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How To Depreciate Property

For use in preparing
2001 Returns



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Introduction

After Publication 946 was printed, the Job Creation and Worker Assistance Act of 2002 was signed into law by the President. The new law made several changes in the tax rules explained in the publication. Some of the changes apply to property placed in service during 2001. This supplemental publication describes those changes and explains what you should do if you are affected by them.

The situations and examples in Publication 946 do not reflect any of the changes made by the Job Creation and Worker Assistance Act of 2002.

The new law contains the following provisions.

- 30% depreciation deductions (special depreciation allowance and special New York Liberty Zone (Liberty Zone) depreciation allowance) for the year qualified property is placed in service after September 10, 2001.
- An increased dollar limit on the section 179 deduction for qualified Liberty Zone property purchased after September 10, 2001.
- A shorter recovery period for qualified Liberty Zone leasehold improvement property placed in service after September 10, 2001.
- An increase in the maximum depreciation deduction for 2001 for a qualified passenger automobile placed in service after September 10, 2001.

For details on how the new law affects other areas of the federal income tax, see Publication 3991, *Highlights of the Job Creation and Worker Assistance Act of 2002*.

If you believe you qualify for an increased deduction under any of these new rules, you must file the revised 2001 Form 4562 (dated March 2002) for 2001 calendar or fiscal years and 2000 fiscal years ending after September 10, 2001. If you have already filed a tax return, this supplemental publication explains how to claim these benefits and how to elect **not** to claim the special depreciation allowance or special Liberty Zone depreciation allowance. See *Table 2* at the end of the supplement for an overview of the rules that apply if you filed your return before June 1, 2002.

Special Depreciation Allowance

You can take a special depreciation allowance for qualified property you place in service after September 10, 2001. The allowance is an additional deduction of 30% of the property's depreciable basis. To figure the depreciable basis, you must first multiply the property's cost or other basis by the percentage of business/investment use and then reduce that amount by any section 179 deduction and certain other deductions and credits for the property. See *What Is the Basis for Depreciation?* on page 23 in Publication 946 for more information on figuring depreciable basis.

The allowance is deductible for both regular tax and alternative minimum tax (AMT) purposes. There is no AMT adjustment required for any depreciation figured on the remaining basis of the property. In the year you claim the allowance (generally the year you place the property in service), you must reduce the depreciable basis of the property by the allowance before figuring your regular depreciation deduction.

Example 1. On November 1, 2001, you bought and placed in service in your business qualified property that cost \$100,000. You did not elect to claim a section 179 deduction. You can deduct 30% of the cost (\$30,000) as a special depreciation allowance for 2001. You use the remaining \$70,000 of cost to figure your regular depreciation deduction for 2001 and later years.

Example 2. The facts are the same as in Example 1, except that you choose to deduct \$24,000 of the property's cost as a section 179 deduction. You use the remaining \$76,000 of cost to figure your special depreciation allowance of \$22,800 ($\$76,000 \times 30\%$). You use the remaining \$53,200 of cost to figure your regular depreciation deduction for 2001 and later years.

Qualified Property

To qualify for the special depreciation allowance, your property must meet the following requirements.

- 1) It is new property of one of the following types.
 - a) Property depreciated under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less. See *Can You Use MACRS To Depreciate Your Property and Which Recovery Period Applies?* on pages 7 and 23, respectively, in Publication 946.
 - b) Water utility property. See *25-year property* on page 22 in Publication 946.
 - c) Computer software that is not a section 197 intangible as described in *Computer software* on page 5 in Publication 946. (The cost of some computer software is treated as part of the cost of hardware and is depreciated under MACRS.)
 - d) Qualified leasehold improvement property (defined later).

- 2) It meets the following tests (explained later under *Tests To Be Met*).
 - a) Acquisition date test.
 - b) Placed in service date test.
 - c) Original use test.
- 3) It is **not** excepted property (explained later under *Excepted Property*).

Qualified leasehold improvement property. Generally, this is any improvement to an interior part of a building that is nonresidential real property, provided all of the following requirements are met.

- The improvement is made under or pursuant to a lease by the lessee (or any sublessee) or the lessor of that part of the building.
- That part of the building is to be occupied exclusively by the lessee (or any sublessee) of that part.
- The improvement is placed in service more than 3 years after the date the building was first placed in service.

However, a qualified leasehold improvement does not include any improvement for which the expenditure is attributable to any of the following.

- The enlargement of the building.
- Any elevator or escalator.
- Any structural component benefiting a common area.
- The internal structural framework of the building.

Generally, a binding commitment to enter into a lease is treated as a lease and the parties to the commitment are treated as the lessor and lessee. However, a binding commitment between related persons is not treated as a lease.

Related persons. For this purpose, the following are related persons.

- Members of an affiliated group.
- The persons listed in items (1) through (9) under *Related persons* on page 8 of Publication 946 (except that "80% or more" should be substituted for "more than 10%" each place it appears).
- An executor and a beneficiary of the same estate.

Tests To Be Met

To qualify for the special depreciation allowance, the property must meet all of the following tests.

Acquisition date test. Generally, you must have acquired the property either:

- After September 10, 2001, and before September 11, 2004, but only if no written binding contract for the acquisition was in effect before September 11, 2001, or

- Pursuant to a written binding contract entered into after September 10, 2001, and before September 11, 2004.

Property you manufacture, construct, or produce for your own use meets this test if you began the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004.

Placed in service date test. Generally, the property must be placed in service for use in your trade or business or for the production of income after September 10, 2001, and before January 1, 2005.

If you sold property you placed in service after September 10, 2001, and you leased it back within 3 months after the property was originally placed in service, the property is treated as placed in service no earlier than the date it is used under the leaseback.

Original use test. The original use of the property must have begun with you after September 10, 2001. "Original use" means the first use to which the property is put, whether or not by you. Additional capital expenditures you incurred after September 10, 2001, to recondition or rebuild your property meet the original use test.

Excepted Property

The following property does not qualify for the special depreciation allowance.

- Property used by any person before September 11, 2001.
- Property required to be depreciated using ADS. This includes listed property used 50% or less in a qualified business use.
- Qualified New York Liberty Zone leasehold improvement property (defined next).

Qualified New York Liberty Zone leasehold improvement property. This is any qualified leasehold improvement property (as defined earlier) if all of the following requirements are met.

- The improvement is to a building located in the New York Liberty Zone (defined later under *New York Liberty Zone Benefits*).
- The improvement is placed in service after September 10, 2001, and before January 1, 2007.
- No written binding contract for the improvement was in effect before September 11, 2001.

Election Not To Claim the Allowance

You can elect *not* to claim the special depreciation allowance for qualified property. If you make this election for any property, it applies to all property in the same property class placed in service during the year. To make this election, attach a statement to your return indicating you elect not to claim the allowance and the class of property for which you are making the election.

When to make election. Generally, you must make the election on a timely filed tax return (including extensions) for the year in which you place the property in service.

However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the original return (not including extensions). Attach the election statement to the amended return. At the top of the election statement, write "Filed pursuant to section 301.9100-2."

Revoking an election. Once you elect not to deduct the special depreciation allowance for a class of property, you cannot revoke the election without IRS consent. A request to revoke the election is subject to a user fee.

Rules for Returns Filed Before June 1, 2002

The following rules apply if you placed qualified property in service after September 10, 2001, and filed your return before June 1, 2002. The rules apply to returns for the following years.

- 2000 fiscal years that end after September 10, 2001.
- 2001 calendar and fiscal years.

Claiming the allowance. If you did not claim the allowance on your return and did not make the election not to claim the allowance, you can do either of the following to claim the allowance.

- File an amended return by the due date (not including extensions) of your return for the year following the year the property was placed in service. Write "Filed Pursuant to Rev. Proc. 2002-33" at the top of the amended return.
- File Form 3115, *Application for Change in Accounting Method*, with your return for the year following the year the property was placed in service. Your return must be filed by the due date (including extensions). Write "Automatic Change Filed Under Rev. Proc. 2002-33" on the appropriate line of Form 3115. You must also file a copy (with signature) of the completed Form 3115 with the IRS National Office no later than when you file the original with your return. For more information about filing Form 3115, including the address to send it to, see Revenue Procedure 2002-9, Revenue Procedure 2002-19, and Revenue Procedure 2002-33.

Example 1. You are an individual and you use the calendar year. You placed qualified property in service for your business in December 2001. You filed your 2001 income tax return before April 15, 2002. You did not claim the special depreciation allowance for the property and did not make the election not to claim the allowance. You can claim the special allowance by filing an amended 2001 return by April 15, 2003, with "Filed Pursuant to Rev. Proc. 2002-33" at the top of the amended return. You must file an amended return by April 15, 2003, even if you get an extension of time to file your 2002 tax return.

Example 2. The facts concerning your 2001 return are the same as in *Example 1*. In addition, you got an automatic 4-month extension of time (to August 15, 2003) to file your 2002 return. You can claim the special allowance by filing a Form 3115 (with "Filed Pursuant to Rev. Proc. 2002-33" on the appropriate line) with your 2002 return by August 15, 2003. You must also file a copy of this Form 3115 with the IRS National Office no later than when you file your 2002 return.

Electing not to claim the allowance. Generally, you have elected **not** to claim the special depreciation allowance for a class of property if you:

- Filed your return timely (including extensions) for the year you placed qualified property in service and indicated on a statement with the return that you are not claiming the allowance, or
- Filed your return timely and filed an amended return within 6 months of the due date of the original return (not including extensions) and indicated on a statement with the amended return that you are not claiming the allowance.

The statement must indicate that you are not deducting the special depreciation allowance and the class of property to which the election applies. The statement can be either attached to or written on the return. You can, for example, write "not deducting 30%" on Form 4562.

Deemed election. If you have not followed either of the procedures described above to elect **not** to claim the allowance, you may still be treated as making the election. You will be treated as making the election if you meet both of the following conditions.

- You filed your return for the year you placed the property in service and claimed depreciation, but not the special allowance, for any class of property.
- You do not file an amended return or a Form 3115 within the time prescribed for claiming the special allowance. See *Claiming the allowance*, earlier.

Passenger Automobiles

The limit on your depreciation deduction (including any section 179 deduction) for any passenger automobile that is qualified property (defined earlier) placed in service after September 10, 2001, and for which you claim the special depreciation allowance is increased. Generally, the limit is increased from \$3,060 to \$7,660. However, if the automobile is a qualified electric car, the limit is increased from \$9,280 to \$23,080 (\$22,980 if placed in service in 2002). *Table 1* shows the maximum deduction amounts for 2001.

Table 1. Maximum Deduction for 2001

Qualified Vehicle	Placed in Service Before Sept. 11	Placed in Service After Sept. 10
Passenger automobile	\$3,060	\$ 7,660
Electric car	9,280	23,080 ¹
¹ \$22,980 if you place an electric car in service in 2002.		

Election not to claim the allowance. The increased maximum depreciation deduction does not apply if you elected **not** to claim the special depreciation allowance as explained earlier under *Election Not To Claim the Allowance and Rules for Returns Filed Before June 1, 2002*.

New York Liberty Zone Benefits

Several benefits are available for property you place in service in the New York Liberty Zone (Liberty Zone). They include a special depreciation allowance for the year you place the property in service, an increased section 179 deduction, and the classification of certain leasehold improvement property as 5-year property.

Area defined. The 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.

Special Liberty Zone Depreciation Allowance

You can take a special depreciation allowance for qualified Liberty Zone property you place in service after September 10, 2001. The allowance is an additional deduction of 30% of the property's depreciable basis. To figure the depreciable basis, you must first multiply the property's cost or other basis by the percentage of business/investment use and then reduce that amount by any section 179 deduction and certain other deductions and credits for the property. See *What Is the Basis for Depreciation?* on page 23 in Publication 946 for more information on figuring depreciable basis.

The allowance is deductible for both regular tax and alternative minimum tax (AMT) purposes. There is no AMT adjustment required for any depreciation figured on the remaining basis of the property. In the year you claim the allowance (generally the year you place the property in service), you must reduce the depreciable basis of the property by the allowance before figuring your regular depreciation deduction.



You cannot claim the special Liberty Zone depreciation allowance for property eligible for the special depreciation allowance explained earlier in Qualified Property under Special Depreciation Allowance. Qualified property is eligible for only one special depreciation allowance.

Example 1. On November 1, 2001, you bought and placed in service in your business, which is in the Liberty Zone, qualified Liberty Zone property that cost \$200,000. You did not elect to claim a section 179 deduction. You can deduct 30% of the cost (\$60,000) as a special Liberty Zone depreciation allowance for 2001. You use the remaining \$140,000 of cost to figure your regular depreciation deduction for 2001 and later years.

Example 2. The facts are the same as in *Example 1*, except that you choose to deduct \$59,000 of the property's cost as a section 179 deduction. (See *Increased Section 179 Deduction*, later, for information concerning how this section 179 deduction amount is figured). You use the remaining \$141,000 of cost to figure your special Liberty Zone depreciation allowance of \$42,300 (\$141,000 × 30%). You use the remaining \$98,700 of cost to figure your regular depreciation deduction for 2001 and later years.

Qualified Liberty Zone Property

For a 2001 calendar or fiscal year and a 2000 fiscal year that ends after September 10, 2001, property qualifies for the special Liberty Zone depreciation allowance if it meets the following requirements.

- 1) It is one of the following types of property.
 - a) Used property depreciated under MACRS with a recovery period of 20 years or less. See *Can You Use MACRS To Depreciate Your Property and Which Recovery Period Applies?* on pages 7 and 23, respectively, in Publication 946.
 - b) Used water utility property. See *25-year property* on page 22 in Publication 946.
 - c) Used computer software that is not a section 197 intangible as described in *Computer software* on page 5 in Publication 946. (The cost of some computer software is treated as part of the cost of hardware and is depreciated under MACRS.)
 - d) Certain nonresidential real property and residential rental property (defined later).
- 2) It meets the following tests (explained later under *Tests to be met*).
 - a) Acquisition date test.
 - b) Placed in service date test.
 - c) Substantial use test.
 - d) Original use test.
- 3) It is **not** excepted property (explained later under *Excepted property*).

Nonresidential real property and residential rental property. This property is qualifying property only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attack of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, such property replaces real property included in a continuous area that includes real property destroyed or condemned.

For these purposes, real property is considered destroyed (or condemned) only if an entire building or structure was destroyed (or condemned) as a result of the terrorist attack. Otherwise, the property is considered damaged real property. For example, if certain structural components of a building (such as walls, floors, or plumbing fixtures) are damaged or destroyed as a result of the terrorist attack, but the building is not destroyed (or condemned), then only costs related to replacing the damaged

or destroyed structural components qualify for the special Liberty Zone depreciation allowance.

Tests to be met. To qualify for the special Liberty Zone depreciation allowance, your property must meet all of the following tests.

Acquisition date test. You must have acquired the property by purchase after September 10, 2001, and there must not have been a binding written contract for the acquisition in effect before September 11, 2001.

For information on the acquisition of property by purchase, see *Property Acquired by Purchase* on page 15 of Publication 946.

Property you manufacture, construct, or produce for your own use meets this test if you began the manufacture, construction, or production of the property after September 10, 2001.

Placed in service date test. Generally, the property must be placed in service for use in your trade or business or for the production of income before January 1, 2007 (January 1, 2010, in the case of qualifying nonresidential real property and residential rental property).

If you sold property you placed in service after September 10, 2001, and you leased it back within 3 months after the property was originally placed in service, the property is treated as placed in service no earlier than the date it is used under the leaseback.

Substantial use test. Substantially all use of the property must be in the Liberty Zone and in the active conduct of your trade or business in the Liberty Zone.

Original use test. The original use of the property in the Liberty Zone must have begun with you after September 10, 2001.

Used property can be qualified Liberty Zone property if it has not previously been used within the Liberty Zone. Also, additional capital expenditures you incurred after September 10, 2001, to recondition or rebuild your property meet the original use test if the original use of the property in the Liberty Zone began with you.

Excepted property. The following property does not qualify for the special Liberty Zone depreciation allowance.

- Property eligible for the special depreciation allowance explained earlier in *Qualified Property under Special Depreciation Allowance*.
- Property required to be depreciated using ADS. This includes listed property used 50% or less in a qualified business use.
- Qualified New York Liberty Zone leasehold improvement property (defined earlier in *Excepted Property under Special Depreciation Allowance*).

Example. In December 2001, you bought and placed in service in your business in the Liberty Zone the following property.

- New office furniture with a MACRS recovery period of 7 years.
- A used computer with a MACRS recovery period of 5 years.

The computer had not previously been used within the Liberty Zone.

Because the office furniture is new property, it qualifies for the special depreciation allowance, but not the special Liberty Zone depreciation allowance. Because the computer is used property that had not previously been used in the Liberty Zone, it qualifies for the special Liberty Zone depreciation allowance, but not the special depreciation allowance.

Election Not To Claim the Liberty Zone Allowance

You can elect **not** to claim the special Liberty Zone depreciation allowance for qualified property. If you make this election for any property, it applies to all property in the same property class placed in service during the year. To make this election, attach a statement to your return indicating you elect not to claim the allowance and the class of property for which you are making the election.

When to make the election. Generally, you must make the election on a timely filed tax return (including extensions) for the year in which you place the property in service.

However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the original return (not including extensions). Attach the election statement to the amended return. At the top of the election statement, write "Filed pursuant to section 301.9100-2."

Revoking an election. Once you elect not to deduct the special Liberty Zone depreciation allowance for a class of property, you cannot revoke the election without IRS consent. A request to revoke the election is subject to a user fee.

Returns filed before June 1, 2002. The rules that apply to the special depreciation allowance discussed earlier in *Rules for Returns Filed Before June 1, 2002* under *Special Depreciation Allowance* also apply to the special Liberty Zone depreciation allowance.

Increased Section 179 Deduction

Under section 179 of the Internal Revenue Code, you can choose to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year you place the property in service. For tax years beginning in 2000, that limit was \$20,000. For tax years beginning in 2001 and 2002, that limit is generally \$24,000. If the cost of qualifying section 179 property placed in service in a year is over \$200,000, you must reduce the dollar limit (but not below zero) by the amount of the cost over \$200,000.

Increased Dollar Limit

The dollar limit on the section 179 deduction is increased for certain property placed in service in the Liberty Zone. The increase is the smaller of the following amounts.

- \$35,000.
- The cost of section 179 property that is qualified Liberty Zone property placed in service during the year.



If you use the revised 2001 Form 4562 (dated March 2002) for a tax year beginning in 2000, you must reduce the section 179 dollar limit to \$20,000 before adding the additional amount for qualified property.

Qualified property. To qualify for the increased section 179 deduction, your property must be section 179 property that is either:

- Qualified Liberty Zone property, or
- Property that would be qualified Liberty Zone property except that it is eligible for the special depreciation allowance.

Qualified Liberty Zone property is explained earlier in *Qualified Liberty Zone Property* under *Special Liberty Zone Depreciation Allowance*. Property eligible for the special depreciation allowance is explained earlier in *Qualified Property* under *Special Depreciation Allowance*. For information on the requirements that must be met for property to qualify for the section 179 deduction, see *What Property Qualifies?* on page 14 of Publication 946.

Example 1. In 2002, you place in service in your business, which is in the Liberty Zone, qualified property (defined earlier) costing \$25,000. Because this cost is less than \$35,000, the dollar limit on the section 179 deduction is increased by \$25,000 to \$49,000 (\$24,000 + \$25,000).

Example 2. In 2002, you place in service in your business, which is in the Liberty Zone, qualified property (defined earlier) costing \$75,000. Because \$35,000 is less than the cost of the property you place in service, the dollar limit on the section 179 deduction you can claim is increased by \$35,000 to \$59,000 (\$24,000 + \$35,000).

Reduced Dollar Limit

Generally, you must reduce the dollar limit for a year by the cost of qualifying section 179 property placed in service in the year that is more than \$200,000. However, if the cost of your Liberty Zone property exceeds \$200,000, you take into account only 50% (instead of 100%) of the cost of qualified property placed in service in a year.

Example. In 2002, you place in service in your business, which is in the Liberty Zone, qualified property costing \$460,000. Your increased dollar limit is \$59,000 (\$35,000 + \$24,000). Because 50% of the cost of the property you place in service (\$230,000) is \$30,000 more than \$200,000, you must reduce your \$59,000 dollar limit to \$29,000 (\$59,000 – \$30,000).

Recapture Rules

Rules similar to those explained on page 20 of Publication 946 under *When Must You Recapture the Deduction?* apply with respect to any qualified property you stop using in the Liberty Zone.

Returns Filed Before June 1, 2002

If you filed a return before June 1, 2002, and did not deduct the increased section 179 amount for qualified property placed in service after September 10, 2001, you can deduct the increased amount by filing an amended return by the due date (not including extensions) of the return for the year after the year the property was placed in service. This rule applies to returns for the following years.

- 2000 fiscal years that end after September 10, 2001.
- 2001 calendar and fiscal years.

On the amended return, write "Filed Pursuant to Rev. Proc. 2002-33."

Liberty Zone Leasehold Improvement Property

Qualified Liberty Zone leasehold improvement property (described earlier in *Qualified Property* under *Special Depreciation Allowance*) is 5-year property. This means that it is depreciated over a recovery period of 5 years. For information about recovery periods, see *Which Recovery Period Applies?* on page 23 of Publication 946.

The straight-line method must be used with respect to qualified Liberty Zone leasehold improvement property.

Under ADS, the recovery period for qualified Liberty Zone leasehold improvement property is 9 years.

Returns Filed Before June 1, 2002

If you filed either of the following returns before June 1, 2002, and did not depreciate qualified Liberty Zone leasehold improvement property placed in service during the tax year as 5-year property using the straight line method, you should file an amended return before you file your return for the year after the year the property was placed in service.

- Your 2000 fiscal year return (for a 2000 fiscal year that ends after September 10, 2001).
- Your 2001 calendar or fiscal year return.

On the amended return, write "Filed Pursuant to Rev. Proc. 2002-33."

Table 2. Rules for Returns Filed Before June 1, 2002

Note: This chart highlights the rules for returns affected by the Job Creation and Worker Assistance Act of 2002 that were filed before June 1, 2002, without accounting for any of the new benefits under the law. See the text for definitions and examples. **Do not rely on this chart alone.**

IF you want to...	THEN you...	BY...
claim the special depreciation allowance or special Liberty Zone depreciation allowance	<ul style="list-style-type: none"> • must file an amended return 	<ul style="list-style-type: none"> • the due date (not including extensions) of your return for the year after the year the property was placed in service, or
	<ul style="list-style-type: none"> • must file Form 3115, <i>Application for Change in Accounting Method</i>, with your return for the year after the year the property was placed in service • must file a copy of your completed Form 3115 with the IRS National Office 	<ul style="list-style-type: none"> • the due date (including extensions) of your return for the year after the year the property was placed in service, and • the date you file the original Form 3115 with your return for the year after the year the property was placed in service.
elect not to claim the special depreciation allowance or the special Liberty Zone depreciation allowance ¹	<ul style="list-style-type: none"> • must have filed your return timely for the year the property was placed in service, and • must file an amended return stating you are not claiming the allowance 	<ul style="list-style-type: none"> • the date that is 6 months after the due date of the original return (not including extensions).
deduct the increased section 179 amount	<ul style="list-style-type: none"> • must file an amended return 	<ul style="list-style-type: none"> • the due date (not including extensions) of your return for the year after the year the property was placed in service.
use a 5-year recovery period for depreciating qualified Liberty Zone leasehold improvement property	<ul style="list-style-type: none"> • should file an amended return 	<ul style="list-style-type: none"> • the date you file your return for the year after the year the property was placed in service.

¹See also *Deemed election* under *Rules for Returns Filed Before June 1, 2002*, earlier.

