grades kindergarten through 12 may deduct up to $250 each year of substantiated out-of-pocket expenses for classroom materials as an adjustment to gross income.

3. The PATH Act made the provision permanent beginning in 2015.

4. For tax years beginning after December 31, 2015, qualifying expenses include qualifying professional development expenses and the $250 limit is indexed for inflation.

C. S Corporation Provisions

1. Basis Adjustment of S Corporation Stock [I.R.C. § 1367; PATH Act § 115]

   a. Effective for contributions made in tax years beginning after December 31, 2014.

   b. Under prior law, if an S corporation donated appreciated property to charity during its tax years beginning after 2011 and before 2015, each shareholder's basis in the corporation was reduced by only his or her pro rata share of the corporation's basis in the property, rather than by the property's fair market value.

   c. The PATH Act makes that provision permanent.

2. Built-in Gains Lookback Period [I.R.C. § 1374; PATH Act § 127]

   a. Effective for tax years beginning after December 31, 2014.

   b. The PATH Act makes the 5-year lookback rule permanent.

   c. Under current Treasury regulations, these rules, including the five-year recognition period, also would apply to REITs and RICs that do not elect "deemed sale" treatment.

D. Enhanced Deduction for Donation of Food [I.R.C. § 170(e); PATH Act § 113]

1. Generally effective for contributions made after December 31, 2014; the modifications to increase the corporate percentage limit and to provide for presumptions relating to basis and valuation are effective for tax years beginning after December 31, 2015.

2. Under former law, taxpayers that operated on the cash basis, or otherwise were not required to maintain inventory accounts, had a zero basis in their food inventory, and could not claim a charitable contribution deduction for donations of food inventory.

3. Under the new law, if the taxpayer does not account for inventory under I.R.C. § 471 and is not required to capitalize indirect costs under I.R.C. § 263A, the taxpayer may elect, solely for computing the enhanced deduction for food inventory, to treat the basis of any apparently wholesome food as being equal to 25% of the fair market value (FMV) of such food. This provision allows many cash basis taxpayers, including farmers, to claim a deduction for such contributions.

4. Previously, the IRS often contested the market value of the contribution when the taxpayer did not sell the inventory because of internal standards of the taxpayer, lack of market, or because the taxpayer produced the inventory exclusively for the purposes of transferring the food to an organization described in I.R.C. § 501(c)(3). Under the PATH Act, FMV is determined without regard for such considerations and must be based on the price at which similar food items are sold by the taxpayer at, or about, the time of the contribution.

5. For tax years beginning after December 31, 2015, the PATH Act modifies the enhanced deduction for food inventory contributions by:

   a. Increasing the charitable percentage limitation for food inventory contributions and clarifying the carryover and coordination rules for these contributions

      ii. The 10% of net income limitation applicable to taxpayers other than C corporations is increased to 15%.

      iii. For C corporations, these contributions are made subject to a limitation of 15% of taxable income (as modified).

a) The general 10% for a C corporation does not apply to these contributions, but the 10% limitation applicable to other contributions is reduced by the amount of these contributions.

b) Qualifying food inventory contributions in excess of these 15% limitations may be carried forward and treated as qualifying food inventory contributions in each of the 5 succeeding tax years in order of time.

b. Including a presumption concerning the tax basis of food inventory donated by certain businesses. If the taxpayer does not account for inventory under I.R.C. § 471 and is not required to capitalize indirect costs under I.R.C. § 263A, the taxpayer may elect, solely for computing the enhanced deduction for food inventory, to treat the basis of any apparently wholesome food as being equal to 25% of the fair market value of such food.

c. Including presumptions that may be used when valuing donated food inventory for apparently wholesome food that cannot or will not be sold solely by reason of internal standards of the taxpayer, lack of market, or similar circumstances, or by reason of being produced by the taxpayer exclusively for the purposes of transferring the food to an organization described in I.R.C. § 501(c)(3). The fair market value of such contribution shall be determined

i. without regard to such internal standards, such lack of market or similar circumstances, or such exclusive purpose, and

ii. by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contributions (or, if not so sold at such time, in the recent past).

Example 6. Cash Basis Individual

Daisy Dogood raises broccoli. In July of 2016 Daisy had more broccoli than she could sell at her farm market. She donated the excess to a local soup kitchen that qualifies as an I.R.C. § 501(c)(3) organization. Her net income from the farm business was $7,150 for the year. If Daisy had been able to sell the broccoli at her stand, the inventory would have sold for $280. Daisy is not required to maintain inventories.

Daisy's tax basis in the broccoli for purposes of the contributed food inventory deduction is $70 (25% of the $280 FMV). Assuming the broccoli is wholesome food, Daisy's charitable contribution deduction is calculated as the lesser of:

1. Her $70 basis plus ½ of the $210 ($280 – $70) profit that she would have realized, which is $175 [$70 + (½ × $210)], or
2. Two times her $70 basis, which is $140.

Her deduction is limited to 15% of the net income from the business (15% × $7,150 = $1,072). Daisy's $140 deduction is less than 15% of her net business income, and she can include the $140 as a charitable contribution on her Schedule A (Form 1040), Itemized Deductions. Daisy must aggregate the deduction with any other charitable contributions Daisy made and it is subject to the overall 50% of AGI limit on contributions to public charities.

Practitioner Note

Non-deductible Contribution of Food Inventory

If Daisy had instead given the broccoli to a local nonprofit environmental organization that was having a fund-raising dinner, she would not be entitled to a deduction. The donee must also use the property for the care of the ill, the needy, or infants. Daisy would determine her deduction under the general rules for charitable contributions and the FMV of the contribution would be reduced by any ordinary income that would have been generated had the property been sold. Because Daisy has no basis in the food inventory, her ordinary income would equal, and therefore completely offset, the FMV of the contribution.

V. Business Credits

A. Research Credit [I.R.C. § 41; PATH Act § 121]

1. The provision to make the research credit permanent applies to amounts paid or incurred after December 31, 2014. The provision to allow the research credit against AMT and the provision to allow the research credit against FICA taxes are effective for tax years beginning after December 31, 2015.

2. The credit for research activities is reinstated for 2015 and made permanent. It includes:

   a. the general research credit, which is equal to 20% of the amount by which the taxpayer's qualified research expenses for a tax year exceed its base amount for that year;

   b. the simplified alternative credit, which is equal to 14% of qualified research expenses that exceed 50% of the average qualified research expenses for the 3 preceding tax years;

   c. the basic research credit, which is equal to 20% of the excess of:

      i. 100% corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over

      ii. The sum of:

         a) the greater of two minimum basic research floors plus

         b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.

   d. the energy research credit, which applies to all qualified expenditures, not just those in excess of a base amount.

3. For tax years beginning after December 31, 2015, the PATH Act also modifies the research credit to:

   a. allow an eligible small business to offset both regular tax and AMT liabilities with the credit; and

   b. allow a qualified small business to elect to claim a certain amount of its research credit as a payroll tax credit against its employer FICA tax liability, rather than against its income tax liability.

B. Work Opportunity Credit [I.R.C. § 51; PATH Act § 142]

1. Generally effective for individuals who begin work for the employer after December 31, 2014; the provision relating to wages paid to qualified long-term unemployment recipients is effective for individuals who begin work for the employer after December 31, 2015.

2. The PATH Act extends for 5 years the present-law employment credit provision (through tax years beginning on or before December 31, 2019).

3. Additionally, the PATH Act expands the work opportunity tax credit to employers who hire individuals who are qualified long-term unemployment recipients.

a. For purposes of the provision, such persons are individuals who have been certified by the designated local agency as being in a period of unemployment of 27 weeks or more, which includes a period in which the individual was receiving unemployment compensation under state or federal law.

b. With respect to wages paid to such individuals, employers would be eligible for a 40% credit on the first $6,000 of wages paid to such individual, for a maximum credit of $2,400 per eligible employee.

C. Reservist Pay Credit [I.R.C. § 45P; PATH Act § 122]

1. Generally effective after December 31, 2014; the provision making the credit available to employers of any size applies to tax years beginning after December 31, 2015.

2. Employers who make differential wage payments may take a 20% credit for those payments. Differential payments compensate reservists called to active duty for all or part of the difference between their private-sector wages and their earnings from the U.S. military.

3. The PATH Act reinstates the 20% credit for 2015 and makes it permanent.

4. It also permanently modifies the credit by making it available to an employer of any size, rather than only to eligible small business employers.

D. Business Energy Credits [I.R.C. §§ 40, 40A, 45, 45L, 48, 6426, and 6427; PATH Act §§ 184, 185, 186, 187, 188, and 192]

1. Generally effective for tax years beginning after December 31, 2014

2. The extensions through 2016 include the following business energy credits:

a. Production of cellulosic biofuel (with cultivated algae, cyanobacteria, and lemna added as qualifying feedstocks)

b. Production of biodiesel and renewable biodiesel (excise and income tax credits)

c. Production of electricity from Indian coal and from renewable resources (with some modifications, including the exclusion of paper that is segregated for recycling)

d. Construction or production of energy-efficient homes (with updated construction standards)

e. Manufacture of energy-efficient appliances

f. Production of alternative fuels and alternative fuel mixtures (excise tax credit)

E. Other Credits

1. Low-Income Housing [I.R.C. § 42; PATH Act § 131

a. Effective on January 1, 2015

b. The PATH Act makes permanent the 9% minimum applicable percentage for newly constructed non-Federally subsidized buildings.

2. Exclusion of Military Housing Allowance for Low-income Housing Allowance [I.R.C. § 42(d); PATH Act § 132]

a. Effective as if included in the enactment of § 3005 of the Housing Assistance Tax Act of 2008

b. The PATH Act makes permanent the special rule that the military basic housing allowance is not included in income for purposes of the low-income housing credit income eligibility rules.

3. Indian Employment Credit [I.R.C. § 45A; PATH Act § 161]

a. Effective for tax years beginning after December 31, 2014

b. The Indian employment credit is available to businesses located on Indian reservations that hire unrelated members of the tribe who live on or near the reservation and perform services at the business on the reservation.

c. The PATH Act extends the credit for 2 years (through tax years beginning on or before December 31, 2016).

VI. Table of Expiration Dates

A. Several provisions in the Internal Revenue Code were previously subject to a sunset date. Legislation has extended some of those sunset dates and made some of those provisions permanent.

B. The first column of Figure 7 lists the Internal Revenue Code section for each provision, in numerical order. The second column reports the section of the PATH Act or CCA of 2016 that extended the provision. The third column briefly describes the provision. The last column reports the date the provision expired or will expire or "None" if there is no sunset date.

FIGURE 7. Expiration Dates of Tax Provisions

I.R.C. Section	Act §	Description	Expiration Date
		Business and Personal Credits	
24	PATH 101	Additional child tax credit: Reduction of the earnings threshold from $10,000 to $3,000 for refundable portion of the credit	None
25A	PATH 102	American opportunity tax credit	None
25C	PATH 181	Credit for nonbusiness energy property*	2016
25D	CAA 304(a)	Credit for residential energy property*	2022
30B(a)	PATH 193	Alternative motor vehicle credit for qualified fuel cell motor vehicles	2016
30C	PATH 182	Alternative fuel vehicle refueling property credit	2016
30D	PATH 183	New qualified plug-in electric drive motor vehicle credit	2016
32(b)(3)(A)	PATH 103	Earned income tax credit: 45% for 3 or more qualifying children	None
32(b)(3)(B)	PATH 103	Earned income credit increase beginning and ending income levels for joint returns by $5,000 indexed after 2009	None
35	Not Extended	Health coverage tax credit	2019
40(b)(6)(H)	PATH 184	Second-generation biofuel producer credit	2016
40A(a)	PATH 185	Income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agribiodiesel producers	2016
40A(f)	PATH 185	Income tax credits for renewable diesel fuel and renewable diesel used to produce a qualified mixture	2016
41	PATH 121	Tax credit for research and experimentation expenses*	None
42	PATH 131	Determination of low-income housing credit rate for credit allocations with respect to non–federally subsidized buildings	None
42(d)	PATH 132	Low-income housing credit treatment of military basic housing allowances	None
45	PATH 187	Beginning-of-construction date for renewable power facilities eligible to claim the electricity production credit	2016
45(e)(10)	PATH 186	Credit for production of Indian coal	2016

45A	PATH 161	Indian employment tax credit	2016
45D	PATH 141	New markets tax credit	2019
45G	PATH 162	Railroad track maintenance credit	2016
45J	Not Extended	Placed-in-service date for eligibility for the credit for production from certified advanced nuclear power facilities	2020
45L	PATH 188	Credit for constructing new energy-efficient homes	2016
45N	PATH 163	Mine rescue team training credit	2016
45P	PATH 122	Employer wage credit for payments to activated military reservists*	None
48(a)(5)	PATH 187	Election to claim energy credit in lieu of electricity production credit	2016
48(a)(6)	PATH 303	Increased credit for business solar energy property	2022
51	PATH 142	Work opportunity tax credit	2019
		Income and Deductions	
54E	PATH 164	Allocation of bond cap for qualified zone academy bonds	2016
62(a)(2)(D)	PATH 104	Educator deduction (kindergarten–grade 12)*	None
108	PATH 151	COD income exclusion for discharge of principal residence debt	2016
132(f)	PATH 105	Parity for income exclusion of employer-provided mass transit and parking benefits	None
163(h)(3)(E)	PATH 152	Mortgage insurance premium deduction as qualified residence interest	2016
164(b)	PATH 106	Deduction for state and local general sales taxes	None
168(e)(3)(A)	PATH 165	3-year depreciation for race horses 2 years old or younger	2016
168(e)(3)(E)	PATH 123	15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant property, and qualified retail improvements	None
168(i)(15)(D)	PATH 166	7-year recovery period for motorsports entertainment complexes	2016
168(j)	PATH 167	Accelerated depreciation for Indian reservation property*	2016
168(k)	PATH 143	50% additional first-year depreciation (AFYD)	2019
168(k)(4)	PATH 143	Election to accelerate alternative minimum tax credits in lieu of AFYD	2019
168(l)	PATH 189	Special depreciation allowance for second generation biofuel plant property	2016
170(b)	PATH 111	Special rules for charitable contributions of conservation easements*	None
170(e)	PATH 113	Enhanced charitable deduction for contributions of food inventory*	None
179	PATH 124	Increase in expensing limits to $500,000/$200,000 and expansion of definition of eligible property to qualified real property*	None
179D(h)	PATH 190	Energy-efficient commercial buildings deduction	2016
179E	PATH 168	Election to expense advanced mine safety equipment	2016
181(f)	PATH 169	Special expensing rules for film and television productions*	2016
199	PATH 170	Domestic production activities deduction for activities in Puerto Rico	2016
213	Not Extended	7.5% adjusted gross income (AGI) floor for individuals age 65 and older for medical expenses	2016
222	PATH 153	Deduction for qualified tuition and related expenses	2016
408(d)(8)	PATH 112	Tax-free distributions from IRAs for charitable purposes	None
		Employer Plans	
420	Not Extended	Transfer of excess pension assets to retiree health and life insurance accounts	2025

431	Not Extended	Automatic amortization extension for multiemployer defined benefit pension plans	2014
432	Not Extended	Additional funding rules for multiemployer defined benefit pension plans in endangered or critical status	2014
Pub. L. No. 109-280, §§ 201, 221**	Not Extended	Deemed approval of adoption, use, or cessation of shortfall funding method for multiemployer defined benefit pension plans	2014
		Accounting Methods, Corporations, and Other Provisions	
451(i)	PATH 191	Special rule for sales or dispositions to implement FERC or state electric restructuring policy	2016
512	PATH 114	Modification of tax treatment of certain payments to controlling exempt organizations	None
871	PATH 125	Treatment of certain regulated investment company (RIC) dividends	None
897(h)(4)(A)	PATH 133	RIC qualified investment entity treatment for FIRPTA	None
953, 954	PATH 128	Active financing exceptions under subpart F	None
954(c)(6)	PATH 144	Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules	2019
1202	PATH 126	100% exclusion for qualified small business stock	None
1367	PATH 115	Basis adjustment to stock of S corporations making charitable contributions of property	None
1374	PATH 127	Reduced recognition period for S corporation built-in gains tax	None
		Zone and Disaster Area Incentives	
1391, 1394,	PATH 171	Designation of empowerment zones and related provisions for exclusion for gain on qualified small business stock, tax-exempt bonds, employment credit, increased section 179 expensing, and nonrecognition of gain on rollover of investments	2016
1400L	Not Extended	New York Liberty Zone tax-exempt bond financing	2013
Pub. L. No. 110-343, § 702**	Not Extended	Extension of replacement period for nonrecognition of gain for areas damaged by 2008 Midwestern severe storms, tornadoes, and flooding	2013
		Excise Taxes	
4041, 4081	Not Extended	All but 4.3¢ per gallon of the taxes on highway gasoline, diesel fuel, kerosene, and alternative fuels	09/30/2022
4041	Not Extended	Reduced rate of tax on partially exempt methanol or ethanol fuel	09/30/2022
4043	Not Extended	Surtax on fuel used in aircraft in a fractional ownership program	09/30/2021
4051	Not Extended	Tax on retail sale of heavy highway vehicles	09/30/2022
4071	Not Extended	Tax on heavy truck tires	09/30/2022
4041, 4042, 4081	Not Extended	Leaking Underground Storage Tank Trust Fund financing rate	09/30/2022
4081	Not Extended	All but 4.3¢ per gallon of taxes on noncommercial aviation kerosene and noncommercial aviation gasoline	09/30/2022

4121	Not Extended	Black Lung Disability Trust Fund: Increase in amount of excise tax on coal	12/31/2018
4191	PATH 174	Suspension of medical device excise tax	2017
4261	Not Extended	Domestic and international air passenger ticket taxes and ticket tax exemption for aircraft in fractional ownership aircraft programs	09/30/2015
4271	Not Extended	Air cargo tax	3/31/2016
4481	Not Extended	Annual use tax on heavy highway vehicles	09/30/2023
4611	Not Extended	Oil Spill Liability Trust Fund financing rate	12/31/2017
6426	Not Extended	Excise tax credits for liquefied hydrogen fuel mixtures	09/30/2014
6426, 6427	Not Extended	Excise tax credits and outlay payments for liquefied hydrogen	09/30/2014
6426, 6427	PATH 192	Excise tax credits and outlay payments for alternative fuels, alternative fuel mixtures, biodiesel fuel mixtures, and renewable diesel fuel mixtures	2016
7652(f)	PATH 172	Temporary increase in limit on excise tax revenues on distilled spirits (from $10.50 to $13.25 per proof gallon) covered into the treasuries of Puerto Rico and the Virgin Islands	2016
Pub. L. No. 109-432 § 119**	PATH 173	Extension of American Samoa economic development credit	2016

* The provision is modified as well as extended.

** This provision was not included in the Internal Revenue Code.

Part Two: Regulatory Update

Tangible Property Regulations

I. Introduction

A. Final regulations [T.D. 9636, 2013-43 I.R.B. 331] provide new rules affecting all taxpayers that acquire, produce, or improve tangible property. The new rules are generally taxpayer-friendly and provide much needed clarity for deciding whether costs are currently deductible or must be capitalized and depreciated. Some safe harbors simplify the application and implementation of the new rules for both small and large business taxpayers.

B. The final regulations retain many provisions from the temporary and proposed regulations, but a few favorable surprises were added that create a number of new safe harbors. The most significant changes include

1. refined criteria for defining betterments and restorations to tangible property,

2. an increase in the dollar ceiling for treating an item of property as materials and supplies from $100 to $200,

3. an annual election of a revised and simplified de minimis safe harbor up to $5,000 for taxpayers with an applicable financial statement (AFS) and up to $2,500 for small business taxpayers without an AFS that allows a current deduction for the acquisition or production of units of tangible property [Treas. Reg. § 1.263(a)-1(f)],

4. a revised routine maintenance safe harbor that includes buildings,

5. an annual election that allows small business taxpayers to deduct some building improvement costs along with their repair and maintenance costs, and

6. an annual book conformity election for all taxpayers to capitalize repair and maintenance costs that are also capitalized on the taxpayer's books.

> **Observation**
>
> Elections Can Provide Timing Certainty
>
> Some taxpayers will not need to make any of the new elections. However, when the taxpayer and tax practitioner are not certain whether a small (or sometimes large) amount paid is currently deductible (that is, whether the item acquired or produced is a material or supply or the work done qualifies as a repair or maintenance) or whether the amount paid must be capitalized (that is, whether the item acquired or produced is a depreciable asset or the work done qualifies as a depreciable improvement), the safe harbors can provide audit protection and thus some peace of mind.

II. Background

A. I.R.C. § 263(a) generally requires capitalization of amounts paid to acquire, produce, or improve tangible property, whereas I.R.C. § 162 allows a current deduction for ordinary and necessary business expenses, including costs for materials, supplies, repairs, and maintenance.

B. Determining whether an expenditure is currently deductible or whether it must be capitalized and depreciated requires a careful examination and thorough understanding of all the particular facts and circumstances related to the nature of the taxpayer's particular industry and its business operations.

III. De Minimis Safe Harbor

A. The final tangible property regulations include a de minimis safe harbor that allows taxpayers to elect to deduct the cost of tangible property, rather than recovering the cost through depreciation expense.

B. The de minimis safe harbor increases a farm client's ability to expense the purchase cost of livestock and small equipment.

C. Under the Treas. Reg. § 1.263(a)-1(f)(1) de minimis safe harbor, a taxpayer can take a current-year deduction (when the cost is paid or incurred) for the acquisition or production of units of tangible property that cost less than a specified amount, even if I.R.C. § 263(a) would require the taxpayer to capitalize the cost, or if Treas. Reg. § 1.162-3 would require the taxpayer to deduct the amount paid when the property is first used or consumed in the business.

1. Thus, a farm client may be able to deduct otherwise capitalizable expenditures under the safe harbor.

2. However, for a farmer who intends to later sell the property at a gain, electing the de minimis safe harbor may increase the tax owed on the later sale.

D. Although the taxpayer's accounting procedures can set any dollar limit for expensing, the per item tax deduction is limited to $2,500 for taxpayers without an applicable financial statement (AFS) and $5,000 for taxpayers with an AFS.

1. Therefore, if the accounting procedure sets a threshold that exceeds $2,500 ($5,000 for taxpayers with an AFS), only the items that cost $2,500 ($5,000) or less qualify for the safe harbor.

2. For farmers, the safe harbor is particularly useful to expense small equipment and livestock held for productive use, such as animals held for dairy or breeding.

Practitioner Note

Increased De Minimis Amount

Notice 2015-82 increased the de minimis amount for taxpayers without an AFS from $500 to $2,500 for tax years beginning on or after January 1, 2016.

3. When a taxpayer properly applies the de minimis safe harbor, the amount paid is not treated as a capital expenditure or as materials and supplies.

   a. Instead the taxpayer deducts the amount under Treas. Reg. § 1.162-1, provided the expense otherwise constitutes an ordinary and necessary business expense.

   b. Any subsequent gain on disposition of the property is ordinary income (it is not an I.R.C. § 1221 disposition of a capital asset or property used in a trade or business under I.R.C. § 1231) [Treas. Reg. § 1.263(a)-1(f)(3)(iii)], so in some situations, it may be preferable to not elect to expense the property under the de minimis safe harbor.

Example 7. Sale of Equipment

In 2016, Sandy Crop paid $2,450 for a welder. She does not have an AFS but does have an accounting procedure under which she must expense items if their cost is $2,500 or less. If Sandy elected the de minimis safe harbor for 2016 she *must* expense the $2,450 she paid for the level.

Question 1

Sandy later sells the welder for $2,800. How does she report that sale?

Answer 1

The level has no tax basis. The full $2,800 sale price is ordinary income and reported on line 10 of Form 4797, Sales of Business Property.

Question 2

How does Sandy report the sale if she claimed a $2,450 section 179 deduction rather than making the de minimis election?

Answer 2

The level is no longer subject to the de minimis safe harbor rules and therefore is section 1245 property. Sandy would still have a $2,800 gain, but I.R.C. § 1245 recaptures as ordinary income only the amount of gain created by prior depreciation deductions (including section 179 deductions). Sandy would report $2,450 as ordinary income (the section 179 deduction) and the remaining $350 would be I.R.C. § 1231 gain. Sandy's net I.R.C. § 1231 gains for the year are taxed as capital gain.

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Example 8. Sale of Livestock

Dan Dairyman has an accounting procedure that requires him to deduct the cost of any item he purchased for $1,000 or less. In 2016, he bought young heifers, which he raised to become part of his milking herd. The animals cost $600 each. He used his full $500,000 section 179 deduction in 2016 to expense the cost of a new milking facility. Dan elected the de minimis safe harbor and expensed the young heifers on his 2016 tax return.

Dan raised the heifers to milking age and 3 years later he sold them for $1,000 each because he had insufficient room in his dairy barn. The $1,000 gain on each heifer is ordinary income.

If Dan did not elect to expense the original purchase price of the heifers under the de minimis safe harbor, the gain on the sale of the heifers is eligible for preferential tax treatment under I.R.C. § 1231. The gain treated as ordinary income is limited to the amount of depreciation taken after the animals were placed in service.

____

Observation

Self-Employment Tax

Property expensed under the de minimis safe harbor is not I.R.C. § 1231 property. If it is not property that must be included in inventory and is not held for sale in the ordinary course of business, the taxpayer must report a sale of the property on line 10 of Form 4797 as ordinary income. The income from the sale does not meet the test for self-employment income and, even though it is ordinary income, the taxpayer does not report the income on Schedule C (Form 1040), Profit or Loss From Business, or Schedule F (Form 1040), Profit of Loss From Farming, where it would be subject to self-employment tax.