

**TECHNICAL EXPLANATION OF THE
“JOB CREATION AND WORKER ASSISTANCE ACT OF 2002”**

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JOINT COMMITTEE ON TAXATION



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I. BUSINESS PROVISIONS

A. Special Depreciation Allowance for Certain Property (sec. 101 of the bill and sec. 168 of the Code)

Present Law

Depreciation deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to \$25,000 for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Explanation of Provision

The provision allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.² The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer’s alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is

² The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS³ apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property⁴. Second, the original use⁵ of the property must commence with the taxpayer on or after September 11, 2001.⁶

³ A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

⁴ Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) of that portion of the building, or by the lessor of that portion of the building. That portion of the building is to be occupied exclusively by the lessee (or any sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

For purposes of the provision, a binding commitment to enter into a lease would be treated as a lease, and the parties to the commitment would be treated as lessor and lessee. A lease between related persons would not be considered a lease for this purpose.

Finally, New York Liberty Zone qualified leasehold improvement property is not eligible for the additional first year depreciation deduction.

⁵ The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as “original use,” the factors used to determine whether property qualified as “new section 38 property” for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the “original use” requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the “original use” requirement. For example, if on February 1, 2002, a taxpayer buys from X for \$20,000 a machine that has been previously used by X. Prior to September 11, 2004, the taxpayer makes an expenditure on the property of \$5,000 of the type that must be capitalized. Regardless of whether the \$5,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the “original use” requirement and would be qualified property (assuming all other conditions are met). No part of the \$20,000 purchase price would qualify for the additional first year depreciation.

Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the place in service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.⁷ Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before September 11, 2004, and no binding written contract for the acquisition is in effect before September 11, 2001 or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") shall be eligible for the additional first year depreciation.⁸

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) is increased in the first year by \$4,600 for automobiles that qualify (and do not elect out of the increased first year deduction). The \$4,600 increase is not indexed for inflation.

The following examples illustrate the operation of the provision.

EXAMPLE 1. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs \$1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of \$300,000. The remaining \$700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

⁶ A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

⁷ In order for property to qualify for the extended placed in service date, the property is required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding \$1 million.

⁸ For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

EXAMPLE 2. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs \$50,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a \$24,000 deduction under section 179. The taxpayer then is allowed an additional first-year depreciation deduction of \$7,800 based on \$26,000 (\$50,000 original cost less the section 179 deduction of \$24,000) of adjusted basis. Finally, the remaining adjusted basis of \$18,200 (\$26,000 adjusted basis less \$7,800 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

Effective Date

The provision applies to property placed in service after September 10, 2001.

G. Treatment of Qualified Leasehold Improvement Property (sec. 301 of the bill and new sec. 1400L of the Code)

Present Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System (“MACRS”) of section 168.

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).³⁸ This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.³⁹ If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).⁴⁰

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease.⁴¹ This rule conforms the treatment of

³⁸ The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System (“ACRS”) to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

³⁹ Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

⁴⁰ If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a “structural component” of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

⁴¹ The conference report describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.⁴²

Explanation of Provision

The provision provides that 5-year property for purposes of the depreciation rules of section 168 includes qualified New York Liberty Zone leasehold improvement property (“qualified NYLZ leasehold improvement property”). The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6)⁴³ that is placed in service after September 10, 2001 and before January 1, 2007 (and not subject to a binding contract on September 10, 2001) in the New York Liberty Zone. The straight-line method is required to be used with respect to qualified NYLZ leasehold improvement property. A 9-year period is specified as the class life of qualified NYLZ leasehold improvement property for purposes of the alternative depreciation system.

⁴² Under present law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

⁴³ Section 168(e)(6) regarding qualified leasehold improvement property is added by section 205 of the bill.