

## Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(d)–1: Applicable conventions—half-year and mid-quarter conventions.

T.D. 9091

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### Special Depreciation Allowance

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the depreciation of property subject to section 168 of the Internal Revenue Code (MACRS property) and the depreciation of computer software subject to section 167. Specifically, these regulations provide guidance regarding the additional first year depreciation allowance provided by sections 168(k) and 1400L(b) for certain MACRS property and computer software. The regulations reflect changes to the law made by the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. The text of these temporary regulations also serves as the text of the proposed regulations (REG–157164–02) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Dates:* These regulations are effective September 8, 2003.

*Applicability Dates:* For dates of applicability, see §§1.167(a)–14T(e), 1.168(d)–1T(d), 1.168(k)–1T(g), 1.169–3T(g), and 1.1400L(b)–1T(g).

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SUPPLEMENTARY INFORMATION:

#### Background

This document contains amendments to 26 CFR part 1 to provide regulations under

sections 168(k) and 1400L(b) of the Internal Revenue Code (Code). Sections 168(k) and 1400L(b) were added to the Code by, respectively, sections 101 and 301(a) of the Job Creation and Worker Assistance Act of 2002, Public Law 107–147 (116 Stat. 21), and were modified by section 201 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108–27 (117 Stat. 752).

#### Explanation of Provisions

##### *Background*

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business or held for the production of income. The depreciation allowable for tangible, depreciable property placed in service after 1986 generally is determined under section 168 (MACRS property). The depreciation allowable for computer software that is placed in service after August 10, 1993, and is not an amortizable section 197 intangible is determined under section 167(f)(1).

Section 168(k)(1) allows a 30-percent additional first year depreciation deduction for qualified property acquired after September 10, 2001, and, in most cases, placed in service before January 1, 2005. Section 168(k)(4) allows a 50-percent additional first year depreciation deduction for 50-percent bonus depreciation property acquired after May 5, 2003, and, in most cases, placed in service before January 1, 2005. Section 1400L(b) allows a 30-percent additional first year depreciation deduction for qualified New York Liberty Zone property (Liberty Zone property) acquired after September 10, 2001, and placed in service before January 1, 2007 (January 1, 2010, in the case of qualifying nonresidential real property and residential rental property).

##### *Scope*

The regulations provide the requirements that must be met for depreciable property to qualify for the additional first year depreciation deduction provided by sections 168(k) and 1400L(b). Further, the regulations instruct taxpayers how to determine the additional first year depreciation deduction and the amount of

depreciation otherwise allowable for this property.

#### *Property Eligible for the Additional First Year Depreciation Deduction*

The regulations provide that depreciable property must meet four requirements to be qualified property under section 168(k)(2) (property for which the 30-percent additional first year depreciation deduction is allowable) or 50-percent bonus depreciation property under section 168(k)(4) (property for which the 50-percent additional first year depreciation deduction is allowable). These requirements are: (1) the depreciable property must be of a specified type; (2) the original use of the depreciable property must commence with the taxpayer after September 10, 2001, for qualified property or after May 5, 2003, for 50-percent bonus depreciation property; (3) the depreciable property must be acquired by the taxpayer within a specified time period; and (4) the depreciable property must be placed in service by a specified date. These requirements are more fully discussed below.

##### *Property of a Specified Type*

The regulations provide that qualified property or 50-percent bonus depreciation property must be one of the following: (1) MACRS property that has a recovery period of 20 years or less; (2) computer software as defined in, and depreciated under, section 167(f)(1); (3) water utility property as defined in section 168(e)(5) and depreciated under section 168; or (4) qualified leasehold improvement property depreciated under section 168. Because the additional first year depreciation deduction applies to MACRS property that is depreciated under the general depreciation system (GDS) or would be depreciated under the GDS but for an alternative depreciation system (ADS) election made by the taxpayer, the regulations provide that for purposes of determining the eligibility of MACRS property as qualified property or 50-percent bonus depreciation property, the recovery period applicable for the MACRS property under section 168(c) of the GDS is used regardless of any election made by the taxpayer to depreciate the class of property under the ADS of section 168(g). Further, with respect to

qualified leasehold improvement property, the regulations define those improvements specified in section 168(k)(3)(B) that are not considered as qualified leasehold improvement property.

The regulations also provide that qualified property or 50-percent bonus depreciation property does not include: (1) property excluded from the application of section 168 as a result of section 168(f); (2) property that is required to be depreciated under the ADS; (3) any class of property for which the taxpayer elects not to deduct the 30-percent or 50-percent additional first year depreciation; or (4) qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c).

Property is required to be depreciated under the ADS if the property is described under section 168(g)(1)(A) through (D) or if other provisions of the Code require depreciation for the property to be determined under the ADS (for example, section 263A(e)(2)(A) or section 280F(b)(1)). Thus, MACRS property for which the taxpayer makes an election under section 168(g)(7) to depreciate the property under the ADS is eligible for the additional first year depreciation deduction (assuming all other requirements are met).

With respect to the election out of the additional first year depreciation deduction, a taxpayer may elect out of the 30-percent additional first year depreciation deduction for any class of qualified property. For any class of 50-percent bonus depreciation property, a taxpayer may elect either to deduct the 30-percent, instead of the 50-percent, additional first year depreciation deduction or to deduct no additional first year depreciation deduction. The regulations provide the rules for making these elections and also define what is a class of property for purposes of the elections.

#### *Original Use*

Pursuant to section 168(k)(2)(A)(ii), the regulations provide that qualified property is property the original use of which commences with the taxpayer after September 10, 2001. Further, pursuant to section 168(k)(4)(B)(i), the regulations provide that 50-percent bonus depreciation property is property the original use

of which commences with the taxpayer after May 5, 2003. The regulations provide that the original use generally means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, new property initially used by a taxpayer for personal use and then subsequently converted by the taxpayer for use in its trade or business satisfies the original use requirement. However, new property acquired by a taxpayer for personal use and then subsequently acquired by a different taxpayer for use in its trade or business does not satisfy the original use requirement.

Likewise, additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfies the original use requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer does not satisfy the original use requirement. The question of whether property is reconditioned or rebuilt property is a question of fact. The regulations provide a safe harbor that property containing used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property. See Rev. Rul. 68-111, 1968-1 C.B. 29.

The regulations also provide special rules for certain sale-leaseback transactions and syndication transactions. If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and the property is involved in a sale-leaseback transaction described in section 168(k)(2)(D)(ii), the taxpayer-lessor is considered the original user of the property. Likewise, if qualified property is originally placed in service by a lessor after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service by a lessor after May 5, 2003, and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property does not change during this three-month period, the purchaser of the property in the last sale is considered the original user of the property.

The regulations also provide that if in the ordinary course of its business a taxpayer sells fractional interests in qualified property or 50-percent bonus depreciation property to unrelated third parties, each first fractional owner of the property is considered as the original user of its proportionate share of the property. Furthermore, if a taxpayer uses the qualified property or the 50-percent bonus depreciation property before all of the fractional interests are sold and the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to an unrelated third party subsequent to the taxpayer's use begins with the first purchaser of that interest.

#### *Acquisition of Property*

Pursuant to section 168(k)(2)(A)(iii), the regulations provide that qualified property is property: (1) acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001; or (2) acquired by the taxpayer pursuant to a written binding contract that was entered into after September 10, 2001, and before January 1, 2005. Further, pursuant to section 168(k)(4)(B)(ii), the regulations provide that 50-percent bonus depreciation property is property acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before May 6, 2003.

The regulations define a binding contract as any contract that is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount. However, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. Further, the fact that there will be little or no damages because the contract price does not significantly differ from the fair market value will not be taken into account in determining whether a contract limits damages.

The regulations also provide that a contract is binding even if the contract is subject to a condition, as long as the condition is not within the control of either one of the parties or a predecessor. Further, an

option to either acquire or sell property is not treated as a binding contract.

The regulations also provide that a binding contract does not include a supply agreement or similar agreement, if the amount and design specifications of the property to be purchased have not been specified. In this case, the contract is not treated as a binding contract until both the amount and design specifications are specified.

With respect to self-constructed property, the regulations provide that the property acquisition requirement is met if a taxpayer manufactures, constructs, or produces qualified property or 50-percent bonus depreciation property for its own use and such manufacturing, construction, or production began after, respectively, September 10, 2001, or May 5, 2003, and before January 1, 2005. Further, property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into before the manufacture, construction, or production of the property begins is considered to be manufactured, constructed, or produced by the taxpayer.

The regulations also define when construction begins. Construction of qualified property or 50-percent bonus depreciation property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature has begun depends on the facts and circumstances. The regulations, however, provide a safe harbor that physical work of a significant nature has begun when the taxpayer incurs or pays more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities).

The regulations also provide rules for a contract to acquire, or for the manufacture, construction, or production of, a component of the larger self-constructed property. If a binding contract to acquire a component was in effect, or the manufacture, construction, or production of a component began, before September 11, 2001, for qualified property or before May 6, 2003, for 50-percent bonus depreciation property, the component does not qualify for the additional first year depreciation deduction. Similarly, if a

binding contract to acquire a component was in effect, or the manufacture, construction, or production of a component began, before September 11, 2001, for qualified property or before May 6, 2003, for 50-percent bonus depreciation property, but the manufacture, construction, or production of the larger self-constructed property began after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, the larger self-constructed property qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the component does not. Additionally, if the manufacture, construction, or production of the larger self-constructed property began before September 11, 2001, for qualified property or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any acquired or self-constructed component related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction. However, if the binding contract to acquire the component was entered into, or the manufacture, construction, or production of the component began, after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property begins after December 31, 2004, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

The regulations provide rules for when certain acquired or self-constructed property will not meet the acquisition date requirement (disqualified transactions). When the user of property as of the date on which the property was originally placed in service, or a related party to the user, acquired, or had a written binding contract in effect for the acquisition of, the property at any time before September 11, 2001, or before May 6, 2003, as applicable, the property does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. Similarly, property manufactured, constructed, or produced for the taxpayer or a related

party does not qualify for the 30-percent or 50-percent additional first year depreciation deduction if the manufacture, construction, or production began at any time before September 11, 2001, or before May 6, 2003, as applicable. For this purpose, persons are related if they have a relationship specified in section 267(b) or 707(b).

#### *Placed-in-service Date*

Pursuant to section 168(k)(2)(A)(iv) and 168(k)(4)(B)(iii), the regulations provide that qualified property or 50-percent bonus depreciation property is property that is placed in service by the taxpayer before January 1, 2005. However, the placed in service date of January 1, 2005, is extended for one year to January 1, 2006, for property described in section 168(k)(2)(B).

The regulations also provide special rules for sale-leaseback transactions and syndication transactions. If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and is involved in a sale-leaseback transaction described in section 168(k)(2)(D)(ii), the property is treated as originally placed in service by the taxpayer-lessor not earlier than the date on which the property is used by the lessee under the sale-leaseback. Likewise, if qualified property is originally placed in service by a lessor after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service by a lessor after May 5, 2003, and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property does not change during this three-month period, the property is treated as originally placed in service not earlier than the date of the last sale by the purchaser of the property in the last sale.

Special rules also are provided for certain nonrecognition transactions. In the case of a technical termination of a partnership under section 708(b)(1)(B), qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination is treated as originally placed in service by the new partnership

on the date the qualified property or the 50-percent bonus depreciation property is contributed by the terminated partnership to the new partnership. Additionally, qualified property or 50-percent bonus depreciation property transferred in a “step-in-the-shoes” transaction described in section 168(i)(7) in the taxable year the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor is treated as originally placed in service on the date the transferor placed the qualified property or the 50-percent bonus depreciation property in service.

### *Liberty Zone Property*

Generally, the requirements for determining the eligibility of property for the additional first year depreciation deduction for Liberty Zone property provided by section 1400L(b) are similar to the requirements for the 30-percent additional first year depreciation deduction for qualified property provided by section 168(k)(1). There are, however, some differences that are discussed below.

The regulations provide that Liberty Zone property includes the same property that is described as qualified property or 50-percent bonus depreciation property for purposes of section 168(k). In addition, Liberty Zone property includes nonresidential real property or residential rental property to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. Real property is considered to have been destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

While Liberty Zone property includes the same property that is described as qualified property or 50-percent bonus depreciation property for purposes of section 168(k), only one additional first year depreciation deduction is allowable for the property. Thus, pursuant to section 1400L(b)(2)(C)(i), the regulations provide

that if the 30-percent or 50-percent additional first year depreciation deduction under section 168(k) applies to the property, it is not Liberty Zone property.

Pursuant to section 1400L(b)(2)(A)(ii), property is Liberty Zone property if substantially all of the use of the property is in the Liberty Zone and the property is used in the active conduct of a taxpayer’s trade or business in the Liberty Zone. The regulations provide that the term *substantially all* means 80 percent or more.

In addition to the application of the original use rules for qualified property, the regulations provide that used property will satisfy the original use requirement for Liberty Zone property if the used property has not been previously used within the Liberty Zone.

Pursuant to section 1400L(b)(2)(A)(iv), the regulations provide that Liberty Zone property is property that is acquired by the taxpayer by purchase after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 10, 2001. The term *by purchase* is defined in section 179(d) and §1.179-4(c). The regulations also provide that the binding contract rules and the disqualified transactions rules for qualified property apply to Liberty Zone property. The self-construction rules for qualified property also apply to self-constructed Liberty Zone property except that the requirement to begin the manufacture, construction, or production of the qualified property before January 1, 2005, does not apply to Liberty Zone property.

Finally, the regulations provide that Liberty Zone property generally must be acquired by a taxpayer after September 10, 2001, and placed in service by the taxpayer before January 1, 2007. However, qualifying nonresidential real property and residential rental property must be acquired by a taxpayer after September 10, 2001, and placed in service by the taxpayer before January 1, 2010.

### *Computation of Additional First Year Depreciation Deduction and Otherwise Allowable Depreciation*

The allowable additional first year depreciation deduction for qualified property or Liberty Zone property is equal to 30 percent of the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of

the property. The allowable additional first year depreciation deduction for 50-percent bonus depreciation property is equal to 50 percent of the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the property. For qualified property or 50-percent bonus depreciation property described in section 168(k)(2)(B) (property having a longer production period), the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the property is limited to the property’s basis attributable to manufacture, construction, or production of the property before January 1, 2005.

The additional first year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. However, for alternative minimum tax purposes, the amount of the additional first year depreciation deduction is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes. The amount of the additional first year depreciation deduction is not affected by a taxable year of less than 12 months for either regular or alternative minimum tax purposes.

Before determining the amount of depreciation otherwise allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property, the taxpayer must first reduce the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the property by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater (the remaining adjusted depreciable basis). Then, the remaining adjusted depreciable basis is depreciated using the applicable depreciation provisions of the Code for the property (that is, section 168 for MACRS property and section 167(f)(1) for computer software). This amount of depreciation is allowed for both regular tax and alternative minimum tax purposes, and is affected by a taxable year of less than 12 months. However, for alternative minimum tax purposes, the amount of depreciation allowed is determined by calculating the remaining adjusted depreciable basis of the property for alternative minimum tax purposes and using the same depreciation method, recovery period, and convention that applies to the property for regular tax purposes. If a taxpayer uses the optional depreciation tables in Rev.

Proc. 87–57, 1987–2 C.B. 687, to compute depreciation for qualified property, 50-percent bonus depreciation property, or Liberty Zone property that is MACRS property, the regulations also provide that the remaining adjusted depreciable basis of the property is the basis to which the annual depreciation rates in those tables apply.

### *Special Rules*

The regulations also provide rules for the following situations: (1) qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service and disposed of in the same taxable year; (2) redetermination of basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (3) recapture of additional first year depreciation for purposes of section 1245 and section 1250; (4) a certified pollution control facility that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (5) like-kind exchanges and involuntary conversions of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (6) a change in use of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (7) the computation of earnings and profits; (8) the increase in the limitation of the amount of depreciation for passenger automobiles; and (9) the step-up in basis due to a section 754 election.

With respect to qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service and disposed of in the same taxable year, the regulations provide that the additional first year depreciation deduction is not allowed. This rule is consistent with the general rule in §1.168(d)–1(b)(3)(ii) for MACRS property placed in service and disposed of in the same taxable year. However, as previously discussed, the additional first year depreciation deduction is allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service by a terminated partnership in the same taxable year in which a technical termination of the partnership occurs. In this case, the new partnership, and not the terminated partnership, claims the additional first year depreciation deduction. Similarly,

the additional first year depreciation deduction is allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service by a transferor in the same taxable year in which the property is transferred in a step-in-the-shoes transaction described in section 168(i)(7). In this case, the additional first year depreciation deduction for the transferor's taxable year in which the property is placed in service is allocated between the transferor and the transferee on a monthly basis. The allocation shall be made in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee.

The regulations also provide rules for a redetermination of basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property (for example, due to a contingent purchase price or a discharge of indebtedness). If the unadjusted depreciable basis of the property is redetermined by the date on which the property must be last placed in service to meet the placed-in-service date requirement in section 168(k)(2)(A)(iv), 168(k)(4)(B)(iii), or 1400L(b)(2)(A)(v), the additional first year depreciation deduction allowable for the property is redetermined. If the redetermination of basis occurs after that date, the additional first year depreciation deduction is not redetermined. The regulations instruct taxpayers how to determine the depreciation adjustment for an increase or decrease in basis. If there is an increase in basis, the taxpayer claims the additional first year depreciation deduction attributable to the increase in the taxable year in which the increase occurs. If there is a decrease in basis, the taxpayer includes in its income the excess additional first year depreciation deduction attributable to the decrease in the taxable year in which the decrease occurs.

Because the additional first year depreciation deduction is not a ratable method of computing depreciation, the regulations provide that the additional first year depreciation deduction is not a straight line method for purposes of section 1250. Thus, the additional first year depreciation deduction is an accelerated depreciation method for purposes of determining recapture under section 1250. For purposes of

section 1245, all depreciation deductions are subject to recapture.

With respect to a certified pollution control facility that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property, the regulations provide that the additional first year depreciation deduction is allowable in the facility's placed in service year even if the taxpayer elects to amortize the basis of the facility under section 169 in the placed-in-service year. The regulations also amend the regulations under section 169 to provide that the amortizable basis under section 169 must be reduced by the additional first year depreciation deduction allowed or allowable, whichever is greater, applicable to the facility.

With respect to MACRS property or computer software acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033, the regulations provide that the carryover basis and the excess basis, if any, of the acquired MACRS property or acquired computer software are eligible for the additional first year depreciation deduction if the acquired MACRS property or acquired computer software is qualified property, 50-percent bonus depreciation property, or Liberty Zone property. However, if qualified property, 50-percent bonus depreciation property, or Liberty Zone property is placed in service and then disposed of in an exchange or involuntary conversion in the same taxable year, the unadjusted depreciable basis of the exchanged or involuntarily converted property is not eligible for the additional first year depreciation deduction.

The regulations also provide rules when the use of qualified property, 50-percent bonus depreciation property, or Liberty Zone property changes in the hands of the same taxpayer during the placed-in-service year or a subsequent taxable year. The regulations provide that no additional first year depreciation deduction is allowed for qualified property, 50-percent bonus depreciation property, or Liberty Zone property converted to personal use in the placed-in-service year. However, property converted to business or income-producing use is eligible for the additional first year depreciation deduction in the taxable year the property is converted to business or income-producing use (assuming all the requirements are met). With respect to a

change in the use of depreciable property subsequent to the placed-in-service year, the regulations provide that the change in the use will not affect the determination of whether the property was eligible for the additional first year depreciation deduction in the taxable year the property was originally placed-in-service. Thus, if property is not qualified property in its placed-in-service year and a change in the use in a subsequent taxable year would result in the property being qualified property, no additional first year depreciation deduction is allowed for the property. Likewise, if property is qualified property in its placed-in-service year and a change in the use in a subsequent taxable year would result in the property no longer being qualified property, the additional first year depreciation deduction allowable for the property in its placed-in-service year is not redetermined.

Furthermore, the regulations provide that the additional first year depreciation deduction is not allowable for purposes of computing earnings and profits. Pursuant to section 168(k)(2)(E) and (4)(D), the regulations also provide the increase in the limitation under section 280F(a)(1) of the amount of depreciation for certain passenger automobiles that are qualified property or 50-percent bonus depreciation property. Finally, the regulations provide that any increase in basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property due to a section 754 election generally is not eligible for the additional first year depreciation deduction because any such increase in basis of property does not satisfy the original use requirement.

### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility

Analysis is not required. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Drafting Information

The principal author of these regulations is Douglas H. Kim, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.167(a)–14 is amended by:

1. Revising paragraphs (b)(1) and (e)(2).
2. Revising paragraph heading (e).
3. Adding paragraph (e)(3).

The additions and revisions read as follows:

*§1.167(a)–14 Treatment of certain intangible property excluded from section 197.*

\* \* \* \* \*

(b) \* \* \*

(1) *In general.* [Reserved]. For further guidance, see §1.167(a)–14T(b)(1).

\* \* \* \* \*

(e) *Effective dates* \* \* \*

(2) *Change in method of accounting.* [Reserved]. For further guidance, see §1.167(a)–14T(e)(2).

(3) *Qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or section 179 property.* [Reserved]. For further guidance, see §1.167(a)–14T(e)(3).

Par. 3. Section 1.167(a)–14T is added to read as follows:

*§1.167(a)–14T Treatment of certain intangible property excluded from section 197 (temporary).*

(a) For further guidance, see §1.167(a)–14(a).

(b) *Computer software—(1) In general.* The amount of the deduction for computer software described in section 167(f)(1) and §1.197–2(c)(4) is determined by amortizing the cost or other basis of the computer software using the straight line method described in §1.167(b)–1 (except that its salvage value is treated as zero) and an amortization period of 36 months beginning on the first day of the month that the computer software is placed in service. Before determining the amortization deduction allowable under this paragraph (b), the cost or other basis of computer software that is section 179 property, as defined in section 179(d)(1)(A)(ii), must be reduced for any portion of the basis the taxpayer properly elects to treat as an expense under section 179. In addition, the cost or other basis of computer software that is qualified property under section 168(k)(2) or §1.168(k)–1T, 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1T, or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1T, must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b) for the computer software. If costs for developing computer software that the taxpayer properly elects to defer under section 174(b) result in the development of property subject to the allowance for depreciation under section 167, the rules of this paragraph (b) will apply to the unrecovered costs. In addition, this paragraph (b) applies to the cost of separately acquired computer software if the cost to acquire the software is separately stated and the cost is required to be capitalized under section 263(a).

(b)(2) through (e)(1) For further guidance, see §1.167(a)–14(b)(2) through (e)(1).

(e)(2) *Change in method of accounting.* See §1.197–2(1)(4) for rules relating to changes in method of accounting for property to which §1.167(a)–14T applies. However, see §1.168(k)–1T(g)(4) or 1.1400L(b)–1T(g)(4) for rules relating to

changes in method of accounting for computer software to which the third sentence in §1.167(a)–14T(b)(1) applies.

(3) *Qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or section 179 property.* This section also applies to computer software that is qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to computer software that is 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section also applies to computer software that is section 179 property placed in service by a taxpayer in a taxable year beginning after 2002 and before 2006. This section expires on September 4, 2006.

Par. 4. Section 1.168(d)–1 is amended by:

1. Revising paragraph (b)(3)(ii).

2. Paragraph heading (d) is revised and the text of paragraph (d) is redesignated as paragraph (d)(1).

3. Adding paragraph (d)(2).

The additions and revisions read as follows:

*§1.168(d)–1 Applicable conventions—half-year and mid-quarter conventions.*

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(ii) [Reserved]. For further guidance, see §1.168(d)–1T(b)(3)(ii).

\* \* \* \* \*

(d) *Effective dates*—(1) *In general.*

\* \* \*

(2) *Qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property.* [Reserved]. For further guidance, see §1.168(d)–1T(d).

Par. 5. Section 1.168(d)–1T is added to read as follows:

*§1.168(d)–1T Applicable conventions—half-year and mid-quarter conventions (temporary).*

(a) through (b)(3)(i) For further guidance, see §1.168(d)–1(a) through (b)(3)(i).

(b)(3)(ii) The applicable convention, as determined under this section, applies to all depreciable property (except non-residential real property, residential rental property, and any railroad grading or tunnel bore) placed in service during the taxable year, excluding property placed in service and disposed of in the same taxable year. No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year. However, see §1.168(k)–1T(f)(1) for qualified property or 50-percent bonus depreciation property, and §1.1400L(b)–1T(f)(1) for qualified New York Liberty Zone property, that is placed in service in the same taxable year in which either a partnership is terminated as a result of a technical termination under section 708(b)(1)(B) or the property is transferred in a transaction described in section 168(i)(7).

(b)(3)(iii) through (d)(1) For further guidance, see §1.168(d)–1(b)(3)(iii) through (d)(1).

(d)(2) *Qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property.* This section also applies to qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section expires on September 4, 2006.

Par. 6. Section 1.168(k)–0T is added to read as follows:

*§1.168(k)–0T Table of contents (temporary).*

This section lists the headings that appear in §1.168(k)–1T.

§1.168(k)–1T Additional first year depreciation deduction (temporary).

(a) Scope and definitions.

(1) Scope.

(2) Definitions.

(b) Qualified property or 50-percent bonus depreciation property.

(1) In general.

(2) Description of qualified property or 50-percent bonus depreciation property.

(i) In general.

(ii) Property not eligible for additional first year depreciation deduction.

(A) Property that is not qualified property.

(B) Property that is not 50-percent bonus depreciation property.

(3) Original use.

(i) In general.

(ii) Conversion to business or income-producing use.

(iii) Sale-leaseback and syndication transactions.

(A) Sale-leaseback transaction.

(B) Syndication transaction.

(C) Sale-leaseback transaction followed by a syndication transaction.

(iv) Fractional interests in property.

(v) Examples.

(4) Acquisition of property.

(i) In general.

(A) Qualified property.

(B) 50-percent bonus depreciation property.

(ii) Definition of binding contract.

(A) In general.

(B) Conditions.

(C) Options.

(D) Supply agreements.

(E) Components.

(iii) Self-constructed property.

(A) In general.

(B) When does construction begin.

(C) Components of self-constructed property.

(1) Acquired components.

(2) Self-constructed components.

(iv) Disqualified transactions.

(A) In general.

(B) Related party defined.

(v) Examples.

(5) Placed-in-service date.

(i) In general.

(ii) Sale-leaseback and syndication transactions.

(A) Sale-leaseback transaction.

(B) Syndication transaction.

(C) Sale-leaseback transaction followed by a syndication transaction.

(iii) Technical termination of a partnership.

(iv) Section 168(i)(7) transactions.

(c) Qualified leasehold improvement property.

(1) In general.

(2) Certain improvements not included.

(3) Definitions.

(d) Computation of depreciation deduction for qualified property or 50-percent bonus depreciation property.

(1) Additional first year depreciation deduction.

(i) In general.

- (ii) Property having a longer production period.
- (iii) Alternative minimum tax.
- (2) Otherwise allowable depreciation deduction.
  - (i) In general.
  - (ii) Alternative minimum tax.
  - (3) Examples.
  - (e) Election not to deduct additional first year depreciation.
    - (1) In general.
      - (i) Qualified property.
      - (ii) 50-percent bonus depreciation property.
        - (2) Definition of class of property.
        - (3) Time and manner for making election.
          - (i) Time for making election.
          - (ii) Manner of making election.
        - (4) Special rules for 2000 or 2001 returns.
        - (5) Failure to make election.
        - (f) Special rules.
          - (1) Property placed in service and disposed of in the same taxable year.
            - (i) In general.
            - (ii) Technical termination of a partnership.
            - (iii) Section 168(i)(7) transactions.
            - (iv) Examples.
              - (2) Redetermination of basis.
                - (i) Increase in basis.
                - (ii) Decrease in basis.
                - (iii) Definition.
                - (iv) Examples.
              - (3) Section 1245 and 1250 depreciation recapture.
              - (4) Coordination with section 169.
              - (5) Like-kind exchanges and involuntary conversions.
                - (i) Scope.
                - (ii) Definitions.
                - (iii) Computation.
                  - (A) In general.
                  - (B) Year of disposition and year of replacement.
                - (iv) Sale-leasebacks.
                - (v) Examples.
              - (6) Change in use.
                - (i) Change in use of depreciable property.
                - (ii) Conversion to personal use.
                - (iii) Conversion to business or income-producing use.
                  - (A) During the same taxable year.
                  - (B) Subsequent to the acquisition year.
                - (iv) Depreciable property changes use subsequent to the placed-in-service year.
                - (v) Examples.
              - (7) Earnings and profits.
              - (8) Limitation of amount of depreciation for certain passenger automobiles.

- (9) Section 754 election.
- (g) Effective date.
  - (1) In general.
  - (2) Technical termination of a partnership or section 168(i)(7) transactions.
  - (3) Like-kind exchanges and involuntary conversions.
  - (4) Change in method of accounting.
    - (i) Special rules for 2000 or 2001 returns.
    - (ii) Like-kind exchanges and involuntary conversions.

Par. 7. Section 1.168(k)-1T is added to read as follows:

*§1.168(k)-1T Additional first year depreciation deduction (temporary).*

(a) *Scope and definitions*—(1) *Scope*. This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 168(k)(1) for qualified property and the 50-percent additional first year depreciation deduction allowable under section 168(k)(4) for 50-percent bonus depreciation property.

(2) *Definitions*. For purposes of section 168(k) and this section, the following definitions apply:

(i) *Depreciable property* is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations thereunder.

(ii) *MACRS property* is tangible, depreciable property that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143) and subject to section 168, except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(iii) *Unadjusted depreciable basis* is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations thereunder (other than section 1016(a)(2) and (3)) (for example,

a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(iv) *Adjusted depreciable basis* is the unadjusted depreciable basis of the property, as defined in §1.168(k)-1T(a)(2)(iii), less the adjustments described in section 1016(a)(2) and (3).

(b) *Qualified property or 50-percent bonus depreciation property*—(1) *In general*. Qualified property or 50-percent bonus depreciation property is depreciable property that—

(i) Meets the requirements in §1.168(k)-1T(b)(2) (description of property);

(ii) Meets the requirements in §1.168(k)-1T(b)(3) (original use);

(iii) Meets the requirements in §1.168(k)-1T(b)(4) (acquisition of property); and

(iv) Meets the requirements in §1.168(k)-1T(b)(5) (placed-in-service date).

(2) *Description of qualified property or 50-percent bonus depreciation property*—(i) *In general*. Depreciable property will meet the requirements of this paragraph (b)(2) if the property is—

(A) MACRS property (as defined in §1.168(k)-1T(a)(2)(ii)) that has a recovery period of 20 years or less. For purposes of this paragraph (b)(2)(i)(A) and section 168(k)(2)(B)(i)(II) and 168(k)(4)(C), the recovery period is determined in accordance with section 168(c) regardless of any election made by the taxpayer under section 168(g)(7);

(B) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(C) Water utility property as defined in section 168(e)(5) and depreciated under section 168; or

(D) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

(ii) *Property not eligible for additional first year depreciation deduction*—(A) *Property that is not qualified property*. For purposes of the 30-percent additional first year depreciation deduction, depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(1) Described in section 168(f);

(2) Required to be depreciated under the alternative depreciation system of section

168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in section 263A(e)(2)(A) or section 280F(b)(1));

(3) Included in any class of property for which the taxpayer elects not to deduct the 30-percent additional first year depreciation (for further guidance, see paragraph (e) of this section); or

(4) Qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

(B) *Property that is not 50-percent bonus depreciation property.* For purposes of the 50-percent additional first year depreciation deduction, depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(1) Described in paragraph (b)(2)(ii)(A)(1), (2), or (4) of this section; or

(2) Included in any class of property for which the taxpayer elects the 30-percent, instead of the 50-percent, additional first year depreciation deduction or elects not to deduct any additional first year depreciation (for further guidance, see paragraph (e) of this section).

(3) *Original use*—(i) *In general.* For purposes of the 30-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer after September 10, 2001. For purposes of the 50-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer after May 5, 2003. Except as provided in paragraph (b)(3)(iii) and (iv) of this section, original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfies the original use requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer does not satisfy the original use requirement. The question of whether property is reconditioned or rebuilt property is a question of fact. For purposes of this paragraph (b)(3)(i), property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used

parts is not more than 20 percent of the total cost of the property.

(ii) *Conversion to business or income-producing use.* If a taxpayer initially acquires new property for personal use and subsequently uses the property in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is considered as the original user of the property. If a person initially acquires new property for personal use and a taxpayer subsequently acquires the property from the person for use in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is not considered the original user of the property.

(iii) *Sale-leaseback and syndication transactions*—(A) *Sale-leaseback transaction.* If new property is originally placed in service by a person after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and is sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the taxpayer-lessor is considered the original user of the property.

(B) *Syndication transaction.* If new property is originally placed in service by a lessor (including by operation of paragraph (b)(5)(ii)(A) of this section) after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, the purchaser of the property in the last sale during the three-month period is considered the original user of the property.

(C) *Sale-leaseback transaction followed by a syndication transaction.* If a sale-leaseback transaction that satisfies the requirements in paragraph (b)(3)(iii)(A) of this section is followed by a syndication transaction that satisfies the requirements in paragraph (b)(3)(iii)(B) of this section, the original user of the property is determined in accordance with paragraph (b)(3)(iii)(B) of this section.

(iv) *Fractional interests in property.* If, in the ordinary course of its business, a

taxpayer sells fractional interests in property to unrelated third parties, each first fractional owner of the property is considered as the original user of its proportionate share of the property. Furthermore, if the taxpayer uses the property before all of the fractional interests of the property are sold but the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to an unrelated third party subsequent to the taxpayer's use of the property begins with the first purchaser of that fractional interest. For purposes of this paragraph (b)(3)(iv), persons are not related if they do not have a relationship described in section 267(b) or 707(b) and the regulations thereunder.

(v) *Examples.* The application of this paragraph (b)(3) is illustrated by the following examples:

*Example 1.* On August 1, 2002, A buys from B for \$20,000 a machine that has been previously used by B in B's trade or business. On March 1, 2003, A makes a \$5,000 capital expenditure to recondition the machine. The \$20,000 purchase price does not qualify for the additional first year depreciation deduction because the original use requirement of this paragraph (b)(3) is not met. However, the \$5,000 expenditure satisfies the original use requirement of this paragraph (b)(3) and, assuming all other requirements are met, qualifies for the 30-percent additional first year depreciation deduction, regardless of whether the \$5,000 is added to the basis of the machine or is capitalized as a separate asset.

*Example 2.* C, an automobile dealer, uses some of its automobiles as demonstrators in order to show them to prospective customers. The automobiles that are used as demonstrators by C are held by C primarily for sale to customers in the ordinary course of its business. On September 1, 2002, D buys from C an automobile that was previously used as a demonstrator by C. D will use the automobile solely for business purposes. The use of the automobile by C as a demonstrator does not constitute a "use" for purposes of the original use requirement and, therefore, D will be considered the original user of the automobile for purposes of this paragraph (b)(3). Assuming all other requirements are met, D's purchase price of the automobile qualifies for the 30-percent additional first year depreciation deduction for D, subject to any limitation under section 280F.

*Example 3.* On April 1, 2000, E acquires a horse to be used in E's thoroughbred racing business. On October 1, 2003, F buys the horse from E and will use the horse in F's horse breeding business. The use of the horse by E in its racing business prevents the original use of the horse from commencing with F. Thus, F's purchase price of the horse does not qualify for the additional first year depreciation deduction.

*Example 4.* In the ordinary course of its business, G sells fractional interests in its aircraft to unrelated parties. G holds out for sale eight equal fractional interests in an aircraft. On January 1, 2003, G sells five of the eight fractional interests in the aircraft to H, an

unrelated party, and *H* begins to use its proportionate share of the aircraft immediately upon purchase. On June 1, 2003, *G* sells to *I*, an unrelated party to *G* and *H*, the remaining unsold  $\frac{3}{8}$  fractional interests in the aircraft. *H* is considered the original user as to its  $\frac{5}{8}$  fractional interest in the aircraft and *I* is considered the original user as to its  $\frac{3}{8}$  fractional interest in the aircraft. Thus, assuming all other requirements are met, *H*'s purchase price for its  $\frac{5}{8}$  fractional interest in the aircraft qualifies for the 30-percent additional first year depreciation deduction and *I*'s purchase price for its  $\frac{3}{8}$  fractional interest in the aircraft qualifies for the 50-percent additional first year depreciation deduction.

(4) *Acquisition of property*—(i) *In general*—(A) *Qualified property*. For purposes of the 30-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(4) if the property is—

(1) Acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001; or

(2) Acquired by the taxpayer pursuant to a written binding contract that was entered into after September 10, 2001, and before January 1, 2005.

(B) *50-percent bonus depreciation property*. For purposes of the 50-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(4) if the property is acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before May 6, 2003.

(ii) *Definition of binding contract*—(A) *In general*. A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for \$100 and the contract contained no provision for liquidated damages, the contract

is considered binding notwithstanding the fact that the asset had a fair market value of \$99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation by the seller, the contract is not considered binding.

(B) *Conditions*. A contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions or because any term is to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding notwithstanding the fact that insubstantial terms remain to be negotiated by the parties to the contract.

(C) *Options*. An option to either acquire or sell property is not a binding contract.

(D) *Supply agreements*. A binding contract does not include a supply or similar agreement if the amount and design specifications of the property to be purchased have not been specified. The contract will not be a binding contract for the property to be purchased until both the amount and the design specifications are specified. For example, if the provisions of a supply or similar agreement state the design specifications of, and the pricing for, the property to be purchased, a purchase order under the agreement for a specific number of assets is treated as a binding contract.

(E) *Components*. A binding contract to acquire one or more components of a larger property will not be treated as a binding contract to acquire the larger property. If a binding contract to acquire the component does not satisfy the requirements of this paragraph (b)(4), the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable.

(iii) *Self-constructed property*—(A) *In general*. If a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business (or for its production of income), the acquisition rules in paragraph (b)(4)(i) of this section are treated as met for qualified property if the taxpayer begins manufacturing,

constructing, or producing the property after September 10, 2001, and before January 1, 2005, and for 50-percent bonus depreciation property if the taxpayer begins manufacturing, constructing, or producing the property after May 5, 2003, and before January 1, 2005. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract (as defined in paragraph (b)(4)(ii) of this section) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered to be manufactured, constructed, or produced by the taxpayer.

(B) *When does construction begin*. For purposes of paragraph (b)(4)(iii) of this section, construction of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. For purposes of this paragraph (b)(4)(iii)(B), physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching). For example, if a retail motor fuels outlet is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; that is, when work begins on the excavation for footings, pouring the pads for the outlet, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings) does not constitute the beginning of construction. However, if a retail motor fuels outlet is to be assembled on-site from modular units constructed off-site and delivered to the site where the outlet will be used, construction begins when physical work of a significant nature commences at the off-site location.

(C) *Components of self-constructed property*—(1) *Acquired components*. If a

binding contract (as defined in paragraph (b)(4)(ii) of this section) to acquire a component does not satisfy the requirements of paragraph (b)(4)(i) of this section, the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. A binding contract (as defined in paragraph (b)(4)(ii) of this section) to acquire one or more components of a larger self-constructed property will not preclude the larger self-constructed property from satisfying the acquisition rules in paragraph (b)(4)(iii)(A) of this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met), must not include the unadjusted depreciable basis of any component that does not satisfy the requirements of paragraph (b)(4)(i) of this section. If the manufacture, construction, or production of the larger self-constructed property begins before September 11, 2001, for qualified property, or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any acquired components related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. If a binding contract to acquire the component is entered into after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

(2) *Self-constructed components.* If the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (b)(4)(iii)(A) of this section, the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. However, if the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (b)(4)(iii)(A) of

this section, but the manufacture, construction, or production of the larger self-constructed property satisfies the requirements of paragraph (b)(4)(iii)(A) of this section, the larger self-constructed property qualifies for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met) even though the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met), must not include the unadjusted depreciable basis of any component that does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. If the manufacture, construction, or production of the larger self-constructed property began before September 11, 2001, for qualified property, or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any self-constructed components related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. If the manufacture, construction, or production of a component begins after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

(iv) *Disqualified transactions—(A) In general.* Property does not satisfy the requirements of this paragraph (b)(4) if the user of the property as of the date on which the property was originally placed in service (including by operation of paragraph (b)(5)(ii), (iii), and (iv) of this section), or a related party to the user, acquired, or had a written binding contract (as defined in paragraph (b)(4)(ii) of this section) in effect for the acquisition of, the property at any time before September 11, 2001 (for qualified property), or before May 6, 2003

(for 50-percent bonus depreciation property). In addition, property manufactured, constructed, or produced for the taxpayer or a related party does not satisfy the requirements of this paragraph (b)(4) if the manufacture, construction, or production of the property for the taxpayer or a related party began at any time before September 11, 2001 (for qualified property), or before May 6, 2003 (for 50-percent bonus depreciation property).

(B) *Related party defined.* For purposes of this paragraph (b)(4)(iv), persons are related if they have a relationship specified in section 267(b) or 707(b) and the regulations thereunder.

(v) *Examples.* The application of this paragraph (b)(4) is illustrated by the following examples:

*Example 1.* On September 1, 2001, *J*, a corporation, entered into a written agreement with *K*, a manufacturer, to purchase 20 new lamps for \$100 each within the next two years. Although the agreement specifies the number of lamps to be purchased, the agreement does not specify the design of the lamps to be purchased. Accordingly, the agreement is not a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section.

*Example 2.* Same facts as *Example 1*. On December 1, 2001, *J* placed a purchase order with *K* to purchase 20 new model XPC5 lamps for \$100 each for a total amount of \$2,000. Because the agreement specifies the number of lamps to be purchased and the purchase order specifies the design of the lamps to be purchased, the purchase order placed by *J* with *K* on December 1, 2001, is a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section. Accordingly, the cost of the 20 lamps qualifies for the 30-percent additional first year depreciation deduction.

*Example 3.* Same facts as *Example 1* except that the written agreement between *J* and *K* is to purchase 100 model XPC5 lamps for \$100 each within the next two years. Because this agreement specifies the amount and design of the lamps to be purchased, the agreement is a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section. Accordingly, because the agreement was entered into before September 11, 2001, any lamp acquired by *J* under this contract does not qualify for the additional first year depreciation deduction.

*Example 4.* On September 1, 2001, *L* began constructing an electric generation power plant for its own use. On November 1, 2002, *L* ceases construction of the power plant prior to its completion. Between September 1, 2001, and November 1, 2002, *L* incurred \$3,000,000 for the construction of the power plant. On May 6, 2003, *L* resumed construction of the power plant and completed its construction on August 31, 2003. Between May 6, 2003, and August 31, 2003, *L* incurred another \$1,600,000 to complete the construction of the power plant and, on September 1, 2003, *L* placed the power plant in service. None of *L*'s total expenditures of \$4,600,000 qualify for the additional first year depreciation deduction because, pursuant to paragraph (b)(4)(iii)(A) of this section, *L*

began constructing the power plant before September 11, 2001.

*Example 5.* Same facts as *Example 4* except that *L* began constructing the electric generation power plant for its own use on October 1, 2001. *L*'s total expenditures of \$4,600,000 qualify for the additional first year depreciation deduction because, pursuant to paragraph (b)(4)(iii)(A) of this section, *L* began constructing the power plant after September 10, 2001, and placed the power plant in service before January 1, 2005. Accordingly, the additional first year depreciation deduction for the power plant will be \$1,380,000, computed as \$4,600,000 multiplied by 30 percent.

*Example 6.* On August 1, 2001, *M* entered into a written binding contract to acquire a new turbine. The new turbine is a component part of a new electric generation power plant that is being constructed on *M*'s behalf. The construction of the new electric generation power plant commenced in November 2001, and the new electric generation power plant was completed in November 2002. Because *M* entered into a written binding contract to acquire a component part (the new turbine) prior to September 11, 2001, pursuant to paragraph (b)(4)(iii)(C) of this section, the component part does not qualify for the additional first year depreciation deduction. However, pursuant to paragraphs (b)(4)(iii)(A) and (C) of this section, the new plant constructed for *M* will qualify for the 30-percent additional first year depreciation deduction because construction of the new plant began after September 10, 2001, and before May 6, 2003. Accordingly, the unadjusted depreciable basis of the new plant that is eligible for the 30-percent additional first year depreciation deduction must not include the unadjusted depreciable basis of the new turbine.

*Example 7.* Same facts as *Example 6* except that *M* entered into the written binding contract to acquire the new turbine on September 30, 2002, and construction of the new plant commenced on August 1, 2001. Because *M* began construction of the new plant prior to September 11, 2001, pursuant to paragraphs (b)(4)(iii)(A) and (C) of this section, neither the new plant constructed for *M* nor the turbine will qualify for the additional first year depreciation deduction because self-construction of the new plant began prior to September 11, 2001.

*Example 8.* On September 1, 2001, *N* began constructing property for its own use. On October 1, 2001, *N* sold its rights to the property to *O*, a related party under section 267(b). Pursuant to paragraph (b)(4)(iv) of this section, the property is not eligible for the additional first year depreciation deduction because *N* and *O* are related parties and construction of the property by *N* began prior to September 11, 2001.

*Example 9.* On September 1, 2001, *P* entered into a written binding contract to acquire property. On October 1, 2001, *P* sold its rights to the property to *Q*, a related party under section 267(b). Pursuant to paragraph (b)(4)(iv) of this section, the property is not eligible for the additional first year depreciation deduction because *P* and *Q* are related parties and a written binding contract for the acquisition of the property was in effect prior to September 11, 2001.

*Example 10.* Prior to September 11, 2001, *R* began constructing an electric generation power plant for its own use. On May 1, 2003, prior to the completion of the power plant, *R* transferred the rights to own and use this power plant to *S*, an unrelated party,

for \$6,000,000. Between May 6, 2003, and June 30, 2003, *S*, a calendar-year taxpayer, incurred another \$1,200,000 to complete the construction of the power plant and, on August 1, 2003, *S* placed the power plant in service. Because *R* and *S* are not related parties, the transaction between *R* and *S* will not be a disqualified transaction pursuant to paragraph (b)(4)(iv) of this section. Accordingly, *S*'s total expenditures of \$7,200,000 for the power plant qualify for the additional first year depreciation deduction. *S*'s additional first year depreciation deduction for the power plant will be \$2,400,000, computed as \$6,000,000 multiplied by 30 percent, plus \$1,200,000 multiplied by 50 percent. The \$6,000,000 portion of the total \$7,200,000 unadjusted depreciable basis qualifies for the 30-percent additional first year depreciation deduction because that portion of the total unadjusted depreciable basis was acquired by *S* after September 10, 2001, and before May 6, 2003. However, because *S* began construction to complete the power plant after May 5, 2003, the \$1,200,000 portion of the total \$7,200,000 unadjusted depreciable basis qualifies for the 50-percent additional first year depreciation deduction.

*Example 11.* On September 1, 2001, *T* acquired and placed in service equipment. On October 15, 2001, *T* sells the equipment to *U*, an unrelated party, and leases the property back from *U* in a sale-leaseback transaction. Pursuant to paragraph (b)(4)(iv) of this section, the equipment does not qualify for the additional first year depreciation deduction because *T*, the user of the equipment, acquired the equipment prior to September 11, 2001.

(5) *Placed-in-service date*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (b)(5) if the property is placed in service by the taxpayer before January 1, 2005, or, in the case of property described in section 168(k)(2)(B), is placed in service by the taxpayer before January 1, 2006.

(ii) *Sale-leaseback and syndication transactions*—(A) *Sale-leaseback transaction.* If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the property is treated as originally placed in service by the taxpayer-lessor not earlier than the date on which the property is used by the lessee under the leaseback.

(B) *Syndication transaction.* If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a lessor (including by operation of paragraph (b)(5)(ii)(A) of this section) and is

sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property after the last sale during this three-month period remains the same as when the property was originally placed in service by the lessor, the property is treated as originally placed in service by the purchaser of the property in the last sale during the three-month period but not earlier than the date of the last sale.

(C) *Sale-leaseback transaction followed by a syndication transaction.* If a sale-leaseback transaction that satisfies the requirements in paragraph (b)(5)(ii)(A) of this section is followed by a syndication transaction that satisfies the requirements in paragraph (b)(5)(ii)(B) of this section, the placed-in-service date of the property is determined in accordance with paragraph (b)(5)(ii)(B) of this section.

(iii) *Technical termination of a partnership.* For purposes of this paragraph (b)(5), in the case of a technical termination of a partnership under section 708(b)(1)(B), qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination is treated as originally placed in service by the new partnership on the date the qualified property or the 50-percent bonus depreciation property is contributed by the terminated partnership to the new partnership.

(iv) *Section 168(i)(7) transactions.* For purposes of this paragraph (b)(5), if qualified property or 50-percent bonus depreciation property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor, the transferred property is treated as originally placed in service on the date the transferor placed in service the qualified property or the 50-percent bonus depreciation property, as applicable. In the case of multiple transfers of qualified property or 50-percent bonus depreciation property in multiple transactions described in section 168(i)(7) in the same taxable year, the placed in service date of the transferred property is deemed to be the date on which the first transferor placed in service the qualified property or the 50-percent bonus depreciation property, as applicable.

(c) *Qualified leasehold improvement property*—(1) *In general.* For purposes of section 168(k), qualified leasehold improvement property means any improvement, which is section 1250 property, to an interior portion of a building that is nonresidential real property if—

(i) The improvement is made under or pursuant to a lease by the lessee (or any sublessee) of the interior portion, or by the lessor of that interior portion;

(ii) The interior portion of the building is to be occupied exclusively by the lessee (or any sublessee) of that interior portion; and

(iii) The improvement is placed in service more than 3 years after the date the building was first placed in service by any person.

(2) *Certain improvements not included.* Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to:

(i) The enlargement of the building;

(ii) Any elevator or escalator;

(iii) Any structural component benefiting a common area; or

(iv) The internal structural framework of the building.

(3) *Definitions.* For purposes of this paragraph (c), the following definitions apply:

(i) *Building* has the same meaning as that term is defined in §1.48-1(e)(1).

(ii) *Common area* means any portion of a building that is equally available to all users of the building on the same basis for uses that are incidental to the primary use of the building. For example, stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas, and rest rooms generally are treated as common areas if they are used by different lessees of a building.

(iii) *Elevator* and *escalator* have the same meanings as those terms are defined in §1.48-1(m)(2).

(iv) *Enlargement* has the same meaning as that term is defined in §1.48-12(c)(10).

(v) *Internal structural framework* has the same meaning as that term is defined in §1.48-12(b)(3)(i)(D)(iii).

(vi) *Lease* has the same meaning as that term is defined in section 168(h)(7). In addition, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and

lessee. However, a lease between related persons is not considered a lease. For purposes of the preceding sentence, related persons are—

(A) Members of an affiliated group (as defined in section 1504 and the regulations thereunder); and

(B) Persons having a relationship described in section 267(b) and the regulations thereunder. For purposes of applying section 267(b), the language “80 percent or more” is used instead of “more than 50 percent.”

(vii) *Nonresidential real property* has the same meaning as that term is defined in section 168(e)(2)(B).

(viii) *Structural component* has the same meaning as that term is defined in §1.48-1(e)(2).

(d) *Computation of depreciation deduction for qualified property or 50-percent bonus depreciation property*—(1) *Additional first year depreciation deduction*—(i) *In general.* Except as provided in paragraph (f)(5) of this section, the allowable additional first year depreciation deduction for qualified property is determined by multiplying the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the qualified property by 30 percent. Except as provided in paragraph (f)(5) of this section, the allowable additional first year depreciation deduction for 50-percent bonus depreciation property is determined by multiplying the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the 50-percent bonus depreciation property by 50 percent. Except as provided in paragraph (f)(1) of this section, the 30-percent or 50-percent additional first year depreciation deduction is not affected by a taxable year of less than 12 months. See paragraph (f)(1) of this section for qualified property or 50-percent bonus depreciation property placed in service and disposed of in the same taxable year. See paragraph (f)(5) of this section for qualified property or 50-percent bonus depreciation property acquired in a like-kind exchange or as a result of an involuntary conversion.

(ii) *Property having a longer production period.* For purposes of paragraph (d)(1)(i) of this section, the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of qualified property or 50-percent bonus depreciation property described in section 168(k)(2)(B)

is limited to the property’s unadjusted depreciable basis attributable to the property’s manufacture, construction, or production after September 10, 2001 (for qualified property), or May 5, 2003 (for 50-percent bonus depreciation property), and before January 1, 2005.

(iii) *Alternative minimum tax.* The 30-percent or 50-percent additional first year depreciation deduction is allowed for alternative minimum tax purposes for the taxable year in which the qualified property or the 50-percent bonus depreciation property is placed in service by the taxpayer. The 30-percent or 50-percent additional first year depreciation deduction for alternative minimum tax purposes is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes.

(2) *Otherwise allowable depreciation deduction.* Before determining the amount otherwise allowable as a depreciation deduction for the qualified property or the 50-percent bonus depreciation property for the placed-in-service year and any subsequent taxable year, the taxpayer must determine the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property. This remaining adjusted depreciable basis is equal to the unadjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property reduced by the amount of the additional first year depreciation allowed or allowable, whichever is greater. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is then depreciated using the applicable depreciation provisions under the Internal Revenue Code for the qualified property or the 50-percent bonus depreciation property. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property that is MACRS property is also the basis to which the annual depreciation rates in the optional depreciation tables apply (for further guidance, see section 8 of Rev. Proc. 87-57, 1987-2 C.B. 687, and §601.601(d)(2)(ii)(b) of this chapter). The depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is affected by a taxable year of less than 12 months.

(ii) *Alternative minimum tax.* For alternative minimum tax purposes, the depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is based on the remaining adjusted depreciable basis for alternative minimum tax purposes. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property for alternative minimum tax purposes is depreciated using the same depreciation method, recovery period (or useful life in the case of computer software), and convention that apply to the qualified property or the 50-percent bonus depreciation property for regular tax purposes.

(3) *Examples.* This paragraph (d) is illustrated by the following examples:

*Example 1.* On March 1, 2003, V, a calendar-year taxpayer, purchased and placed in service qualified property that costs \$1 million and is 5-year property under section 168(e). V depreciates its 5-year property placed in service in 2003 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2003, V is allowed a 30-percent additional first year depreciation deduction of \$300,000 (the unadjusted depreciable basis of \$1 million multiplied by .30). Next, V must reduce the unadjusted depreciable basis of \$1 million by the additional first year depreciation deduction of \$300,000 to determine the remaining adjusted depreciable basis of \$700,000. Then, V's depreciation deduction allowable in 2003 for the remaining adjusted depreciable basis of \$700,000 is \$140,000 (the remaining adjusted depreciable basis of \$700,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

*Example 2.* On June 1, 2003, W, a calendar-year taxpayer, purchased and placed in service 50-percent bonus depreciation property that costs \$126,000. The property qualifies for the expensing election under section 179 and is 5-year property under section 168(e). W did not purchase any other section 179 property in 2003. W makes the election under section 179 for the property and depreciates its 5-year property placed in service in 2003 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2003, W is first allowed a \$100,000 deduction under section 179. Next, W must reduce the cost of \$126,000 by the section 179 deduction of \$100,000 to determine the unadjusted depreciable basis of \$26,000. Then, for 2003, W is allowed a 50-percent additional first year depreciation deduction of \$13,000 (the unadjusted depreciable basis of \$26,000 multiplied by .50). Next, W must reduce the unadjusted depreciable basis of \$26,000 by the additional first year depreciation deduction of \$13,000 to determine the remaining

adjusted depreciable basis of \$13,000. Then, W's depreciation deduction allowable in 2003 for the remaining adjusted depreciable basis of \$13,000 is \$2,600 (the remaining adjusted depreciable basis of \$13,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(e) *Election not to deduct additional first year depreciation*—(1) *In general.* If a taxpayer makes an election under this paragraph (e), the election applies to all qualified property or 50-percent bonus depreciation property, as applicable, that is in the same class of property and placed in service in the same taxable year. The rules of this paragraph (e) apply to the following elections provided under section 168(k):

(i) *Qualified property.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified property placed in service during the taxable year. If this election is made, no additional first year depreciation deduction is allowable for the property placed in service during the taxable year in the class of property.

(ii) *50-percent bonus depreciation property.* For any class of property that is 50-percent bonus depreciation property placed in service during the taxable year, a taxpayer may make an election—

(A) To deduct the 30-percent, instead of the 50-percent, additional first year depreciation. If this election is made, the allowable additional first year depreciation deduction is determined as though the class of property is qualified property under section 168(k)(2); or

(B) Not to deduct any additional first year depreciation. If this election is made, no additional first year depreciation deduction is allowable for the class of property.

(2) *Definition of class of property.* For purposes of this paragraph (e), the term class of property means:

(i) Except for the property described in paragraphs (e)(2)(ii) and (iv) of this section, each class of property described in section 168(e) (for example, 5-year property);

(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder; or

(iv) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

(3) *Time and manner for making election*—(i) *Time for making election.* Except as provided in paragraph (e)(4) of this section, any election specified in paragraph (e)(1) of this section must be made by the due date (including extensions) of the Federal tax return for the taxable year in which the qualified property or the 50-percent bonus depreciation property, as applicable, is placed in service by the taxpayer.

(ii) *Manner of making election.* Except as provided in paragraph (e)(4) of this section, any election specified in paragraph (e)(1) of this section must be made in the manner prescribed on Form 4562, “*Depreciation and Amortization*,” and its instructions. The election is made separately by each person owning qualified property or 50-percent bonus depreciation property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation). If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(4) *Special rules for 2000 or 2001 returns.* For the election specified in paragraph (e)(1)(i) of this section for qualified property placed in service by the taxpayer during the taxable year that included September 11, 2001, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of making this election on the 2000 or 2001 Federal tax return for the taxable year that included September 11, 2001 (for further guidance, see sections 3.03(3) and 4 of Rev. Proc. 2002–33, 2002–1 C.B. 963, Rev. Proc. 2003–50, 2003–29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(5) *Failure to make election.* If a taxpayer does not make the applicable election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (4) of this section, the amount of depreciation allowable for that property under section 167(f)(1) or under section 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction. Thus, any election specified in paragraph (e)(1) of this section shall not be made by the taxpayer in any other manner (for example, the election cannot be made through a

request under section 446(e) to change the taxpayer's method of accounting).

(f) *Special rules*—(1) *Property placed in service and disposed of in the same taxable year*—(i) *In general*. Except as provided in paragraphs (f)(1)(ii) and (iii) of this section, the additional first year depreciation deduction is not allowed for qualified property or 50-percent bonus depreciation property placed in service and disposed of during the same taxable year.

(ii) *Technical termination of a partnership*. In the case of a technical termination of a partnership under section 708(b)(1)(B), the additional first year depreciation deduction is allowable for any qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination and contributed by the terminated partnership to the new partnership. The allowable additional first year depreciation deduction for the qualified property or the 50-percent bonus depreciation property shall not be claimed by the terminated partnership but instead shall be claimed by the new partnership for the new partnership's taxable year in which the qualified property or the 50-percent bonus depreciation property was contributed by the terminated partnership to the new partnership. However, if qualified property or 50-percent bonus depreciation property is both placed in service and contributed to a new partnership in a transaction described in section 708(b)(1)(B) by the terminated partnership during the taxable year of termination, and if such property is disposed of by the new partnership in the same taxable year the new partnership received such property from the terminated partnership, then no additional first year depreciation deduction is allowable to either partnership.

(iii) *Section 168(i)(7) transactions*. If any qualified property or 50-percent bonus depreciation property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor, the additional first year depreciation deduction is allowable for the qualified property or the 50-percent bonus depreciation property. The allowable additional first year depreciation deduction for the qualified property or

the 50-percent bonus depreciation property for the transferor's taxable year in which the property is placed in service is allocated between the transferor and the transferee on a monthly basis. This allocation shall be made in accordance with the rules in §1.168(d)-1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. However, if qualified property or 50-percent bonus depreciation property is both placed in service and transferred in a transaction described in section 168(i)(7) by the transferor during the same taxable year, and if such property is disposed of by the transferee (other than by a transaction described in section 168(i)(7)) during the same taxable year the transferee received such property from the transferor, then no additional first year depreciation deduction is allowable to either party.

(iv) *Examples*. The application of this paragraph (f)(1) is illustrated by the following examples:

*Example 1.* *X* and *Y* are equal partners in *Partnership XY*, a general partnership. On February 1, 2002, *Partnership XY* purchased and placed in service new equipment at a cost of \$30,000. On March 1, 2002, *X* sells its entire 50 percent interest to *Z* in a transfer that terminates the partnership under section 708(b)(1)(B). As a result, terminated *Partnership XY* is deemed to have contributed the equipment to new *Partnership XY*. Pursuant to paragraph (f)(1)(ii) of this section, new *Partnership XY*, not terminated *Partnership XY*, is eligible to claim the 30-percent additional first year depreciation deduction allowable for the equipment for the taxable year 2002 (assuming all other requirements are met).

*Example 2.* On January 5, 2002, *BB* purchased and placed in service new office desks for a total amount of \$8,000. On August 20, 2002, *BB* transferred the office desks to *Partnership BC* in a transaction described in section 721. *BB* and *Partnership BC* are calendar-year taxpayers. Because the transaction between *BB* and *Partnership BC* is a transaction described in section 168(i)(7), pursuant to paragraph (f)(1)(iii) of this section the 30-percent additional first year depreciation deduction allowable for the desks is allocated between *BB* and *Partnership BC* in accordance with the rules in §1.168(d)-1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. Accordingly, the 30-percent additional first year depreciation deduction allowable for the desks for 2002 of \$2,400 (the unadjusted depreciable basis of \$8,000 multiplied by .30) is allocated between *BB* and *Partnership BC* based on the number of months that *BB* and *Partnership BC* held the desks in service. Thus, because the desks were held in service by *BB* for 7 of 12 months, which includes the month in which *BB* placed the desks in service but does not include the month in which the desks were transferred, *BB* is allocated \$1,400 (7/12 x \$2,400 additional first year depreciation deduction). *Partnership BC* is allocated \$1,000, the remaining

5/12 of the \$2,400 additional first year depreciation deduction allowable for the desks.

(2) *Redetermination of basis*. If the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of qualified property or 50-percent bonus depreciation property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) by January 1, 2005 (or January 1, 2006, for property described in section 168(k)(2)(B)), the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property is redetermined as follows:

(i) *Increase in basis*. For the taxable year in which an increase in basis of qualified property or 50-percent bonus depreciation property occurs, the taxpayer shall claim an additional first year depreciation deduction for qualified property by multiplying the amount of the increase in basis for this property by 30 percent or, for 50-percent bonus depreciation property, by multiplying the amount of the increase in basis for this property by 50 percent. For purposes of this paragraph (f)(2)(i), the 30-percent additional first year depreciation deduction applies to the increase in basis if the underlying property is qualified property and the 50-percent additional first year depreciation deduction applies to the increase in basis if the underlying property is 50-percent bonus depreciation property. To determine the amount otherwise allowable as a depreciation deduction for the increase in basis of qualified property or 50-percent bonus depreciation property, the amount of the increase in basis of the qualified property or the 50-percent bonus depreciation property must be reduced by the additional first year depreciation deduction allowed or allowable, whichever is greater, for the increase in basis and the remaining increase in basis of—

(A) Qualified property or 50-percent bonus depreciation property (except for computer software described in paragraph (b)(2)(i)(B) of this section) is depreciated over the recovery period of the qualified property or the 50-percent bonus depreciation property, as applicable, remaining as of the beginning of the taxable year in which the increase in basis occurs, and using the same depreciation method and convention applicable to the qualified property or 50-percent bonus depreciation property, as applicable, that applies for the

taxable year in which the increase in basis occurs; and

(B) Computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is qualified property or 50-percent bonus depreciation property is depreciated ratably over the remainder of the 36-month period (the useful life under section 167(f)(1)) as of the beginning of the first day of the month in which the increase in basis occurs.

(ii) *Decrease in basis.* For the taxable year in which a decrease in basis of qualified property or 50-percent bonus depreciation property occurs, the taxpayer shall include in the taxpayer's income the excess additional first year depreciation deduction previously claimed for the qualified property or the 50-percent bonus depreciation property. This excess additional first year depreciation deduction for qualified property is determined by multiplying the amount of the decrease in basis for this property by 30 percent. The excess additional first year depreciation deduction for 50-percent bonus depreciation property is determined by multiplying the amount of the decrease in basis for this property by 50 percent. For purposes of this paragraph (f)(2)(ii), the 30-percent additional first year depreciation deduction applies to the decrease in basis if the underlying property is qualified property and the 50-percent additional first year depreciation deduction applies to the decrease in basis if the underlying property is 50-percent bonus depreciation property. Also, if the taxpayer establishes by adequate records or other sufficient evidence that the taxpayer claimed less than the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property before the decrease in basis or if the taxpayer claimed more than the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property before the decrease in basis, the excess additional first year depreciation deduction is determined by multiplying the amount of the decrease in basis by the additional first year depreciation deduction percentage actually claimed by the taxpayer for the qualified property or the 50-percent bonus depreciation property, as applicable, before the decrease in basis. To determine the amount includible in the taxpayer's

income for the excess depreciation previously claimed (other than the additional first year depreciation deduction) resulting from the decrease in basis of the qualified property or the 50-percent bonus depreciation property, the amount of the decrease in basis of the qualified property or the 50-percent bonus depreciation property must be adjusted by the excess additional first year depreciation deduction includible in the taxpayer's income (as determined under this paragraph) and the remaining decrease in basis of—

(A) Qualified property or 50-percent bonus depreciation property (except for computer software described in paragraph (b)(2)(i)(B) of this section) is included in the taxpayer's income over the recovery period of the qualified property or the 50-percent bonus depreciation property, as applicable, remaining as of the beginning of the taxable year in which the decrease in basis occurs, and using the same depreciation method and convention of the qualified property or 50-percent bonus depreciation property, as applicable, that applies in the taxable year in which the decrease in basis occurs; and

(B) Computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is qualified property or 50-percent bonus depreciation property is included in the taxpayer's income ratably over the remainder of the 36-month period (the useful life under section 167(f)(1)) as of the beginning of the first day of the month in which the decrease in basis occurs.

(iii) *Definition.* For purposes of this paragraph (f)(2)—

(A) An increase in basis occurs in the taxable year an amount is taken into account under section 461; and

(B) A decrease in basis occurs in the taxable year an amount would be taken into account under section 451.

(iv) *Examples.* The application of this paragraph (f)(2) is illustrated by the following examples:

*Example 1.* (i) On May 15, 2002, CC, a cash-basis taxpayer, purchased and placed in service qualified property that is 5-year property at a cost of \$200,000. In addition to the \$200,000, CC agrees to pay the seller 25 percent of the gross profits from the operation of the property in 2002. On May 15, 2003, CC paid to the seller an additional \$10,000. CC depreciates the 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(ii) For 2002, CC is allowed a 30-percent additional first year depreciation deduction of \$60,000 (the unadjusted depreciable basis of \$200,000 multiplied by .30). In addition, CC's depreciation deduction for 2002 for the remaining adjusted depreciable basis of \$140,000 (the unadjusted depreciable basis of \$200,000 reduced by the additional first year depreciation deduction of \$60,000) is \$28,000 (the remaining adjusted depreciable basis of \$140,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, CC's depreciation deduction for the remaining adjusted depreciable basis of \$140,000 is \$44,800 (the remaining adjusted depreciable basis of \$140,000 multiplied by the annual depreciation rate of .32 for recovery year 2). In addition, pursuant to paragraph (f)(2)(i) of this section, CC is allowed an additional first year depreciation deduction for 2003 for the \$10,000 increase in basis of the qualified property. Consequently, CC is allowed an additional first year depreciation deduction of \$3,000 (the increase in basis of \$10,000 multiplied by .30). Also, CC is allowed a depreciation deduction for 2003 attributable to the remaining increase in basis of \$7,000 (the increase in basis of \$10,000 reduced by the additional first year depreciation deduction of \$3,000). The depreciation deduction allowable for 2003 attributable to the remaining increase in basis of \$7,000 is \$3,111 (the remaining increase in basis of \$7,000 multiplied by .4444, which is equal to 1/remaining recovery period of 4.5 years at January 1, 2003, multiplied by 2). Accordingly, for 2003, CC's total depreciation deduction allowable for the qualified property is \$50,911.

*Example 2.* (i) On May 15, 2002, DD purchased and placed in service qualified property that is 5-year property at a cost of \$400,000. To purchase the property, DD borrowed \$250,000 from Bank2. On May 15, 2003, Bank2 forgives \$50,000 of the indebtedness. DD makes the election provided in section 108(b)(5) to apply any portion of the reduction under section 1017 to the basis of the depreciable property of the taxpayer. DD depreciates the 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(ii) For 2002, DD is allowed a 30-percent additional first year depreciation deduction of \$120,000 (the unadjusted depreciable basis of \$400,000 multiplied by .30). In addition, DD's depreciation deduction allowable for 2002 for the remaining adjusted depreciable basis of \$280,000 (the unadjusted depreciable basis of \$400,000 reduced by the additional first year depreciation deduction of \$120,000) is \$56,000 (the remaining adjusted depreciable basis of \$280,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, DD's deduction for the remaining adjusted depreciable basis of \$280,000 is \$89,600 (the remaining adjusted depreciable basis of \$280,000 multiplied by the annual depreciation rate of .32 for recovery year 2). However, pursuant to paragraph (f)(2)(ii) of this section, DD must include in its taxable income for 2003 the excess depreciation previously claimed for the \$50,000 decrease in basis of the qualified property. Consequently, DD must include in its taxable income for 2003 the

excess additional first year depreciation of \$4,500 (the decrease in basis of \$50,000 multiplied by .30). Also, *DD* must include in its taxable income for 2003 the excess depreciation attributable to the remaining decrease in basis of \$45,500 (the decrease in basis of \$50,000 reduced by the excess additional first year depreciation of \$4,500). The amount includible in taxable income for 2003 for the remaining decrease in basis of \$45,500 is \$20,222 (the remaining decrease in basis of \$45,500 multiplied by .4444, which is equal to 1/remaining recovery period of 4.5 years at January 1, 2003, multiplied by 2). Accordingly, for 2003, *DD*'s total depreciation deduction allowable for the qualified property is \$64,878 (\$89,600 minus \$4,500 minus \$20,222).

(3) *Section 1245 and 1250 depreciation recapture.* For purposes of section 1245 and the regulations thereunder, the additional first year depreciation deduction is an amount allowed or allowable for depreciation. Further, for purposes of section 1250(b) and the regulations thereunder, the additional first year depreciation deduction is not a straight line method.

(4) *Coordination with section 169.* The additional first year depreciation deduction is allowable in the placed-in-service year of a certified pollution control facility (as defined in §1.169-2(a)) that is qualified property or 50-percent bonus depreciation property, even if the taxpayer makes the election to amortize the certified pollution control facility under section 169 and the regulations thereunder in the certified pollution control facility's placed-in-service year.

(5) *Like-kind exchanges and involuntary conversions—(i) Scope.* The rules of this paragraph (f)(5) apply to acquired MACRS property or acquired computer software that is eligible for the additional first year depreciation deduction under section 168(k) at the time of replacement provided the time of replacement is after September 10, 2001, and before January 1, 2005, or, in the case of acquired MACRS property or acquired computer software that is qualified property, or 50-percent bonus depreciation property, described in section 168(k)(2)(B), the time of replacement is after September 10, 2001, and before January 1, 2006.

(ii) *Definitions.* For purposes of this paragraph (f)(5), the following definitions apply:

(A) *Acquired MACRS property* is MACRS property in the hands of the acquiring taxpayer that is acquired in a transaction described in section 1031(a), (b), or (c) for other MACRS property or

that is acquired in connection with an involuntary conversion of other MACRS property in a transaction to which section 1033 applies.

(B) *Exchanged or involuntarily converted MACRS property* is MACRS property that is transferred by the taxpayer in a transaction described in section 1031(a), (b), or (c), or that is converted as a result of an involuntary conversion to which section 1033 applies.

(C) *Acquired computer software* is computer software (as defined in paragraph (b)(2)(i)(B) of this section) in the hands of the acquiring taxpayer that is acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033.

(D) *Exchanged or involuntarily converted computer software* is computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is transferred by the taxpayer in a like-kind exchange under section 1031 or that is converted as a result of an involuntary conversion under section 1033.

(E) *Time of disposition* is when the disposition of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable, takes place.

(F) *Time of replacement* is the later of:

(1) when the property received in the exchange or involuntary conversion is placed in service; or

(2) the time of disposition of involuntarily converted property.

(G) *Carryover basis* is the lesser of:

(1) the basis in the acquired MACRS property or acquired computer software, as applicable and as determined under section 1031(d) or 1033(b) and the regulations thereunder; or

(2) the adjusted depreciable basis of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable.

(H) *Excess basis* is any excess of the basis in the acquired MACRS property or acquired computer software, as applicable and as determined under section 1031(d) or 1033(b) and the regulations thereunder, over the carryover basis as determined under paragraph (f)(5)(ii)(G) of this section.

(I) *Remaining carryover basis* is the carryover basis as determined under paragraph (f)(5)(ii)(G) of this section reduced by—

(1) The percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and

(2) Any adjustments to basis provided by other provisions of the Code and the regulations thereunder (including section 1016(a)(2) and (3)) for periods prior to the disposition of the exchanged or involuntarily converted property.

(J) *Remaining excess basis* is the excess basis as determined under paragraph (f)(5)(ii)(H) of this section reduced by—

(1) The percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income);

(2) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179; and

(3) Any adjustments to basis provided by other provisions of the Code and the regulations thereunder.

(iii) *Computation—(A) In general.* Assuming all other requirements are met, the remaining carryover basis for the year of replacement and the remaining excess basis, if any, for the year of replacement for the acquired MACRS property or the acquired computer software, as applicable, are eligible for the additional first year depreciation deduction. The 30-percent additional first year depreciation deduction applies to the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software if the time of replacement is after September 10, 2001, and before May 6, 2003, or if the taxpayer made the election provided in paragraph (e)(1)(ii)(A) of this section. The 50-percent additional first year depreciation deduction applies to the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software if the time of replacement is after May 5, 2003, and before January 1, 2005, or before January 1, 2006, for 50-percent bonus depreciation property described in section 168(k)(2)(B). The additional first year depreciation deduction is computed separately for the remaining carryover basis and the remaining excess basis. Rules

similar to the rules provided in paragraph (d) of this section apply to property described in section 168(k)(2)(B) and for alternative minimum tax purposes (for example, use the remaining carryover basis as determined for alternative minimum tax purposes).

(B) *Year of disposition and year of replacement.* The additional first year depreciation deduction is allowable for the acquired MACRS property or acquired computer software in the year of replacement. However, the additional first year depreciation deduction is not allowable for the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software if the MACRS property or computer software, as applicable, is placed in service and disposed of in an exchange or involuntary conversion in the same taxable year.

(iv) *Sale-leaseback transaction.* For purposes of this paragraph (f)(5), if MACRS property or computer software is sold to a taxpayer and leased back to a person by the taxpayer within three months after the time of disposition of the MACRS property or computer software, as applicable, the time of replacement for this MACRS property or computer software, as applicable, shall not be earlier than the date on which the MACRS property or computer software, as applicable, is used by the lessee under the leaseback.

(v) *Examples.* The application of this paragraph (f)(5) is illustrated by the following examples:

*Example 1.* (i) In December 2002, *EE*, a calendar-year corporation, acquired for \$200,000 and placed in service Canopy V1, a gas station canopy. Canopy V1 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). *EE* depreciated Canopy V1 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *EE* elected to use the optional depreciation tables to compute the depreciation allowance for Canopy V1. On January 1, 2003, Canopy V1 was destroyed in a fire and was no longer usable in *EE*'s business. On June 1, 2003, in a transaction described in section 1033(a)(2), *EE* acquired and placed in service Canopy W1 with all of the \$160,000 of insurance proceeds *EE* received due to the loss of Canopy V1. Canopy W1 is 50-percent bonus depreciation property under section 168(k)(4) and is 5-year property under section 168(e).

(ii) For 2002, *EE* is allowed a 30-percent additional first year depreciation deduction of \$60,000 for Canopy V1 (the unadjusted depreciable basis of \$200,000 multiplied by .30), and a regular MACRS depreciation deduction of \$28,000 for Canopy V1 (the remaining adjusted depreciable basis of

\$140,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 equals \$56,000 (.50 of Canopy W1's remaining carryover basis of \$112,000 (Canopy V1's remaining adjusted depreciable basis of \$140,000 minus 2002 regular MACRS depreciation deduction of \$28,000)).

*Example 2.* (i) Same facts as in *Example 1*, except *EE* elected not to deduct the additional first year depreciation for 5-year property placed in service in 2002. *EE* deducted the additional first year depreciation for 5-year property placed in service in 2003.

(ii) For 2002, *EE* is allowed a regular MACRS depreciation deduction of \$40,000 for Canopy V1 (the unadjusted depreciable basis of \$200,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 equals \$80,000 (.50 of Canopy W1's remaining carryover basis of \$160,000 (Canopy V1's unadjusted depreciable basis of \$200,000 minus 2002 regular MACRS depreciation deduction of \$40,000)).

*Example 3.* (i) In December 2001, *FF*, a calendar year corporation, acquired for \$10,000 and placed in service Computer X2. Computer X2 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). *FF* depreciated Computer X2 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *FF* elected to use the optional depreciation tables to compute the depreciation allowance for Computer X2. On January 1, 2002, *FF* acquired Computer Y2 by exchanging Computer X2 and \$1,000 cash in a transaction described in section 1031(a). Computer Y2 is qualified property under section 168(k)(1) and is 5-year property under section 168(e).

(ii) For 2001, *FF* is allowed a 30-percent additional first year depreciation deduction of \$3,000 for Computer X2 (unadjusted basis of \$10,000 multiplied by .30), and a regular MACRS depreciation deduction of \$1,400 for Computer X2 (the remaining adjusted depreciable basis of \$7,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the 30-percent additional first year depreciation deduction for Computer Y2 is allowable for the remaining carryover basis of \$5,600 (Computer X2's unadjusted depreciable basis of \$10,000 minus additional first year depreciation deduction allowable of \$3,000 minus 2001 regular MACRS depreciation deduction of \$1,400) and for the remaining excess basis of \$1,000 (cash paid for Computer Y2). Thus, the 30-percent additional first year depreciation deduction for the remaining carryover basis equals \$1,680 (\$5,600 multiplied by .30) and for the remaining excess basis equals \$300 (\$1,000 multiplied by .30), which totals \$1,980.

*Example 4.* (i) In September 2002, *GG*, a June 30 year-end corporation, acquired for \$20,000 and placed in service Equipment X3. Equipment X3 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). *GG* depreciated Equipment X3 under the general depreciation

system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *GG* elected to use the optional depreciation tables to compute the depreciation allowance for Equipment X3. In December 2002, *GG* acquired Equipment Y3 by exchanging Equipment X3 and \$5,000 cash in a transaction described in section 1031(a). Equipment Y3 is qualified property under section 168(k)(1) and is 5-year property under section 168(e).

(ii) Pursuant to paragraph (f)(5)(iii)(B) of this section, no additional first year depreciation deduction is allowable for Equipment X3 and, pursuant to §1.168(d)-1T(b)(3)(ii), no regular depreciation deduction is allowable for Equipment X3.

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the 30-percent additional first year depreciation deduction for Equipment Y3 is allowable for the remaining carryover basis of \$20,000 (Equipment X3's unadjusted depreciable basis of \$20,000) and for the remaining excess basis of \$5,000 (cash paid for Equipment Y3). Thus, the 30-percent additional first year depreciation deduction for the remaining carryover basis equals \$6,000 (\$20,000 multiplied by .30) and for the remaining excess basis equals \$1,500 (\$5,000 multiplied by .30), which totals \$7,500.

*Example 5.* (i) Same facts as in *Example 4*. *GG* depreciated Equipment Y3 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *GG* elected to use the optional depreciation tables to compute the depreciation allowance for Equipment Y3. On July 1, 2003, *GG* acquired Equipment Z1 by exchanging Equipment Y3 in a transaction described in section 1031(a). Equipment Z1 is 50-percent bonus depreciation property under section 168(k)(4) and is 5-year property under section 168(e).

(ii) For the taxable year ending June 30, 2003, the regular MACRS depreciation deduction allowable for the remaining carryover basis of Equipment Y3 is \$2,800 (the remaining carryover basis of \$14,000 multiplied by the annual depreciation rate of .20 for recovery year 1) and for the remaining excess basis of Equipment Y3 is \$700 (the remaining excess basis of \$3,500 multiplied by the annual depreciation rate of .20 for recovery year 1), which totals \$3,500.

(iii) For the taxable year ending June 30, 2004, pursuant to paragraph (f)(5)(iii)(A) of this section, the 50-percent additional first year depreciation deduction allowable for Equipment Z1 is \$7,000 (.50 of Equipment Z1's remaining carryover basis of \$14,000 (Equipment Y3's total unadjusted depreciable basis of \$25,000 minus the total additional first year depreciation deduction of \$7,500 minus the total regular MACRS depreciation deduction of \$3,500)).

(6) *Change in use*—(i) *Change in use of depreciable property.* The determination of whether the use of depreciable property changes is made in accordance with section 168(i)(5) and regulations thereunder.

(ii) *Conversion to personal use.* If qualified property or 50-percent bonus depreciation property is converted from business or income-producing use to personal use

in the same taxable year in which the property is placed in service by a taxpayer, the additional first year depreciation deduction is not allowable for the property.

(iii) *Conversion to business or income-producing use*—(A) *During the same taxable year.* If, during the same taxable year, property is acquired by a taxpayer for personal use and is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use (assuming all of the requirements in paragraph (b) of this section are met). See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use.

(B) *Subsequent to the acquisition year.* If property is acquired by a taxpayer for personal use and, during a subsequent taxable year, is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use (assuming all of the requirements in paragraph (b) of this section are met). For purposes of paragraphs (b)(4) and (5) of this section, the property must be acquired by the taxpayer for personal use after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and converted by the taxpayer from personal use to business or income-producing use by January 1, 2005. See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use.

(iv) *Depreciable property changes use subsequent to the placed-in-service year*—(A) If the use of qualified property or 50-percent bonus depreciation property changes in the hands of the same taxpayer subsequent to the taxable year the qualified property or the 50-percent bonus depreciation property, as applicable, is placed in service and, as a result of the change in use, the property is no longer qualified property or 50-percent bonus depreciation property, as applicable, the additional first year depreciation deduction allowable for the qualified property or the 50-percent

bonus depreciation property, as applicable, is not redetermined.

(B) If depreciable property is not qualified property or 50-percent bonus depreciation property in the taxable year the property is placed in service by the taxpayer, the additional first year depreciation deduction is not allowable for the property even if a change in the use of the property subsequent to the taxable year the property is placed in service results in the property being qualified property or 50-percent bonus depreciation property in the taxable year of the change in use.

(v) *Examples.* The application of this paragraph (f)(6) is illustrated by the following examples:

*Example 1.* (i) On January 1, 2002, *HH*, a calendar year corporation, purchased and placed in service several new computers at a total cost of \$100,000. *HH* used these computers within the United States for 3 months in 2002 and then moved and used the computers outside the United States for the remainder of 2002. On January 1, 2003, *HH* permanently returns the computers to the United States for use in its business.

(ii) For 2002, the computers are considered as used predominantly outside the United States in 2002 pursuant to §1.48-1(g)(1)(i). As a result, the computers are required to be depreciated under the alternative depreciation system of section 168(g). Pursuant to paragraph (b)(2)(ii)(A)(2) of this section, the computers are not qualified property in 2002, the placed-in-service year. Thus, pursuant to (f)(6)(iv)(B) of this section, no additional first year depreciation deduction is allowed for these computers, regardless of the fact that the computers are permanently returned to the United States in 2003.

*Example 2.* (i) On February 8, 2002, *II*, a calendar year corporation, purchased and placed in service new equipment at a cost of \$1,000,000 for use in its California plant. The equipment is 5-year property under section 168(e) and is qualified property under section 168(k). *II* depreciates its 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. On June 4, 2003, due to changes in *II*'s business circumstances, *II* permanently moves the equipment to its plant in Mexico.

(ii) For 2002, *II* is allowed a 30-percent additional first year depreciation deduction of \$300,000 (the adjusted depreciable basis of \$1,000,000 multiplied by .30). In addition, *II*'s depreciation deduction allowable in 2002 for the remaining adjusted depreciable basis of \$700,000 (the unadjusted depreciable basis of \$1,000,000 reduced by the additional first year depreciation deduction of \$300,000) is \$140,000 (the remaining adjusted depreciable basis of \$700,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, the equipment is considered as used predominantly outside the United States pursuant to §1.48-1(g)(1)(i). As a result of this change in use, the

adjusted depreciable basis of \$560,000 for the equipment is required to be depreciated under the alternative depreciation system of section 168(g) beginning in 2003. However, the additional first year depreciation deduction of \$300,000 allowed for the equipment in 2002 is not redetermined.

(7) *Earnings and profits.* The additional first year depreciation deduction is not allowable for purposes of computing earnings and profits.

(8) *Limitation of amount of depreciation for certain passenger automobiles.* For a passenger automobile as defined in section 280F(d)(5), the limitation under section 280F(a)(1)(A)(i) is increased by—

(i) \$4,600 for qualified property acquired by a taxpayer after September 10, 2001, and before May 6, 2003; and

(ii) \$7,650 for qualified property or 50-percent bonus depreciation property acquired by a taxpayer after May 5, 2003.

(9) *Section 754 election.* In general, for purposes of section 168(k) any increase in basis of qualified property or 50-percent bonus depreciation property due to a section 754 election is not eligible for the additional first year depreciation deduction. However, if qualified property or 50-percent bonus depreciation property is placed in service by a partnership in the taxable year the partnership terminates under section 708(b)(1)(B), any increase in basis of the qualified property or the 50-percent bonus depreciation property due to a section 754 election is eligible for the additional first year depreciation deduction.

(g) *Effective date*—(1) *In general.* Except as provided in paragraphs (g)(2) and (3) of this section, this section applies to qualified property under section 168(k)(2) acquired by a taxpayer after September 10, 2001, and to 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section expires on September 4, 2006.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified property or 50 percent bonus depreciation property is transferred in a technical termination of a partnership under section 708(b)(1)(B) or in a transaction described in section 168(i)(7) for a taxable year ending on or before September 8, 2003, and the additional first year depreciation deduction allowable for the property was not determined in accordance with paragraph (f)(1)(ii) or (iii) of this section, as applicable, the Internal Revenue Service

will allow any reasonable method of determining the additional first year depreciation deduction allowable for the property in the year of the transaction that is consistently applied to the property by all parties to the transaction.

(3) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for a taxable year ending on or before September 8, 2003, the additional first year depreciation deduction for the remaining carryover basis of qualified property or 50-percent bonus depreciation property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the Internal Revenue Service will treat the taxpayer's method of not claiming the additional first year depreciation deduction for the remaining carryover basis as a permissible method of accounting and will treat the amount of the additional first year depreciation deduction allowable for the remaining carryover basis as being equal to zero, provided the taxpayer does not claim the additional first year depreciation deduction for the remaining carryover basis in accordance with paragraph (g)(4)(ii) of this section.

(4) *Change in method of accounting—(i) Special rules for 2000 or 2001 returns.* If a taxpayer did not claim on the Federal tax return for the taxable year that included September 11, 2001, any additional first year depreciation deduction for a class of property that is qualified property and did not make an election not to deduct the additional first year depreciation deduction for that class of property, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of claiming the additional first year depreciation deduction for the class of property (for further guidance, see section 4 of Rev. Proc. 2002–33, 2002–1 C.B. 963, Rev. Proc. 2003–50, 2003–29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(ii) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for any taxable year ending on or before September

8, 2003, the additional first year depreciation deduction allowable for the remaining carryover basis of qualified property or 50-percent bonus depreciation property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the taxpayer may claim the additional first year depreciation deduction allowable for the remaining carryover basis in accordance with paragraph (f)(5) of this section either:

(A) by filing an amended return (or a qualified amended return, if applicable (for further guidance, see Rev. Proc. 94–69, 1994–2 C.B. 804, and §601.601(d)(2)(ii)(b) of this chapter)) on or before December 31, 2003, for the year of replacement and any affected subsequent taxable year; or,

(B) by following the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(b) of this chapter).

Par. 8. Section 1.169–3 is amended by:

1. Revising paragraphs (a) and (b)(2).
2. Adding paragraph (g).

The additions and revisions read as follows:

*§1.169–3 Amortizable basis.*

\* \* \* \* \*

(a) [Reserved]. For further guidance, see §1.169–3T(a).

\* \* \* \* \*

(b) \* \* \*

(2) [Reserved]. For further guidance, see §1.169–3T(b)(2).

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(g) *Effective date for qualified property, 50-percent bonus depreciation property, and qualified New York Liberty Zone property.* [Reserved]. For further guidance, see §1.169–3T(g).

Par. 9. Section 1.169–3T is added to read as follows:

*§1.169–3T Amortizable basis (temporary).*

(a) *In general.* The amortizable basis of a certified pollution control facility for the purpose of computing the amortization deduction under section 169 is the adjusted basis of the facility for purposes of determining gain (see part II (section 1011 and following), subchapter O, chapter 1 of the Internal Revenue Code), as modified by paragraphs (b), (c), and (d) of this section. The adjusted basis for purposes of determining gain (computed without regard to these modifications) of a facility that performs a function in addition to pollution control, or that is used in connection with more than one plant or other property, or both, is determined under §1.169–2(a)(3). For rules as to additions and improvements to such a facility, see paragraph (f) of this section. Before computing the amortization deduction allowable under section 169, the adjusted basis for purposes of determining gain for a facility that is placed in service by a taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)–1T, 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1T, or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1T must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b), as applicable, for the facility.

(b) *Limitation on post–1968 construction, reconstruction, or erection.* (1) For further guidance, see §1.169–3(b)(1).

(2) If the taxpayer elects to begin the 60-month amortization period with the first month of the taxable year succeeding the taxable year in which the facility is completed or acquired and a depreciation deduction is allowable under section 167 (including an additional first-year depreciation allowance under former section 179; for a facility that is acquired by the taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)–1T or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1T, the additional first year depreciation deduction under section 168(k)(1) or 1400L(b), as applicable; and for a facility that is acquired by the taxpayer after May 5,

2003, and that is 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)-1T, the additional first year depreciation deduction under section 168(k)(4) with respect to the facility for the taxable year in which it is completed or acquired, the amount determined under paragraph (b)(1) of this section shall be reduced by an amount equal to the amount of the depreciation deduction allowed or allowable, whichever is greater, multiplied by a fraction the numerator of which is the amount determined under paragraph (b)(1) of this section, and the denominator of which is the facility's total cost. The additional first-year allowance for depreciation under former section 179 will be allowable only for the taxable year in which the facility is completed or acquired and only if the taxpayer elects to begin the amortization deduction under section 169 with the taxable year succeeding the taxable year in which such facility is completed or acquired. For a facility that is acquired by a taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)-1T or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)-1T, see §1.168(k)-1T(f)(4) or §1.1400L(b)-1T(f)(4), as applicable, with respect to when the additional first year depreciation deduction under section 168(k)(1) or 1400L(b) is allowable. For a facility that is acquired by a taxpayer after May 5, 2003, and that is 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)-1T, see §1.168(k)-1T(f)(4) with respect to when the additional first year depreciation deduction under section 168(k)(4) is allowable.

(c) through (f) For further guidance, see §1.169-3(c) through (f).

(g) *Effective date for qualified property, 50-percent bonus depreciation property, and qualified New York Liberty Zone property.* This section applies to a certified pollution control facility. This section also applies to a certified pollution control facility that is qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to a certified pollution control

facility that is 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section expires on September 4, 2006.

Par. 10. Section 1.1400L(b)-1T is added to read as follows:

*§1.1400L(b)-1T Additional first year depreciation deduction for qualified New York Liberty Zone property (temporary).*

(a) *Scope.* This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 1400L(b) for qualified New York Liberty Zone property.

(b) *Definitions.* For purposes of section 1400L(b) and this section, the definitions of the terms in §1.168(k)-1T(a)(2) apply and the following definitions also apply:

(1) *Building and structural components* have the same meanings as those terms are defined in §1.48-1(e).

(2) *New York Liberty Zone* is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

(3) *Nonresidential real property and residential rental property* have the same meanings as those terms are defined in section 168(e)(2).

(4) *Real property* is a building or its structural components, or other tangible real property except property described in section 1245(a)(3)(B) (relating to depreciable property used as an integral part of a specified activity or as a specified facility), section 1245(a)(3)(D) (relating to single purpose agricultural or horticultural structure), or section 1245(a)(3)(E) (relating to a storage facility used in connection with the distribution of petroleum or any primary product of petroleum).

(c) *Qualified New York Liberty Zone property*—(1) *In general.* Qualified New York Liberty Zone property is depreciable property that—

(i) Meets the requirements in §1.1400L(b)-1T(c)(2) (description of property);

(ii) Meets the requirements in §1.1400L(b)-1T(c)(3) (substantial use);

(iii) Meets the requirements in §1.1400L(b)-1T(c)(4) (original use);

(iv) Meets the requirements in §1.1400L(b)-1T(c)(5) (acquisition of property by purchase); and

(v) Meets the requirements in §1.1400L(b)-1T(c)(6) (placed-in-service date).

(2) *Description of qualified New York Liberty Zone property*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (c)(2) if the property is—

(A) Described in §1.168(k)-1T(b)(2)(i); or

(B) Nonresidential real property or residential rental property depreciated under section 168, but only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. For purposes of this section, real property is considered as destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Otherwise, the real property is considered damaged real property. For example, if certain structural components (for example, walls, floors, and plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks of September 11, 2001, but the building is not destroyed or condemned, then only costs related to replacing the damaged or destroyed structural components qualify under this paragraph (c)(2)(i)(B).

(ii) *Property not eligible for additional first year depreciation deduction.* Depreciable property will not meet the requirements of this paragraph (c)(2) if—

(A) Section 168(k) or §1.168(k)-1T applies to the property; or

(B) The property is described in section §1.168(k)-1T(b)(2)(ii).

(3) *Substantial use.* Depreciable property will meet the requirements of this paragraph (c)(3) if substantially all of the use of the property is in the New York Liberty Zone and is in the active conduct of a trade or business by the taxpayer in New York Liberty Zone. For purposes of this paragraph (c)(3), “substantially all” means 80 percent or more.

(4) *Original use.* Depreciable property will meet the requirements of this paragraph (c)(4) if the original use of the property commences with the taxpayer in the New York Liberty Zone after September 10, 2001. The original use rules in §1.168(k)-1T(b)(3) apply for purposes of this paragraph (c)(4). In addition, used property will satisfy the original use requirement in this paragraph (c)(4) so long as the property has not been previously used within the New York Liberty Zone.

(5) *Acquisition of property by purchase—(i) In general.* Depreciable property will meet the requirements of this paragraph (c)(5) if the property is acquired by the taxpayer by purchase (as defined in section 179(d) and §1.179-4(c)) after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001. For purposes of this paragraph (c)(5), the rules in §1.168(k)-1T(b)(4)(ii) (binding contract), the rules in §1.168(k)-1T(b)(4)(iii) (self-constructed property), and the rules in §1.168(k)-1T(b)(4)(iv) (disqualified transactions) apply. For purposes of the preceding sentence, the rules in §1.168(k)-1T(b)(4)(iii) shall be applied without regard to ‘and before January 1, 2005.’

(ii) *Exception for certain transactions.* For purposes of this section, the new partnership of a transaction described in §1.168(k)-1T(f)(1)(ii) (technical termination of a partnership) or the transferee of a transaction described in §1.168(k)-1T(f)(1)(iii) (section 168(i)(7) transactions) is deemed to acquire the depreciable property by purchase.

(6) *Placed-in-service date.* Depreciable property will meet the requirements of this paragraph (c)(6) if the property is placed in service by the taxpayer on or before December 31, 2006. However, nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section must be placed in service by the taxpayer on or before December 31, 2009. The rules in §1.168(k)-1T(b)(5)(ii) (relating to sale-leaseback and syndication transactions), the rules in §1.168(k)-1T(b)(5)(iii) (relating to a technical termination of a partnership under section 708(b)(1)(B)), and the rules in §1.168(k)-1T(b)(5)(iv)

(relating to section 168(i)(7) transactions) apply for purposes of this paragraph (c)(6).

(d) *Computation of depreciation deduction for qualified New York Liberty Zone property.* The computation of the allowable additional first year depreciation deduction and the otherwise allowable depreciation deduction for qualified New York Liberty Zone property is made in accordance with the rules for qualified property in §1.168(k)-1T(d)(1)(i) and (2).

(e) *Election not to deduct additional first year depreciation—(1) In general.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified New York Liberty Zone property placed in service during the taxable year. If a taxpayer makes an election under this paragraph (e), the election applies to all qualified New York Liberty Zone property that is in the same class of property and placed in service in the same taxable year, and no additional first year depreciation deduction is allowable for the class of property.

(2) *Definition of class of property.* For purposes of this paragraph (e), the term class of property means—

(i) Except for the property described in paragraphs (e)(2)(ii), (iv), and (v) of this section, each class of property described in section 168(e) (for example, 5-year property);

(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(iv) Nonresidential real property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section; or

(v) Residential rental property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section

(3) *Time and manner for making election—(i) Time for making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made by the due date (including extensions) of the federal tax return for the taxable year in which the qualified New York Liberty Zone property is placed in service by the taxpayer

(ii) *Manner of making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made in the manner prescribed on Form 4562, “*Depreciation and Amortization*,” and its instructions. The election is made separately by each person owning qualified New York Liberty Zone property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation). If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(4) *Special rules for 2000 or 2001 returns.* For the election specified in paragraph (e)(1) of this section for qualified New York Liberty Zone property placed in service by the taxpayer during the taxable year that included September 11, 2001, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of making this election on the 2000 or 2001 federal tax return for the taxable year that included September 11, 2001 (for further guidance, see sections 3.03(3) and 4 of Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(5) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (e)(4) of this section, the amount of depreciation allowable for that property under section 167(f)(1) or under section 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction. Thus, the election specified in paragraph (e)(1) of this section shall not be made by the taxpayer in any other manner (for example, the election cannot be made through a request under section 446(e) to change the taxpayer’s method of accounting).

(f) *Special rules—(1) Property placed in service and disposed of in the same taxable year.* Rules similar to those provided in §1.168(k)-1T(f)(1) apply for purposes of this paragraph (f)(1).

(2) *Redetermination of basis.* If the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of qualified

New York Liberty Zone property is re-determined (for example, due to contingent purchase price or discharge of indebtedness) on or before December 31, 2006 (or on or before December 31, 2009, for nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section), the additional first year depreciation deduction allowable for the qualified New York Liberty Zone property is redetermined in accordance with the rules provided in §1.168(k)-1T(f)(2).

(3) *Section 1245 and 1250 depreciation recapture.* The rules provided in §1.168(k)-1T(f)(3) apply for purposes of this paragraph (f)(3).

(4) *Coordination with section 169.* Rules similar to those provided in §1.168(k)-1T(f)(4) apply for purposes of this paragraph (f)(4).

(5) *Like-kind exchanges and involuntary conversions.* This paragraph (f)(5) applies to acquired MACRS property (as defined in §1.168(k)-1T(f)(5)(ii)(A)) or acquired computer software (as defined in §1.168(k)-1T(f)(5)(ii)(C)) that is eligible for the additional first year depreciation deduction under section 1400L(b) at the time of replacement provided the time of replacement is after September 10, 2001, and on or before December 31, 2006, or in the case of acquired MACRS property or acquired computer software that is qualified New York Liberty Zone property described in paragraph (c)(2)(i)(B) of this section, the time of replacement is after September 10, 2001, and on or before December 31, 2009. The rules and definitions similar to those provided in §1.168(k)-1T(f)(5) apply for purposes of this paragraph (f)(5).

(6) *Change in use.* Rules similar to those provided in §1.168(k)-1T(f)(6) apply for purposes of this paragraph (f)(6).

(7) *Earnings and profits.* The rule provided in §1.168(k)-1T(f)(7) applies for purposes of this paragraph (f)(7).

(8) *Section 754 election.* Rules similar to those provided in §1.168(k)-1T(f)(9) apply for purposes of this paragraph (f)(8).

(g) *Effective date*—(1) *In general.* Except as provided in paragraphs (g)(2) and (3) of this section, this section applies to qualified New York Liberty Zone property acquired by a taxpayer after September 10, 2001. This section expires on September 4, 2006.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified New York Liberty Zone property is transferred in a technical termination of a partnership under section 708(b)(1)(B) or in a transaction described in section 168(i)(7) for a taxable year ending on or before September 8, 2003, and the additional first year depreciation deduction allowable for the property was not determined in accordance with paragraph (f)(1) of this section, the Internal Revenue Service will allow any reasonable method of determining the additional first year depreciation deduction allowable for the property in the year of the transaction that is consistently applied to the property by all parties to the transaction.

(3) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for a taxable year ending on or before September 8, 2003, the additional first year depreciation deduction for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the Internal Revenue Service will treat the taxpayer's method of not claiming the additional first year depreciation deduction for the remaining carryover basis as a permissible method of accounting and will treat the amount of the additional first year depreciation deduction allowable for the remaining carryover basis as being equal to zero, provided the taxpayer does not claim the additional first year depreciation deduction for the remaining carryover basis in accordance with paragraph (g)(4)(ii) of this section.

(4) *Change in method of accounting*—(i) *Special rules for 2000 or 2001 returns.* If a taxpayer did not claim on the federal tax return for the taxable year that included September 11, 2001, any additional first year depreciation deduction for a class of property that is qualified New York Liberty Zone property and did not make an election not to deduct the additional first year depreciation deduction for that class of property, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time

and manner of claiming the additional first year depreciation deduction for the class of property (for further guidance, see section 4 of Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(ii) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for any taxable year ending on or before September 8, 2003, the additional first year depreciation deduction allowable for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the taxpayer may claim the additional first year depreciation deduction allowable for the remaining carryover basis in accordance with paragraph (f)(5) of this section either—

(A) By filing an amended return (or a qualified amended return, if applicable (for further guidance, see Rev. Proc. 94-69, 1994-2 C.B. 804, and §601.601(d)(2)(ii)(b) of this chapter)) on or before December 31, 2003, for the year of replacement and any affected subsequent taxable year; or,

(B) By following the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002-9, 2002-1 C.B. 327, and §601.601(d)(2)(ii)(b) of this chapter).

Robert E. Wenzel,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved August 29, 2003.

Gregory F. Jenner,  
*Assistant Secretary of the  
Treasury (Tax Policy).*

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