

**PRESENT LAW AND BACKGROUND RELATING TO
SELECTED BUSINESS INCOME TAX PROVISIONS**

Scheduled for a Public Hearing
Before the
COMMITTEE ON WAYS AND MEANS
on June 2, 2011

Prepared by the Staff
of the
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INTRODUCTION AND OVERVIEW

The House Ways and Means Committee has scheduled a public hearing for June 2, 2011, on selected business tax issues under the Federal income tax. This document,¹ prepared by the staff of the Joint Committee on Taxation, describes present Federal income tax rules applicable to businesses with respect to capital expenditures, capital cost recovery, other types of cost recovery, tax accounting methods, general business credits, the corporate alternative minimum tax, and differences between tax accounting and financial accounting for selected items of expense of businesses.

Overview of corporate income tax

Since its inception in 1909, the Federal income tax assessed on the earnings of corporations as entities separate and apart from their owners has undergone significant changes, both with respect to the corporate income tax rate structure and the tax base. The following describes the corporate income tax in general as it exists today, along with a table of corporate tax rates in effect this year (2011).

In general

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income.²

The taxable income of a corporation generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenses, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Income Tax Provisions*, (JCX-34-11), June 1, 2011. This document can also be found on our website at www.jct.gov.

² Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States. A qualified small business corporation may elect, under subchapter S of the Code, not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders. Special rules (not discussed herein) also apply to certain insurance companies, cooperative organizations, and to a corporation that has elected to be taxable as a regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).

organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year typically may be carried back two years or carried forward 20 years and allowed as a deduction in another taxable year. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain domestic manufacturing activities.

The Code also specifies certain expenditures that typically may not be deducted, such as expenses associated with earning tax-exempt income,³ certain entertainment expenditures, certain executive compensation in excess of \$1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, penalties, bribes, kickbacks and illegal payments.

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. Beginning in 2010, the percentage is generally⁴ nine percent.⁵

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses are listed in section E of this document, relating to the

³ For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

⁴ In the case of oil related qualified production activities income, for any taxable year beginning after 2009, the percentage is reduced by three percent of the least of: (1) oil related qualified production activities income of the taxpayer for the taxable year; (2) qualified production activities income of the taxpayer for the taxable year; or (3) taxable income (determined without regard to the deduction for income attributable to domestic manufacturing activities).

⁵ At the fully phased-in nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate on qualifying income of 31.85 percent ($0.91 \times 0.35 = 0.3185$). A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

general business credit. Credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. For purposes of calculating tax liability, corporations filing a consolidated return generally are treated as divisions of a single corporation; thus, the losses (and credits) of one corporation generally can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Table 1.—Federal Corporate Income Tax Rate Structure in 2011

Corporate Taxable Income	Income Tax Rate (percent)
First \$50,000	15
\$50,001-\$75,000	25
\$75,001-\$100,000	34
\$100,001-\$335,000	39*
\$335,001-\$10,000,000	34
\$10,000,001-\$15,000,000	35
\$15,000,001-\$18,333,333	38*
Over \$18,333,333	35
* Rates higher than the top bracket rate reflect phaseouts of the benefit from the lower bracket rates and are not technically the top corporate statutory rate.	

Overview of business entities other than corporations

Significant business activity is conducted through entities other than corporations. Such business entities include passthrough entities such as partnerships (including limited liability companies (“LLCs”)) and S corporations. For Federal income tax purposes, these passthrough entities generally are not subject to tax at the entity level. Rather, the owners – that is, partners or S corporation shareholders – are subject to tax on their shares of the entity’s income, gain, loss, deduction, and credit, whether or not distributed.⁶ The tax treatment of passthrough

⁶ Partners and S corporation shareholders who are individuals generally report this income on Schedule E.

entities differs from the generally applicable entity level tax on income of corporations.⁷ In addition, noncorporate business income is generated by sole proprietorships and farms.⁸

Allowable deductions for businesses conducted in passthrough entity form are generally the same as allowable deductions for businesses conducted in corporate form. However, the calculation of these deductions is affected by the fact that they are taken into account for tax purposes by the partners or S corporation shareholders rather than by the partnership or S corporation at the entity level.

There are no limitations on the identity of a partner in a partnership under present law. Thus, a partner in a business conducted through a partnership (including an LLC) can generally be an individual, a corporation, or another partnership, for example. Permissible shareholders of S corporations are restricted to individuals (other than nonresident aliens), estates, certain trusts, and certain tax-exempt organizations, and may not exceed 100 in number (taking into account applicable attribution rules).

Tax rate schedules for individuals

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2011, the regular individual income tax rate schedules are as follows:

⁷ Business entities also include specialized corporations that are not subject to entity level tax under the Federal income tax rules. Federal tax rules applicable to these entities generally require that they distribute substantially all their income and require that they meet other specified limitations on activities, assets, and types of income, for example. These types of entities include regulated investment companies (RICs) (mutual funds in common parlance), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), and cooperatives. In addition, some business activities are conducted through tax-exempt entities, whether as activities subject to unrelated business income tax (UBIT), or as permitted under the Federal tax rules relating to tax-exempt organizations.

⁸ This income is generally reported by individuals on Schedules C and F.

Table 2.—Federal Individual Income Tax Rates for 2011

If taxable income is:	Then income tax equals:
Single Individuals	
Not over \$8,500	10% of the taxable income
Over \$8,500 but not over \$34,500	\$850 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$83,600	\$4,750 plus 25% of the excess over \$34,500
Over \$83,600 but not over \$174,400	\$17,025 plus 28% of the excess over \$83,600
Over \$174,400 but not over \$379,150	\$42,449 plus 33% of the excess over \$174,400
Over \$379,150	\$110,016 plus 35% of the excess over \$379,150
Heads of Households	
Not over \$12,150	10% of the taxable income
Over \$12,150 but not over \$46,250	\$1,215 plus 15% of the excess over \$12,150
Over \$46,250 but not over \$119,400	\$6,330 plus 25% of the excess over \$46,250
Over \$119,400 but not over \$193,350	\$24,618 plus 28% of the excess over \$119,400
Over \$193,350 but not over \$379,150	\$45,324 plus 33% of the excess over \$193,350
Over \$379,150	\$106,638 plus 35% of the excess over \$379,150
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over \$17,000	10% of the taxable income
Over \$17,000 but not over \$69,000	\$1,715 plus 15% of the excess over \$17,000
Over \$69,000 but not over \$139,350	\$9,598 plus 25% of the excess over \$69,000
Over \$139,350 but not over \$212,300	\$27,323 plus 28% of the excess over \$139,350
Over \$212,300 but not over \$379,150	\$54,399 plus 33% of the excess over \$212,300
Over \$379,150	\$106,725 plus 35% of the excess over \$379,150
Married Individuals Filing Separate Returns	
Not over \$8,500	10% of the taxable income
Over \$8,500 but not over \$34,500	\$850 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$83,600	\$4,750 plus 25% of the excess over \$34,500
Over \$83,600 but not over \$174,400	\$17,025 plus 28% of the excess over \$83,600
Over \$174,400 but not over \$379,150	\$42,449 plus 33% of the excess over \$174,400
Over \$379,150	\$110.016 plus 35% of the excess over \$379,150

The following table is the staff of the Joint Committee on Taxation's estimate of the individual rate structure in 2013 upon the expiration of the EGTRRA sunset as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Table 3.—Federal Individual Income Tax Rates for 2013

If taxable income is:	Then income tax equals:
Single Individuals	
Not over \$35,500	15% of the taxable income
Over \$35,500 but not over \$86,000	\$5,325 plus 28% of the excess over \$35,500
Over \$86,000 but not over \$179,400	\$19,465 plus 31% of the excess over \$86,000
Over \$179,400 but not over \$390,050	\$48,419 plus 36% of the excess over \$179,400
Over \$390,050	\$124,253 plus 39.6% of the excess over \$390,050
Heads of Households	
Not over \$47,600	15% of the taxable income
Over \$47,600 but not over \$122,850	\$7,140 plus 28% of the excess over \$47,600
Over \$122,850 but not over \$198,900	\$28,210 plus 31% of the excess over \$122,850
Over \$198,900 but not over \$390,050	\$51,786 plus 36% of the excess over \$198,900
Over \$390,050	\$120,600 plus 39.6% of the excess over \$390,050
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over \$59,300	15% of the taxable income
Over \$59,300 but not over \$143,350	\$8,895 plus 28% of the excess over \$59,300
Over \$143,350 but not over \$218,450	\$32,429 plus 31% of the excess over \$143,350
Over \$218,450 but not over \$390,050	\$55,710 plus 36% of the excess over \$218,450
Over \$390,050	\$117,486 plus 39.6% of the excess over \$390,050
Married Individuals Filing Separate Returns	
Not over \$35,500	15% of the taxable income
Over \$35,500 but not over \$86,000	\$5,325 plus 28% of the excess over \$35,500
Over \$86,000 but not over \$179,400	\$19,465 plus 31% of the excess over \$86,000
Over \$179,400 but not over \$390,050	\$48,419 plus 36% of the excess over \$179,400
Over \$390,050	\$124,253 plus 39.6% of the excess over \$390,050

A. Capital Expenditures

Current expenditures and capital expenditures

Section 162 generally allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. A capital expenditure, however, generally is not currently deductible. Capital expenditures generally are recovered over an appropriate period as discussed below. Section 263 defines a capital expenditure as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. A capital expenditure also includes any amount expended for restoring property or in making good the exhaustion thereof for which an allowance (for depreciation, amortization or depletion) is or has been made. Treasury regulations state that capital expenditures generally include amounts paid or incurred “to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or to adapt property to a new or different use.”⁹ Treasury regulations also state that capital expenditures generally include “the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.”¹⁰

In 1974, the Supreme Court stated that the “purpose of section 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing.”¹¹ The courts also have recognized that, although an expenditure may provide some future benefit, the amount of the expenditure may be so small as not to warrant capitalization. For example, a taxpayer was permitted a current deduction for capital costs of less than \$500 per item because requiring capitalization would be a significant burden on the taxpayer.¹² Moreover, the court held, any distortion of income would be minimal and “no provision in the Code is so inflexible as to call for that intractable a result.”¹³

⁹ Treas. Reg. sec. 1.263(a)-1(b). In an attempt provide additional guidance with respect to these factually intensive rules, the government is looking to issue revised regulations addressing the treatment of payments to acquire, produce, or improve tangible property. As part of this effort, the government withdrew regulations proposed in 2006 and replaced them with new proposed regulations in 2008. Prop. Treas. Reg. sec. 1.263(a)-1, -2 and -3, 73 Fed. Reg. 12838-12867 (March 10, 2008).

¹⁰ Treas. Reg. sec. 1.263(a)-2(a).

¹¹ *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

¹² *Cincinnati, New Orleans & Texas Pacific Railway. Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970).

¹³ *Ibid.* p. 572.

In 1992, the Supreme Court again addressed the issue of capitalization. In *INDOPCO v. Commissioner*,¹⁴ the taxpayer, a corporation, incurred legal and professional fees as the result of being the target of a friendly acquisition. The Court required the taxpayer to capitalize these fees, because it concluded that the costs created significant long-term benefits. The Court specifically rejected the taxpayer's position that only expenditures that create or enhance a separate and distinct asset are capital expenditures.¹⁵ In addition, the Court stated, "[a]lthough the mere presence of an incidental future benefit – 'some future aspect' – may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."¹⁶

In 2004, Treasury and IRS promulgated final regulations that addressed the treatment of intangibles as well as amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. The intangible property regulations provide that capitalization is generally required for an amount paid to acquire or create an intangible, create or enhance a separate and distinct intangible asset, create or enhance a future benefit identified in published guidance as an intangible for which capitalization is required and to facilitate an acquisition or creation of an intangible asset.¹⁷ The amount required to be capitalized is generally added to the basis of the intangible acquired or created.¹⁸ These regulations do not, however, impact the present law treatment of any amount specifically addressed under any other section of the Code with the exception of sections 162 and 212 as well as the Treasury regulations thereunder. For example, amounts deductible under section 174 as research and experimentation expenditures are not required to be capitalized under the intangible property regulations.

The regulations addressing amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions require the capitalization of amounts paid to facilitate those transactions. Under these rules, capitalization may be required where the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized

¹⁴ 503 U.S. 79 (1992).

¹⁵ The taxpayer's argument was in part based upon its interpretation of the Supreme Court's decision in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), which held that only expenditures that create or enhance a separate and distinct asset are to be capitalized.

¹⁶ *INDOPCO*, 503 U.S. at 87.

¹⁷ Treas. Reg. sec. 1.263(a)-4. However, under "the 12-month rule," a taxpayer is not required to capitalize amounts paid to create (or facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of: (1) 12 months after the first date on which the taxpayer realizes the right or benefit or (2) the end of the tax year following the tax year in which the payment is made. Treas. Reg. sec. 1.263(a)-4(f).

¹⁸ Sec. 1012.

on the transaction.¹⁹ In general, an amount is treated as paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Subject to a special rule that requires capitalization of amounts that are treated as inherently facilitative,²⁰ an amount paid by a taxpayer in the process of investigating or otherwise pursuing a “covered transaction” is treated as facilitating the transaction only if the amount relates to activities performed on or after the earlier of the following dates: (1) the date on which a letter of intent, exclusivity agreement or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (2) the date on which the material terms of the transaction as tentatively agreed to by representatives of the acquirer and the target are authorized or approved by the taxpayer’s board of directors (or its committee) or other representatives as authorized or approved by governing officials of the taxpayer (in circumstances where the taxpayer is not a corporation).²¹

For this purpose, a “covered transaction” includes: (1) a taxable acquisition by the taxpayer of assets that constitute a trade or business; (2) a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of

¹⁹ Treas. Reg. sec. 1.263(a)-5. Transactions to which the regulations apply include: (1) an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer or target of the acquisition); (2) an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b); (3) an acquisition of an ownership interest in the taxpayer (other than such an acquisition by the taxpayer); (4) a restructuring, recapitalization, or reorganization of the capital (including transactions described in sections 368 and 355); (5) a transfer described in section 351 or section 721 whether the taxpayer is the transferor or transferee); (6) a formation or organization of a disregarded entity; (7) an acquisition of capital; (8) a stock issuance; (9) a borrowing; and (10) writing an option. Treas. Reg. sec. 1.263(a)-5(a).

Section 1.263(a)-5(f) provides that an amount that is contingent on the successful closing of a transaction described in § 1.263(a)-5(a) (“success-based fee”) is presumed to facilitate the transaction. A taxpayer may rebut the presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. As the treatment of success-based fees has been the subject of controversy, the Service recently issued guidance providing a safe harbor for the treatment of success-based fees. Under the safe harbor, the Service will not challenge a taxpayer’s allocation of a success-based fee between activities that facilitate a transaction described in § 1.263(a)-5(e)(3) and activities that do not facilitate the transaction if the taxpayer treats 70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction and capitalizes the remaining 30 percent as an amount that does facilitate the transaction. Rev. Proc. 2011-29; 2011-18 IRB 746

²⁰ An amount is generally treated as inherently facilitative if it is paid for: (1) securing an appraisal, formal written evaluation, or fairness opinion related to the transaction; (2) structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction; (3) preparing and reviewing the documents that effectuate the transaction; (4) obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings; (5) obtaining shareholder approval of the transaction; or (6) conveying property between the parties to the transaction. Treas. Reg. sec. 1.263(a)-5(3)(2).

²¹ Treas. Reg. sec. 1.263(a)-5(e)(1).

section 267(b) or 707(b); and (3) certain reorganization transactions under section 368 (whether the taxpayer is the acquirer or the target in the reorganization).²²

²² Treas. Reg. sec. 1.263(a)-5(e)(3).

B. Capital Cost Recovery

1. MACRS depreciation

In general

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. 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 MACRS depreciation categories generally are set out in the Internal Revenue Code and Internal Revenue Service guidance.²³

The MACRS recovery periods applicable to most tangible personal property range from three 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 taxpayer’s depreciation deduction would be maximized by using the straight-line method. In general, the recovery periods for real property are 39 years for non-residential real property and 27.5 years for residential rental property.

Temporary bonus depreciation rules

An additional first-year depreciation deduction is allowed equal to 100 percent of the adjusted basis of qualified property placed in service after September 8, 2010, and before January 1, 2012 (before January 1, 2013, for certain longer-lived and transportation property), and an additional 50-percent first-year depreciation deduction²⁴ is allowed for qualified property placed in service after December 31, 2011, and before January 1, 2013, (after December 31, 2012, and before January 1, 2014, for certain longer-lived and transportation property). The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits.²⁵

50-percent additional first year depreciation

Property qualifying for the 50-percent additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property

²³ Sec. 168; Rev. Proc. 87-56, 1987-2 C.B. 674.

²⁴ An additional first-year depreciation deduction is also allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property).

²⁵ Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

(as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).²⁶ Second, the original use²⁷ of the property must commence with the taxpayer after December 31, 2007.²⁸ Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2013. An extension of the placed in service date of one year is provided for certain property with a recovery period of 10 years or longer and certain transportation property.²⁹ Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property.

To qualify for the 50-percent additional first-year depreciation deduction, property generally must be acquired (1) after December 31, 2007, and before January 1, 2013 (before January 1, 2014 in the case of certain longer-lived and transportation property), but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2013.³⁰ 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 December 31, 2007, and before January 1, 2013. 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

²⁶ The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

²⁷ 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.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

²⁸ 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.

If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

²⁹ Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

³⁰ Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

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 January 1, 2013 (“progress expenditures”) is eligible for the additional first-year depreciation deduction.³¹

Property does not qualify for the 50-percent additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

In the case of the 50-percent additional first year depreciation deduction, the basis of the property is appropriately adjusted to reflect the additional first-year depreciation deduction. Nevertheless, there are no adjustments 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. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year 50-percent depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2012, a taxpayer purchased new depreciable property and placed it in service.³² The property’s cost is \$1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is \$500. The remaining \$500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2012. The total depreciation deduction with respect to the property for 2012 is \$600. The remaining \$400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

100-percent additional first-year depreciation

Property qualifies for the 100-percent additional first-year depreciation if it meets the requirements for the 50-percent additional first-year depreciation and also meets the following requirements. First, the taxpayer acquires the property after September 8, 2010 and before

³¹ For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

³² Assume that the cost of the property is not eligible for expensing under section 179.

January 1, 2012.³³ Second, the taxpayer must place the property in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 in the case of certain longer-lived and transportation property). Third, the original use of the property must commence with the taxpayer after September 8, 2010.

Election to accelerate certain credits in lieu of claiming bonus depreciation

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional minimum tax credits in lieu of claiming depreciation under section 168(k) for “eligible qualified property” placed in service after December 31, 2010, and before January 1, 2013 (January 1, 2014 in the case of certain longer-lived and transportation property).³⁴ The provision applies with respect to “round 2 extension property,” which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the additional first-year depreciation deduction for certain property placed in service after December 31, 2010.³⁵ A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 53(c) on the use of minimum tax credits.³⁶ The increase in the allowable credits is treated as refundable. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation³⁷ for certain eligible qualified property that could be

³³ For a definition of “acquire” for this purpose, see section 3.02(1)(a) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664.

³⁴ A similar election could be made by a corporation otherwise eligible for the additional first year depreciation deduction under section 168(k)(4) for eligible qualified property placed in service after March 31, 2008, and before December 31, 2008. A separate election could also be made by a corporation otherwise eligible for the additional first year depreciation deduction with respect to extension property which is certain property placed in service in 2009 (2010 in the case of certain longer-lived and transportation property). Those prior elections could be used to increase the general business credit limitations for a portion of unused research credits.

³⁵ An election under new section 168(k)(4)(I) with respect to round 2 extension property is binding for any property that is eligible qualified property solely by reason of the amendments made by section 401(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (and the application of such extension to this paragraph pursuant to the amendment made by section 401(c)(1) of such Act), even if such property is placed in service in 2012.

³⁶ Special rules apply to an applicable partnership.

³⁷ For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and the shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

claimed as a deduction absent an election under this provision. Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after December 31, 2010; (2) the taxpayer must purchase the property either (a) after December 31, 2010, and before January 1, 2013, but only if no binding written contract for the acquisition is in effect before January 1, 2008,³⁸ or (b) pursuant to a binding written contract that was entered into after December 31, 2007, and before January 1, 2013;³⁹ and (3) the property must be placed in service after December 31, 2010, and before January 1, 2013 (January 1, 2014 for certain longer-lived and transportation property).

The bonus depreciation amount is limited to the lesser of: (1) \$30 million, or (2) six percent of the minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.⁴⁰

Specific recovery periods for certain types of property

Recovery periods under the depreciation rules are provided by statute on a temporary basis for certain types of property. Among other types of property, those for which specific recovery periods are provided by statute include certain energy property, qualified leasehold improvements, qualified restaurant buildings and improvements, qualified retail improvements, and motorsports entertainment complexes.

Five-year cost recovery for certain energy property

The Code provides a five-year statutory recovery period for certain energy property,⁴¹ including (1) equipment that uses solar and wind energy to generate electricity, to heat or cool

³⁸ In the case of passenger aircraft, the written binding contract limitation does not apply.

³⁹ Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

⁴⁰ Under the provision, a taxpayer that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable years ending after March 31, 2008, or for extension property, may choose not to make this election for round 2 extension property. Further, the provision allows a taxpayer that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008, or for extension property, to make the election for round 2 extension property for its first taxable year ending after December 31, 2010, and for each subsequent year. In the case of a taxpayer electing to increase the research or minimum tax credit for eligible qualified property and/or extension property and the minimum tax credit for round 2 extension property, a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group. In computing the maximum amount, the maximum increase amount for extension property or for round 2 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property or round 2 extension property, respectively.

⁴¹ Sec. 168(e)(3)(B)(vi)(I).

(or provide hot water for use in) a structure, or to provide solar process heat, except property used to generate energy for the purposes of heating a swimming pool; (2) equipment that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight;⁴² (3) equipment used to produce, distribute, or use energy derived from a geothermal deposit,⁴³ but only, in the case of electricity generated by geothermal power, up to (but not including) the electrical transmission stage; and (4) qualified fuel cell property⁴⁴ or qualified microturbine property.⁴⁵

Certain property used to generate electricity from biomass also has a statutory recovery period of five years.⁴⁶ For this purpose, biomass property includes (1) a boiler, the primary fuel for which will be an alternate substance; (2) a burner (including necessary on-site equipment to bring the alternate substance to the burner) for a combustor other than a boiler if the primary fuel for such burner will be an alternate substance; and (3) equipment for converting an alternate substance into a qualified fuel.⁴⁷ Such property also includes pollution control equipment⁴⁸ required (by Federal, State, or local regulations) to be installed on or in connection with the above mentioned property and equipment used for the unloading, transfer, storage, reclaiming from storage, and preparation (including, but not limited to, washing, crushing, drying, and weighing) at the point of use of an alternate substance for use in equipment described above.⁴⁹

⁴² In this case, the five-year recovery period applies only with respect to periods ending before January 1, 2017.

⁴³ Geothermal deposit is defined by reference to section 613(e)(2) as a geothermal reservoir consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).

⁴⁴ Qualified fuel cell property is defined as a fuel cell power plant that has a nameplate capacity of at least 0.5 kilowatt of electricity using an electrochemical process, and has an electricity-only generation efficiency greater than 30 percent.

⁴⁵ Qualified microturbine property is defined as a stationary microturbine power plant that has a nameplate capacity of less than 2,000 kilowatts, and has an electricity-only generation efficiency of not less than 26 percent at International Standard Organization conditions.

⁴⁶ Sec. 168(e)(3)(B)(vi)(II).

⁴⁷ This definition is included by reference to section 48(l)(15) as in effect on the day before the date of the enactment (Nov. 5, 1990) of the Revenue Reconciliation Act of 1990.

The term “qualified fuel” means any synthetic solid fuel, and alcohol for fuel purposes if the primary source of energy for the facility producing the alcohol is not oil or natural gas or a product of oil or natural gas.

⁴⁸ The term “pollution control equipment” does not include any equipment that is installed on or in connection with property which, as of October 1, 1978, was using coal (including lignite), and was required to be installed by Federal, State, or local regulations in effect on such date.

⁴⁹ This equipment also includes equipment used for the storage of fuel derived from garbage at the site at which such fuel was produced from garbage.

The term “alternate substance” means any substance other than oil and natural gas, and any product of oil and natural gas.

The property must also be a “qualifying small power production facility,” defined as a “small power production facility” that the Federal Power Commission determines, by rule, meets such requirements (including requirements respecting fuel use, fuel efficiency, and reliability) as the Commission may, by rule, prescribe, and which is owned by a person not primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities).⁵⁰ The term “small power production facility” means a facility that (1) produces electric energy solely by the use, as a primary energy source, of biomass, waste, renewable resources, geothermal resources, or any combination thereof; and (2) has a power production capacity that, together with any other facilities located at the same site (as determined by the Federal Power Commission), is not greater than 80 megawatts.⁵¹

Depreciation of leasehold improvements

Generally, 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. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally 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. However, exceptions exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service on or before December 31, 2011. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service after December 31, 2011 will be subject to the general rules described above.

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), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was

⁵⁰ This definition is included by reference to the Federal Power Act (16 U.S.C. 796(17)(C)), as in effect on September 1, 1986.

⁵¹ This definition is included by reference to the Federal Power Act (16 U.S.C. 796(17)(A)), as in effect on September 1, 1986.

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.

If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service on or before December 31, 2011. Qualified restaurant property is any section 1250 property that is a building (if the building is placed in service after December 31, 2008 and before January 1, 2012) or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.⁵² Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.⁵³ Restaurant property placed in service after December 31, 2011 is subject to the general rules described above.

Qualified retail improvement property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property placed in service after December 31, 2008 and on or before December 31, 2011. Qualified retail improvement property is any improvement to an interior portion of a building that is nonresidential real property if such portion is open to the general public⁵⁴ and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

⁵² Sec. 168(e)(7)(A).

⁵³ Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

⁵⁴ Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

Qualified retail improvement property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail improvement property is not eligible for bonus depreciation.⁵⁵ Qualified retail improvement property placed in service on or after January 1, 2012 is subject to the general rules described above.

Motorsports complexes

A motorsports entertainment complex placed in service before January 1, 2012, is assigned a recovery period of seven years. For these purposes, a motorsports entertainment complex means a racing track facility that is permanently situated on land and which during the 36-month period following its placed-in-service date hosts a racing event. The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands). For motorsports entertainment complexes placed in service after 2011, the generally applicable rules apply; under these rules, generally the cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years, and land improvements are recovered over 15 years.

2. Section 179 expensing

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct on a current basis (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions.⁵⁶ For taxable years beginning after 2009 and before 2012, the maximum amount that a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.⁵⁷ The \$500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000.⁵⁸ For taxable years beginning in 2012, the maximum amount a taxpayer may expense is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. The \$125,000 and \$500,000 amounts are indexed for

⁵⁵ Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

⁵⁶ Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

⁵⁷ The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to \$250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See sec. 179(f)(2).

⁵⁸ The temporary \$500,000 and \$2,000,000 amounts were enacted in the Small Business Jobs Act of 2010, Pub. L. No. 111-240.

inflation.⁵⁹ Off-the-shelf computer software placed in service in taxable years beginning before 2013 is treated as qualifying property.

For taxable years beginning in 2013 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).⁶⁰ No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.⁶¹

⁵⁹ The temporary \$125,000 and 500,000 amounts, indexed for inflation, were enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312.

⁶⁰ Special rules apply with respect to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See sec. 179(f)(4).

⁶¹ Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

C. Other Cost Recovery Provisions

1. 15-year amortization of certain acquired intangibles

The purchase price allocated to goodwill and other intangible assets that are acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period. These rules, contained in section 197 of the Code, were enacted in 1993⁶² to minimize disputes regarding the proper treatment of acquired intangible assets. In 2004, sports franchises were added to the assets subject to the 15-year amortization period.⁶³

Prior to the enactment of section 197, Treasury regulations provided that the cost of intangible property used in a trade or business was amortizable if the property had a limited useful life that could be determined with reasonable accuracy. These regulations also provided that goodwill was not amortizable.⁶⁴ However, taxpayers litigated whether intangibles such as a “customer base” could be amortized if shown to have a determinable value and useful life. The Supreme Court held that if the taxpayer carried its burden of proof, such intangibles could be amortized.⁶⁵ In order to minimize disputes regarding whether an amortizable intangible asset existed and what its useful life and method of amortization might be, Congress specified a single method and period for recovering the cost of most acquired intangible assets and treated goodwill and going concern value as amortizable intangible assets.⁶⁶

Under section 197 of the Code, when a taxpayer acquires intangibles held in connection with a trade or business, any value properly attributable to a “section 197 intangible” is amortizable on a straight-line basis over 15 years.⁶⁷ Such intangibles include goodwill; going concern value; workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment; business books and records, operating systems, or other information base; any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item; customer based intangibles; supplier based intangibles; and any other similar item. They also include any license, permit, or other rights granted by governmental

⁶² Sec. 197, added to the Code by sec.13261 of Pub. L. No. 103-66 (August 10, 1993), the Omnibus Budget Reconciliation Act of 1993.

⁶³ Sec. 886 of Pub. L. No. 108-357 (October 22, 2004), the American Jobs Creation Act of 2004.

⁶⁴ Treas. Reg. sec. 1.167(a)-3, under prior law.

⁶⁵ See, e.g., *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

⁶⁶ See H.R. Rep. No. 103-111 (103d Cong., 1st Sess.), page 760; H.R. Rep. 103-213 (103d Cong., 1st Sess.), page 672 et. seq.

⁶⁷ Secs. 197(d)(1)(F) and 197(f)(4). A franchise is defined as “an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.” Sec. 1253(b)(1).

units⁶⁸ (even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely); any covenant not to compete; and any franchise, trademark or trade name. However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not be amortized over the 15-year period provided in section 197, but instead must be amortized over the period of the grant of the right.⁶⁹ Also, certain financial interests, certain computer software readily available for purchase by the general public, and certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof) are not subject to the 15-year amortization. Also, self-created assets, such as goodwill created through advertising and other expenses, are not subject to the provision.⁷⁰

If there is a disposition of one or more section 197 intangible assets acquired in a transaction or series of related transactions (or any such intangible becomes worthless), and one or more other section 197 intangibles acquired in such transaction or series of related transactions are retained, no loss is allowable until all such section 197 assets are disposed of, and the basis of those assets are adjusted for any loss not recognized.⁷¹

Section 197 contains anti-churning rules that apply to prevent pre-section 197 goodwill, going concern value, or intangibles that would not have been amortizable but for section 197 from being transferred among related parties and becoming eligible for the 15-year amortization.⁷²

2. Deduction for qualified research

Taxpayers may elect to deduct currently the amount of certain research or experimentation expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule requiring the capitalization of business expenses associated with

⁶⁸ Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197-2(b)(8). A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197-2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197-2(c)(13).

⁶⁹ Sec. 197(e)(2). Treas. Reg. sec. 1.197-2(c)(3). An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. Treas. Reg. Sec. 1.197-2(c)(3).

⁷⁰ Thus, section 197 does not require costs attributable to such assets to be capitalized under section 197 and amortized over 15 years.

⁷¹ Sec. 197(f)(1).

⁷² Sec. 197(f)(9).

the development or creation of an asset having a useful life extending beyond the current year.⁷³ Such deductions are reduced by the amount of a taxpayer's research tax credit.⁷⁴ If taxpayers choose to forgo a current deduction, they may capitalize their research expenditures and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.⁷⁵ Alternatively, taxpayers may elect to amortize their research expenditures over a period of 10 years.⁷⁶

In general, no current deduction is allowable for expenditures for the acquisition of land or of depreciable or depletable property used in connection with any research or experimentation. In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.

3. Start-up expenditures⁷⁷

A taxpayer can elect to deduct up to \$5,000 of start-up expenditures in the taxable year in which the active trade or business begins.⁷⁸ The \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds \$50,000.⁷⁹ However, for taxable years beginning in 2010, the provision increases the amount of start-up expenditures a taxpayer can elect to deduct from \$5,000 to \$10,000 and increases the deduction phase-out threshold such that the \$10,000 is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds \$60,000.⁸⁰ Start-up expenditures that are not deductible in the year in which the active trade or business begins are, at the taxpayer's

⁷³ Sec. 174.

⁷⁴ Sec. 280C(c). Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed. Sec. 280C(c)(3).

⁷⁵ Sec. 174(b).

⁷⁶ Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2).

⁷⁷ Similar rules apply to organizational expenditures under section 248. Organizational expenditures are defined as any expenditure which (1) is incident to the creation of the corporation, (2) is chargeable to capital account, and (3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. Sec. 248(b).

⁷⁸ Sec. 195(b)(1)(A).

⁷⁹ *Ibid.*

⁸⁰ The temporary \$10,000 limit and \$60,000 threshold were enacted in the Small Business Jobs Act of 2010, Pub. L. No. 111-240, and apply to start-up expenditures paid or incurred in taxable years beginning after December 31, 2009.

election, amortized over a 15-year period beginning with the month the active trade or business begins.⁸¹ Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began, including amounts paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.⁸²

Treasury regulations⁸³ provide that a taxpayer is deemed to have made an election under section 195(b) to amortize its start-up expenditures for the taxable year in which the active trade or business to which the expenditures relate begins. A taxpayer that chooses to forgo the deemed election must clearly elect to capitalize its start-up expenditures on its timely filed Federal income tax return for the taxable year the active trade or business commences. The election either to amortize or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures related to the active trade or business.

⁸¹ Sec. 195(b)(1)(B).

⁸² Sec. 195(c).

⁸³ Temp. Treas. Reg. sec. 1.195-1T(b).

D. Methods of Accounting for Federal Income Tax Purposes

1. Cash method and accrual method

In general

Section 446(c) of the Code generally allows a taxpayer to select the method of accounting it will use to compute its taxable income provided that such method clearly reflects the income of the taxpayer. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, subject to certain restrictions. Permissible methods include the cash receipts and disbursements method (“cash method”), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary of the Treasury.

Cash method

Generally, a cash method taxpayer is not required to include an amount in income until received. Section 448 generally provides that the cash method of accounting may not be used by any C corporation,⁸⁴ by any partnership that has a C corporation as a partner, or by any tax shelter. Exceptions are made for farming businesses and qualified personal service corporations. Additionally, an exception is provided for C corporations and partnerships that have a C corporation as a partner if the average annual gross receipts of the taxpayer is \$5 million or less for all prior taxable years (including the prior taxable years of any predecessor of the entity). For this purpose, average annual gross receipts is calculated for each tax year by averaging the annual gross receipts for the three-year period ending in such year. The test must be met for all prior tax years beginning after December 31, 1985 in order for a taxpayer to be eligible for the exception.

Section 471 provides that the Secretary may require taxpayers to maintain inventories on the accrual method if necessary to clearly reflect income. This requirement is generally applied to taxpayers for whom the production, purchase, or sale of merchandise is an income-producing factor.⁸⁵ Treasury regulations also provide that in any case in which it is necessary to use an inventory, the accrual method must be used with regard to purchases and sales.⁸⁶ However, an exception is provided for taxpayers whose average annual gross receipts does not exceed \$1 million.⁸⁷ A second exception is provided for taxpayers in certain industries whose average annual gross receipts do not exceed \$10 million or less and that are not otherwise prohibited

⁸⁴ For this purpose, a tax-exempt trust with unrelated business income is treated as a C corporation with respect to the portion of its activities that constitute an unrelated trade or business. Temp. Treas. Reg. sec. 1.448-1T(a)(3).

⁸⁵ Treas. Reg. sec. 1.471-1.

⁸⁶ Treas. Reg. sec. 1.446-1(c)(2).

⁸⁷ Rev. Proc. 2001-10, 2001-02 CB 272 (January 8, 2001).

from using the cash method under section 448.⁸⁸ Such taxpayers may account for inventory as materials and supplies that are not incidental pursuant to Regulations section 1.162-3.⁸⁹

Accrual method

An amount is includible in gross income under the accrual method of accounting when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.⁹⁰ There is no requirement that cash, a note, or other property be received by the taxpayer. Under the accrual method of accounting, the item is includible in gross income because the right to receive the income is fixed, not because the income has actually been received.

In contrast, a liability is taken into account for income tax purposes under the accrual method of accounting when it is incurred. A liability is incurred in the tax year in which all events have occurred that establish the fact of the liability, the amount of the liability is determined with reasonable accuracy, and economic performance has occurred as to the liability.⁹¹ For this purpose, a liability includes any item allowable as a deduction, cost or expense for tax purposes. Additionally, it can include items that may be capitalized, a cost included within the cost of goods sold, or a cost allocable to a long-term contract. Specific rules addressing the type of deduction involved generally discuss the manner in which an incurred liability is treated. For example, section 162 permits the deduction of business expenses in the year incurred; however, sections 263 and 263A require the capitalization of certain costs incurred with possible cost recovery in later years through depreciation deductions, the deduction of the cost of goods sold, or basis recovery upon a disposition.

2. Inventory

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.⁹² In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the

⁸⁸ Rev. Proc. 2002-28, 2002-1 CB 815 (April 12, 2002).

⁸⁹ Under Treas. Reg. sec. 1.162-3, a deduction is permitted for the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the tax year.

⁹⁰ Treas. Regs. sec. 1.451-1(a).

⁹¹ Treas. Reg. sec. 1.446-1(c)(1)(ii).

⁹² Sec. 471(a) and Treas. Regs. sec. 1.471-1.

beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

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

LIFO

In general

Under the LIFO method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.⁹³ Compared to FIFO, LIFO produces net income that more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory is generally not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which sales exceed purchases.⁹⁴

Dollar-value LIFO

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

⁹³ Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year. Sec. 472(b).

⁹⁴ Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (and inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.⁹⁵ In doing so, the Congress acknowledged that the LIFO method is generally considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.⁹⁶

To qualify for the simplified method, a taxpayer must have average annual gross receipts of \$5 million or less for the three preceding taxable years.⁹⁷ Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

Special rules for qualified liquidations of LIFO inventories

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

Lower of cost or market

Treasury regulations provide that taxpayers (other than LIFO taxpayers) may determine the value of ending inventory under the cost method or the “lower-of-cost-or-market” (“LCM”) method.⁹⁸ Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, “subnormal goods,” defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to net selling price, under either the cost or LCM method.

Section 263A

In general, the uniform capitalization rules require that a portion of the direct and indirect costs of producing property or acquiring property for resale be capitalized or included in the cost

⁹⁵ Sec. 474(a).

⁹⁶ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)*, (JCS-10-87), May 4, 1987, p. 482.

⁹⁷ Sec. 474(c).

⁹⁸ Treas. Reg. sec. 1.471-2(c).

of inventory (sec. 263A). The determination of which direct and indirect costs constitute capitalized costs, and the calculation of the amount to capitalize, are very detailed and complex. Compared to financial statement reporting requirements, the uniform capitalization rules tend to allow fewer costs to be expensed and require additional costs to be capitalized or included in inventories.

E. General Business Credit

The general business credit is the sum of various business credits determined under the Code. The component credits of the general business credit are listed below.

The general business credit may not reduce a taxpayer's net income tax below an amount equal to the taxpayer's tentative minimum tax (or, if greater, 25 percent of so much of the taxpayer's regular tax liability as exceeds \$25,000). For purposes of applying this rule to certain credits (the alcohol fuels credit, the low-income housing credit, portions of the renewable electricity production credit, the employer Social Security credit, the railroad track maintenance credit, the small employer health insurance credit, the energy credit, the rehabilitation credit, and work opportunity credit), the tentative minimum tax is treated as being zero.

General business credits determined in a taxable year that exceed the amount allowable in that year generally may be carried back one year and forward up to 20 years. Credits for small businesses determined in 2010 were allowed a five-year carryback.

Components of the General Business Credit for 2011¹	
Provision	Description
Rehabilitation credit (sec. 47)	Credit for restoring certain pre-1936 buildings and certain historic buildings
Energy credit (sec. 48)	Credit for investing in certain solar, geothermal, fuel cell, and other energy property
Advanced coal project credit (sec. 48A)	Credit for investing in advanced coal power facilities
Gasification project credit (sec. 48B)	Credit for investing in gasification facilities
Advanced energy project credit (sec. 48C)	Credit for investing in facilities that manufacture certain renewable power or other advanced energy equipment or products
Work opportunity credit (sec. 51)	Credit for hiring employees from certain targeted groups
Alcohol fuels credit (sec. 40)	Credit for producing ethanol and other alcohol fuels
Research credit (sec. 41)	Credit for conducting research in the United States
Low-income housing credit (sec. 42)	Credit for owners of qualified low-income rental housing
Disabled access credit (sec. 44)	Credit to offset costs incurred by small businesses to comply with the Americans With Disabilities Act of 1990
Renewable electricity production credit (sec. 45)	Credit for producing power from wind, biomass, and other renewable resources
Empowerment zone employment credit (sec. 1396)	Credit for employing people in certain designated areas with high levels of unemployment and poverty
Indian employment credit (sec. 45A)	Credit for employing native Americans living and working on Indian reservations
Employer Social Security credit (sec. 45B)	Credit for an employer's portion of Social Security taxes paid on employee cash tips in excess of the minimum wage

Components of the General Business Credit for 2011¹	
Provision	Description
Orphan drug credit (sec. 45C)	Credit for clinical testing of drugs used to treat certain rare diseases or conditions
New markets tax credit (sec. 45D)	Credit for investing in community development entities, which serve low income communities
Small employer pension plan startup cost credit (45E)	Credit for small employers that start qualified pension plans
Employer-provided child care credit (sec. 45F)	Credit for building or running an employer-provided child care facility
Railroad track maintenance credit (sec.45G)	Credit for railroad track maintenance expenses
Biodiesel fuels credit (sec. 40A)	Credit for producing biodiesel
Distilled spirits credit (sec. 5011)	Credit to wholesalers, distillers, and importers of distilled spirits that approximates the interest cost resulting from the early imposition of certain excise taxes
Advanced nuclear power production credit (sec. 45J)	Credit for producing nuclear power at advanced nuclear power facilities
New energy efficient homes credit (sec. 45L)	Credit for building energy efficient homes
Energy efficient appliance credit (sec. 45M)	Credit for manufacturing energy efficient appliances
Alternative fuel refueling property credit (sec. 30C)	Credit for installing certain biofuel, electric, and alternative fuel refueling property
Mine rescue team training credit (sec. 45N)	Credit for training mine rescue team employees
Agricultural chemicals security credit (sec. 45O)	Credit for conducting backgrounds checks, installing security devices, and taking other measures to safeguard certain fertilizers and pesticides used on farms
Differential wage payment credit (sec. 45P)	Credit for small employers who supplement the military pay of their employees called to active duty
Carbon dioxide sequestration credit (sec. 45Q)	Credit for sequestering industrial source carbon dioxide
Alternative motor vehicle credit (sec. 30B)	Credit for fuel cell vehicles and hybrid vehicle conversions
Plug-in electric drive motor vehicle credit (secs. 30 and 30D)	Credit for plug-in electric drive motor vehicles
Small employer health insurance credit (sec. 45R)	Credit for small employers who provide health insurance to their employees

¹ Excludes expired and phased-out credits.

F. Corporate Alternative Minimum Tax

In general

Present law imposes an alternative minimum tax (“AMT”) on a corporation to the extent the corporation’s tentative minimum tax exceeds its regular tax. This tentative minimum tax is computed at the rate of 20 percent on the alternative minimum taxable income (“AMTI”) in excess of a \$40,000 exemption amount that phases out. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the corporation’s AMTI exceeds \$150,000.

AMTI is the taxpayer’s taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less than \$7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The \$7.5 million threshold is reduced to \$5 million for the corporation’s first 3-taxable year period.

Preference items in computing AMTI

The corporate minimum tax preference items are:

1. The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.
2. The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer’s AMTI by more than 40 percent.
3. Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.
4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Adjustments in computing AMTI

The adjustments that corporations must make in computing AMTI are:

1. Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property.

Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property that qualifies for “bonus depreciation” for the regular tax is computed without regard to any AMT adjustments.

2. Mining exploration and development costs must be capitalized and amortized over a 10-year period.
3. Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.
4. The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.
5. The special rules applicable to Merchant Marine construction funds are not applicable.
6. The special deduction allowable under section 833(b) for Blue Cross and Blue Shield organizations is not allowed.
7. The adjusted current earnings adjustment applies, as described below.

Adjusted current earning (“ACE”) adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction). In determining ACE the following rules apply:

1. For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.
2. Amounts excluded from gross income under the regular tax but included for purposes of determining earnings and profits are generally included in determining ACE.
3. The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).
4. Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.
5. The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.

6. Inventory must be calculated using the FIFO, rather than LIFO, method.
7. The installment sales method generally may not be used.
8. No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.
9. Depletion (other than for oil and gas properties) must be calculated using the cost, rather than the percentage, method.
10. In certain cases, the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.

Other rules

The taxpayer's net operating loss carryover generally cannot reduce the taxpayer's AMT liability by more than 90 percent of AMTI determined without this deduction.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If a corporation is subject to AMT in any year, the amount of AMT is allowed as a credit ("AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in the subsequent year. Corporations are allowed to claim a limited amount of AMT credits in lieu of bonus depreciation.

G. Differences Between Financial and Tax Accounting

In general

U.S. companies are generally subject to separate rules for reporting income, gain, losses, and deductions for U.S. tax and financial reporting purposes.⁹⁹ As a result, income reported for U.S. tax purposes generally differs from income calculated for financial reporting purposes. A primary objective of financial reporting is to provide current and potential investors with an accurate picture of a company's economic position by matching revenues and expenses. Tax reporting, however, generally is designed to reflect income as defined in the Code and permit the IRS to verify the same.

Differences between U.S. tax and financial accounting (hereinafter "book-tax differences") can generally be divided into reporting entity differences and income measurement differences.¹⁰⁰

Reporting entity differences

Many U.S. companies own all or part of other U.S. and foreign entities. As a result, a company typically will be required to prepare consolidated financial statements for financial reporting purposes and may elect, in the case of corporations, to file a consolidated return for U.S. tax purposes.

For financial reporting, the consolidated group generally includes the parent company and all domestic and foreign entities in which the parent has direct or indirect control.¹⁰¹ An entity is treated as having direct or indirect control in another entity if it has a greater than 50 percent ownership in the other entity and such control is not transitory. In general, if an entity owns between 20 percent and 50 percent of another entity, the owner includes its percentage interest in the net income of that entity under the equity method of accounting.¹⁰²

By contrast, a consolidated group for U.S. tax purposes is generally limited to only domestic corporations with which the parent has at least an 80 percent ownership interest by vote and value. This fundamental difference in the definition of a consolidated reporting unit, in combination with complex rules addressing intercompany transactions and eliminations,

⁹⁹ Unless otherwise noted, all references to financial reporting are with respect to U.S. Generally Accepted Accounting Principles ("U.S. GAAP"). Over time, many U.S. companies may convert to International Financial Reporting Standards ("IFRS"). It is anticipated that there would also be several differences between financial reporting under IFRS and U.S. tax reporting.

¹⁰⁰ Lillian F. Mills and George A. Plesko, "Bridging the Reporting GAP: A Proposal for More Informative Reconciling of Book and Tax Income," *National Tax Journal*, Vol. LVI, No. 4 (December 2003).

¹⁰¹ Accounting Standards Codification ("ASC") 810, Consolidation.

¹⁰² *Ibid.*

typically results in a significant difference between a U.S. company's consolidated financial or "book" income as compared to its consolidated taxable income.

Income measurement differences

The differing objectives of financial reporting and tax reporting also lead to differences as to when or how certain items are recognized and measured.¹⁰³ Some items of income or expense that are reported for book purposes are never reported for tax purposes; likewise, some items of income or expense reported for tax purposes are never reported for book purposes. These are commonly referred to as permanent differences. Common examples of permanent differences include interest income from certain municipal bonds, which is recorded for book purposes but not included in U.S. federal taxable income; the domestic production activities deduction under section 199, which results in an exclusion for tax reporting that does not exist for financial reporting; the 50-percent limit on meals and entertainment expenses that applies solely for tax purposes; and the excess of book basis over tax basis in the stock of a foreign subsidiary for which management has asserted permanent reinvestment of the underlying earnings of such foreign entity.

Items of income or expense that are reported in a different period for financial reporting purposes than for tax reporting purposes are commonly referred to as temporary differences. Examples of temporary differences include depreciation of tangible assets, amortization of intangible assets, and the deducting of accruals and reserves (e.g., warranty reserves).

Depreciation

In general, depreciation for book purposes is guided by the above mentioned goal of matching production-related expenses with sales revenue. Hence, cost recovery for tangible assets generally requires using the straight-line method of depreciation over an estimate of the each asset's expected useful life with some residual value.¹⁰⁴ Depreciation of tangible assets for tax purposes, however, is generally accomplished under the more accelerated MACRS depreciation rules without any residual value. Since the basis of the property will be fully recovered (either through depreciation or a future disposition) for both book and tax purposes, this is considered a temporary difference. Nonetheless, the differences in depreciation method will generally result in greater tax depreciation relative to book depreciation in earlier years with book depreciation exceeding tax depreciation in later years of the asset's estimated useful life.

¹⁰³ For financial reporting purposes, these recognition and measurement differences are accounted for under ASC 740, Income Taxes.

¹⁰⁴ ASC 360, Property, Plant and Equipment. Similar rules apply for depletion of minerals as well.

Intangible assets amortization

Although all intangible assets covered under section 197 are amortized straight line over 15 years for tax purposes, the cost recovery of intangible assets for book purposes varies based on the type of intangible asset.

Intangible assets (other than goodwill)

Consistent with the matching principle, the amortization of intangible assets (other than goodwill) for book purposes requires amortization over their estimated useful lives. Depending on the intangible asset, the useful life and, therefore, the recovery period for book purposes could be greater or less than the 15-year straight line recovery period for tax purposes. As the basis of the property will be fully recovered (either through amortization or a future disposition) for both book and tax purposes, this is considered a temporary difference.

Goodwill

Goodwill represents the intangible value of an entity in excess of the value of its identifiable assets. Although goodwill was previously amortized over 40 years straight line for book purposes, the rules were changed for fiscal years beginning after December 15, 2001. Rather than being subject to amortization, goodwill is now subject to an impairment model. Under these rules, goodwill is expensed only if the company determines that it has been impaired.¹⁰⁵ Even under the impairment model, where goodwill exists for both book and tax purposes, the excess of tax amortization over any goodwill impairment (or lack thereof) in a given year is considered a temporary difference.

Accruals

Financial accounting accruals make up one of the largest classes of revenue and expense items that result in temporary differences between book and tax reporting. Sales or services revenue is generally not recognized until it is both “realized and earned” for book purposes. As a result, a company will not typically recognize revenue until the goods or services have been provided and there is reasonable assurance that payment will be received regardless of when cash payment is received from a customer. In circumstances where cash payments are received in advance of the goods or service being provided to the customer, such an advance payment is treated as unearned revenue which is a liability for book purposes. For an accrual basis taxpayer, however, the receipt of certain advance payments for services and certain nonservices to be rendered in the future that are not security deposits and are received without restriction as to use, are generally income in the year received.¹⁰⁶ An example is prepaid rental income where the rental period extends over more than one year.¹⁰⁷

¹⁰⁵ ASC 350, Intangibles - Goodwill and Others.

¹⁰⁶ Rev. Rul. 66-347, 1966-2 CB 196; *Schlude v. Commissioner.*, 372 U.S. 128 (1963), *aff'd* on this issue, 296 F.2d 721 (8th Cir. 1961); *Brown v. Helvering*, 291 U.S. 193 (1934). Examples of exceptions to this general

Accrued expenses for book purposes are deducted when incurred. Additionally, contingent liabilities (other than income taxes) are recorded as a book expense when the contingency is probable and estimable.¹⁰⁸ In contrast, for an accrual method taxpayer, an expense is generally only deductible when all events have occurred that fixed the fact of the liability, the amount of the liability is determinable with reasonable accuracy, and economic performance has occurred.¹⁰⁹ As a result, many accrued and contingent expenses are reported in a later period for tax reporting as compared to book reporting. Some examples of accruals that are expensed for book purposes in advance of when they would be deducted for tax purposes include vacation pay accrual, bonus accrual, warranty reserves, and bad debt expense.

rule of nondeferral are prepaid membership dues (sec. 455), prepaid subscription income (sec. 456), payments for merchandise and long-term construction contracts (Treas. Reg. sec. 1.451-5(a)). Additionally, taxpayers generally may defer to the next succeeding taxable year the taxable income inclusion for advance payments to the extent the advance payments are not recognized in revenues (or, in certain cases, are not earned) in the taxable year of receipt. Rev. Proc. 2004-34, 2004-1 C.B. 911.

¹⁰⁷ In some circumstances, however, a taxpayer may be required to spread the income over the rental period. Sec. 457.

¹⁰⁸ ASC 450, Contingencies.

¹⁰⁹ Sec. 461.