Capital Cost Recovery Changes

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CAPITAL COST RECOVERY CHANGES

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I. Depreciation


B. Residential rental and nonresidential real property.

1. Recovery periods. The Act extends the recovery periods for most depreciable real property.

a. The cost of "residential rental property" is recovered over a 27.5-year period.

i. "Residential rental property" means a building or structure in which 80% or more of the gross rental income from such building or structure in a given year is rental income from dwelling units (other than a hotel, motel, or inn more than one-half of which is used on a transient basis). § 167(j)(2).

b. The cost of "nonresidential real property" is recovered over a 31.5-year period.

i. "Nonresidential real property" means real property (within the meaning of section 1250) that is not residential rental property and that either does not have a mid-point class life under the asset depreciation range ("ADR") system of prior law or has an ADR mid-point class life that is 27.5 years or more.

c. Section 1250 property that is not residential rental property and has an ADR mid-point class life of less than 27.5 years is classified under the rules for other property described below.
2. **Depreciation method.** All residential rental property and nonresidential real property is depreciated using the straight-line method.

3. **Mid-month convention.** Residential rental property and nonresidential real property placed in service or disposed of at any time during a month is treated as having been placed in service or disposed of in the middle of the month.

C. **Other property.**

1. **Introduction.** The Act provides more accelerated depreciation in revised 3-year, 5-year, and 10-year property classes, reclassifies certain assets into new classes, and creates a new 7-year property class and a new 20-year property class. The classification of property is based on the ADR mid-point class life assigned to the property. See generally Rev. Proc. 83-35, 1983-1 C.B. 745.

2. **Classes of property.*** Property is classified as follows:

   a. **3-year property** -- property with an ADR mid-point class life of 4 years or less, except automobiles and light trucks;

   b. **5-year property** -- property with an ADR mid-point class life of more than 4 years and less than 10 years, plus automobiles, light trucks, qualified technological equipment, and computer-based telephone central office switching equipment;

   c. **7-year property** -- property with an ADR mid-point class life of at least 10 years and less than 16 years, plus railroad tracks and any unclassified property with no ADR mid-point class life (other than residential rental property and nonresidential real property);

   d. **10-year property** -- property with an ADR mid-point class life of at least 16 years and less than 20 years;

* See Exhibit A attached hereto for a general classification of assets under the Act.
e. **15-year property** -- property with an ADR mid-point class life of 20 years and less than 25 years; and

f. **20-year property** -- property with an ADR mid-point class life of 25 years or more (other than residential rental property or nonresidential real property).

Note: The Secretary has authority to reassign class lives to property, which in turn would cause its classification under the modified ACRS system to change. Except in limited circumstances, no reassignments should occur for property placed in service before January 1, 1992.

3. **Recovery period.** The applicable recovery period for each class of property is the period for the class to which it is assigned. For example, 3-year property has a 3-year recovery period. **Note:** Taxpayers have no option to elect a longer recovery period for the different types of property other than an election to use the Alternative Depreciation System described below.

4. **Depreciation method.**

a. The applicable depreciation methods are:

i. for all types of property except 15-year property and 20-year property, the 200% declining balance method, switching to the straight-line method for the first taxable year in which such method yields a larger deduction; and

ii. for 15-year property and 20-year property, the 150% declining balance method, switching to the straight-line method for the first taxable year in which such method yields a larger deduction.

**Note:** Taxpayers have no option to elect a straight-line method of cost recovery, other than an election to use the Alternative Depreciation System described below.
5. **Applicable conventions.**

a. **Half-year convention.** Property other than residential rental property and nonresidential real property generally is subject to a half-year convention.

i. Under the half-year convention, all property placed in service or disposed of during any taxable year is treated as placed in service or disposed of at the mid-point of such taxable year.

b. **Mid-quarter convention.** A mid-quarter convention applies if, during any taxable year, the aggregate bases of property (other than residential rental and nonresidential real property) placed in service during the last three months of the taxable year exceeds 40% of the aggregate bases of property placed in service during such taxable year.

i. Under the mid-quarter convention, all property placed in service or disposed of during any quarter of a taxable year is treated as placed in service or disposed of at the mid-point of such quarter.

ii. If the taxpayer is a member of an affiliated group of corporations filing a consolidated return, all such members are treated as one taxpayer for purposes of the 40% determination.

**Note:** All property (other than residential rental property and nonresidential real property) is considered in applying the 40% test whether or not such property is exempt from the modified ACRS rules because of the transition rules.

D. **Alternative depreciation system.** The Act contains an alternative depreciation system ("ADS").

1. **ADS property.** ADS property includes:

   a. any tangible property which during the taxable year is used predominantly outside the United States;
b. any "tax-exempt" use property
   [Note: Taxpayers should consider the new
tax-exempt controlled entity provision.
   See new § 168(h)(6)(F)];

c. any "tax-exempt bond financed" property;

d. any imported property covered by specified
   Executive Orders; and

e. any property as to which an election to use
   ADS is made.

2. Recovery period. ADS property is recovered
   over the ADR mid-point class life of the prop-
   erty (12 years in the case of personal property
   with no class life) or 40 years in the case of
   residential rental and nonresidential real
   property.

3. Depreciation method. ADS property is depreci-
   ated using the straight-line method.

4. Conventions. The conventions described above
   for the modified ACRS system apply to ADS
   property.

5. Election. If a taxpayer elects to use ADS for
   any class of property, ADS will apply irrevo-
   cably to all property in that class placed in
   service during the taxable year. However, the
   election to use ADS may be made separately for
   each parcel of residential rental and nonresi-
   dential real property.

E. Property covered.

1. As under current law, the modified ACRS rules
   are applicable to tangible property only.
   Excluded from their coverage are items of tan-
   gible property excluded under current law.

2. Sound recordings have been added to the list of
   excluded properties.

3. Generally, under rules similar to the current
   law "anti-churning" rules, taxpayers are not
   allowed to use modified ACRS with respect to
   property placed in service after December 31,
   1986, where the result would be more generous
   than under current ACRS. See new § 168(f)(5).
F. Expensing. Under current law, taxpayers may elect to expense tangible personal property used in a trade or business subject to a ceiling amount of $5,000. The Act increases the ceiling amount to $10,000 for taxpayers whose total investment in tangible personal property is $200,000 or less. For taxpayers whose total investment in such property exceeds $200,000, the $10,000 ceiling is reduced by one dollar for every dollar of investment in excess of $200,000. The amount eligible for expensing is limited to the taxable income derived from any trade or business in which the property is used.

G. Additions or improvements. Depreciation deductions with respect to an addition or improvement are calculated in the same manner as those deductions would have been calculated for the underlying asset if that asset had been placed in service when the addition or improvement is placed in service. The taxpayer will commence to claim his deductions on the later of the date the addition or improvement is placed in service or the date the underlying asset is placed in service.

H. Leasehold improvements. Leasehold improvements will be depreciated by a tenant under the modified ACRS system regardless of the remaining term of the leasehold at the time of the addition or improvement.

I. Depreciation for earnings and profits purposes. Generally, the depreciation deductions applicable under ADS are those to be used in making earnings and profits calculations. Any expense deduction under section 179 is spread ratably over 5 years.

J. Treatment of certain transfers. The Act substantially modifies the "in the shoes" rules of existing law. Under the Act, the transactions to which the "in the shoes" rules apply are significantly fewer, limited to transactions described in sections 332, 351, 361, 371(a), 374(a), 721, and 731. The foregoing rule does not apply to partnership terminations under section 708(b). For transactions that occur after December 31, 1985, and before December 31, 1986, and that are either sale-leasebacks or related party sales, the transferee is bound by certain elections of the transferor as to the carryover basis in the property transferred.
K. Effective date.

1. **General rule.** The provisions of the Act modifying ACRS apply to all property placed in service after December 31, 1986, except for property covered by specified transition rules discussed below.

2. **Election to use modified ACRS.** However, the Act contains an election to use modified ACRS for property placed in service after July 31, 1986, and before January 1, 1987. The election shall be made at such time and in such manner as the Secretary prescribes in regulations.

**Question:** Can a taxpayer elect to apply the new rules to property to which the new rules would not apply if the acquisition were to occur after January 1, 1987?

L. Transition rules.

1. **Introduction.** The Act provides exceptions to the general effective date in certain instances. The modifications to ACRS do not apply to property in the following categories:

   a. **Purchased property** -- property that is acquired by a taxpayer pursuant to a written contract that was binding as of March 1, 1986 (and at all times thereafter).

      i. A contract is binding only if it is enforceable against the taxpayer under state law and does not limit damages to a specified amount. A contractual provision that limits damages to an amount equal to at least 5% of the total contract price is not treated as limiting damages.

   b. **Self-constructed property** -- property that is constructed or reconstructed by the taxpayer, if the construction or reconstruction is pursuant to a written contract which was binding on March 1, 1986, the lesser of $1 million or 5% of the cost of such property has been incurred or committed (i.e., required to be incurred pursuant to the written binding contract in effect).
by March 1, 1986, and the construction or reconstruction actually began by March 1, 1986.

c. **Equipped buildings or plant facilities** -- an equipped building or plant facility where construction has commenced as of March 1, 1986, pursuant to a written specific plan, and more than 50% of the cost of such equipped building or facility (including any machinery and equipment for it) has been incurred or committed on March 1, 1986.

i. If the equipped building transition rule is satisfied, the entire equipped building, including equipment, machinery, and appurtenances, is excluded from the modifications to ACRS.

ii. Where the costs incurred or committed before March 2, 1986, do not equal more than one-half the cost of the equipped building, each item of machinery and equipment is treated separately for purposes of determining whether the item qualifies for transition relief.

iii. The written plan for an equipped building must be a definite and specific plan that is available in written form as evidence of the taxpayer's intentions and may be modified to a minor extent after March 1, 1986, so long as the modifications are not substantial.

2. **Sunset.** The transition rules included in the Act will not apply to any property unless such property has an ADR mid-point class life of at least 7 years and is placed in service before the relevant "applicable date." In the case of property with an ADR mid-point class life of at least 7 but less than 20 years, the applicable date is January 1, 1989. In the case of property with an ADR mid-point class life of 20 years or more, the applicable date is January 1, 1991.
3. **Special rule for transferors and transferees.**

   a. If a taxpayer transfers his rights in property under a binding contract to another taxpayer, the modifications to ACRS do not apply to the property in the hands of the transferee, as long as the property was not placed in service by the transferor before the transfer.

   b. If by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of the partnership under section 708(b)(1)(B), the partnership is treated as having transferred its rights in the property under construction or the contract to the new partnership.

4. **Special rules for sale-leasebacks within three months.** The modifications to ACRS do not apply if:

   a. the property is placed in service by a taxpayer who acquired the property from a person in whose hands the property would qualify under a transition or general effective date rule;

   b. the property is leased back by the taxpayer to such person; and

   c. the leaseback occurs not later than the earlier of the relevant applicable date under the sunset provision described in section 2., above, or three months after such property originally was placed in service.

II. **Investment Tax Credit**

   A. **Repeal.** The investment tax credit ("ITC") is repealed for property placed in service after December 31, 1985, except for property covered by a transition rule.

   B. **Transition rules.** Repeal of the ITC is subject to the same transition rules that apply to the modifications to the ACRS rules discussed in Part I., above, with a change in the relevant dates. All
references to "March 1, 1986" and "March 2, 1986" in the ACRS transition rules become "December 31, 1985" and "January 1, 1986," respectively, for purposes of the ITC transition rules.

C. ITC reduction and basis reduction for transition property.

1. **ITC reduction.** In the case of transition property, the ITC amount is reduced by 35% for ITC claimed in any taxable year commencing on or after July 1, 1987. For ITC claimed in a taxable year that begins before and ends after July 1, 1987, a partial ITC reduction will apply based on the number of months in the taxable year after July 1, 1987. Thus, for a calendar year taxpayer, the ITC reduction for 1987 is 17.5% (i.e., 35% x (6/12)). The amount of the ITC reduction may not be claimed in any taxable year.

2. **Full basis adjustment.** The basis of transition property must be reduced by the full amount of ITC earned. The basis reduction is applied after the application of the ITC reduction described above. The basis of such property (as calculated after the ITC adjustment) is used to compute depreciation and gain or loss on disposition of the property.

D. **Qualified progress expenditures.** All ITC with regard to qualified progress expenditures claimed and used in years prior to 1986 is exempt from the repeal of the ITC and 35% ITC reduction rules described above regardless of when the property actually is placed in service. The basis reduction rule and the ITC reduction rule apply to amounts incurred for qualified progress expenditures after 1985 if the property is transition property. The favorable treatment for pre-1986 qualified progress expenditures probably cannot be transferred or sold to another taxpayer even if the property is leased back. See Act, § 211.

E. **Steel companies.** Domestic corporations engaged in the manufacture and production of steel may elect a 15-year carryback of 50% of the ITC carryforwards in existence as of the beginning of the first taxable year beginning after December 31, 1986. This provision only applies to specified steel companies. The amount resulting from the carryback is treated
as a payment against tax made on the last day prescribed by law for filing a tax return for the first taxable year beginning after December 31, 1986. To the extent that the amount resulting from the carryback exceeds the tax liability for such year, that excess can be claimed as a refund under the rules governing refunds. The amount resulting from the carryback must be reinvested in the steel business.

F. Limitation on credits. Under current law, general business credits can be used to reduce up to $25,000 of tax liability plus 85% of the tax liability in excess of $25,000. The Act reduces the limitation to 75%, effective for taxable years that begin after December 31, 1985.

III. Capital Gains and Losses

A. Repeal of preferential taxation.

1. Individuals. The Act repeals the 60% deduction for long-term capital gains. For 1987, the maximum tax rate on long-term capital gains is 28%.

2. Corporations. The Act repeals the alternative 28% tax rate on net capital gains of corporations, effective for periods after December 31, 1986. For 1987, the maximum tax rate on net capital gains is 34%.

3. Gain from pre-1987 installment sales that is recognized after 1986 is subject to the higher rate of tax. Thus, taxpayers should consider electing out of installment reporting for 1986 sales.

IV. Tax Credits for Rehabilitation Expenditures

A. Reduction in credit percentages. The Act replaces the three-tier credit under current law with a two-tier credit for qualified rehabilitation expenditures. The credit percentages are reduced to 20% for the rehabilitation of certified historic structures and 10% for the rehabilitation of nonresidential buildings at least 50 years old (i.e., buildings originally placed in service before 1936). The credit under current law for the rehabilitation of 30-year and 40-year old buildings is repealed.
B. Walls test.

1. **Historic structures.** The Act repeals the requirement under current law that at least 75% of the existing external walls of a building be retained in place as external walls in the rehabilitation process. In place of that test, the following new test is adopted:
   
a. at least 75% of the external walls must be retained in place as either internal or external walls;
   
b. at least 50% of such walls must be retained in place as external walls; and
   
c. at least 75% of the building's internal structural framework must be retained in place.

2. **Certified historic structures.** For certified historic structures, the external walls test of current law and the new walls test under the Act would not be a condition of eligibility for the credit. However, the Secretary of the Interior must approve the rehabilitation as under current law.

C. **Basis adjustment.** The Act requires full basis adjustment for both the 20% credit and the 10% credit.

D. **Passive loss limitation.** The ability of an individual taxpayer to claim the rehabilitation credit is subject to the application of the passive loss rule introduced by the Act. However, with respect to the rehabilitation credit, a taxpayer is entitled to claim the credit in an amount equivalent to a $25,000 deduction (subject to a phase-out between $200,000 and $250,000 of adjusted gross income) regardless of whether the taxpayer actively participates in the activity generating the credit.

E. **Effective date.** The modifications to the rehabilitation credit generally are applicable to property placed in service after December 31, 1986, except for property covered by specified transition rules discussed below.

F. **Transition rules.** Under a general transition rule, modifications to the rehabilitation credit (other
than the reduction in the credit percentages described below) will not apply to property placed in service as part of a rehabilitation:

1. completed pursuant to a written contract that was binding (under applicable state law) on March 1, 1986; or

2. incurred in connection with property (including a leasehold interest) acquired before March 2, 1986, or acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if --

a. the rehabilitation was completed pursuant to a written contract that was binding on March 1, 1986;

b. Part I and Part II of the Historic Preservation Certification Application were filed with the Department of the Interior before March 2, 1986; or

(c. the lesser of $1 million or 5% of the cost of the rehabilitation was incurred before March 2, 1986, or was required to be incurred pursuant to a written contract which was binding on March 1, 1986.

3. Transfers.

a. If a taxpayer transfers his rights in property under rehabilitation eligible for relief under a transition rule, the modifications to the credit would not apply to the property in the hands of the transferee as long as the property was not placed in service by the transferor.

b. If by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of the partnership under section 708(b)(1)(B), the partnership will be treated as having transferred its rights in the property under rehabilitation or the binding contract to the new partnership.

G. Reduction in credit percentages. If property that qualifies under a transition rule is placed in service after December 31, 1986, the credit
percentages would be reduced from 25%, 20%, and 15% under current law to 20%, 13%, and 10%, respectively.

Note: Even if the property is eligible for transition relief, the rehabilitation credit is still subject to the passive loss rules after 1986.

V. Low-Income Housing Credit

A. Overview. The Act provides three separate tax credits for the construction, rehabilitation, and acquisition of low-income buildings:

1. New construction and rehabilitation of existing buildings. Low-income buildings that are constructed or rehabilitated without the use of tax-exempt financing or other federal subsidies may be eligible for a maximum credit of 9% annually for 10 years. The amount of the credit is calculated using only the cost of expenditures made for the construction or rehabilitation. In addition, the credit is determined only with reference to the expenditures that are attributable to the units actually provided to low-income families. A minimum expenditure of $2,000 per low-income unit must be made in the case of a rehabilitation. The $2,000 minimum is computed as an average based on all qualifying expenditures in a building during a specified 24-month period (the "aggregation period").

2. New construction and rehabilitation financed by tax-exempt bonds or other federal subsidiaries. A maximum credit of 4% annually for 10 years is provided for low-income buildings where new construction or rehabilitation is financed with tax-exempt bonds or is financed with "other federal subsidies." This credit also applies only to the expenditures made for construction and rehabilitation and to that portion of those expenditures attributable to the low-income units. A minimum expenditure of $2,000 per low-income unit must be made in the case of a rehabilitation. The $2,000 minimum is computed as an average based on all qualifying expenditures in the building during the aggregation period. Other federal subsidies are defined as a federal loan with an interest rate below the
applicable federal rate. However, a federal loan guarantee (e.g., FHA insurance) does not constitute such a subsidy. If a building is acquired subject to, or by assuming, a federal loan or tax-exempt financing, the rehabilitation expenditures with respect to the building may be eligible for either the 9% credit or the 4% credit based on the nature of the financing.

3. **Acquisition cost of existing buildings.** For existing low-income buildings, a maximum credit of 4% annually for 10 years is provided based on the cost of acquisition of each low-income unit. Such property must not have been previously placed in service within 10 years. The 10-year requirement may be waived by the Secretary for federally-assisted low-income buildings if he finds that a waiver is necessary to avert a foreclosure of the mortgage or in other circumstances as defined in Treasury regulations.

B. **Credit percentages.** For buildings placed in service during 1987, the credit percentages are 9% and 4% annually over 10 years, as indicated above. However, for buildings placed in service after 1987, the credit percentages are to be adjusted monthly by the Treasury Department to reflect a present value during the month in which the building is placed in service of 70% of qualified basis for the 9% credit and 30% of qualified basis for the 4% credit.

C. **Qualified basis.**

1. **Introduction.** Qualified basis is the applicable fraction of the eligible basis of a low-income building. The applicable fraction is the lesser of the proportion of low-income units occupied by qualifying tenants to all residential units (whether or not occupied) or the proportion of floor space of the low-income units occupied by qualifying tenants to the floor space of all residential units (whether or not occupied). The qualified basis for each building is determined on the last day of the first taxable year in which the building is placed in service or, if the taxpayer elects, on the last day of the following taxable year.
2. **Eligible basis.** The eligible basis of a new building (or the rehabilitation of an existing building) is its adjusted basis. The eligible basis of an existing building is the sum of the portion of its adjusted basis attributable to acquisition costs plus amounts chargeable to capital account and incurred by the taxpayer before the close of the first taxable year of the credit period for such building for property (or additions or improvements) subject to the allowance for depreciation.

   a. **Adjusted basis.** Adjusted basis is determined by taking into account the adjustments described in section 1016(a) (for example, the basis adjustment under section 48(q) for any rehabilitation credits), except for depreciation deductions. The cost of land is not included in adjusted basis.

   b. **Cost of nonqualifying units.** The cost of rental units which are not low-income units may be included in eligible basis only if such units are not above the average quality of the low-income units. The allocable cost of tenant facilities (for example, swimming pools and parking areas) may be included in eligible basis, provided there is no separate fee for their use and they are made available on a comparable basis to all tenants in the building.

3. **Time for determination of eligible basis.** Generally, the eligible basis of a building is determined at the time the building is placed in service. Expenditures for rehabilitation of an existing building are treated as placed in service as a separate building at the close of the aggregation period. In the case of rehabilitation expenditures claimed in connection with the purchase of a building, capital expenditures incurred through the end of the first year of the 10-year credit period may be included in eligible basis.

4. **Additions to qualified basis.** The qualified basis of a building may be increased subsequent to the initial determination only by an increase in the number of low-income units or in the floor space of the low-income units.

Credits claimed on additional qualified basis are determined using a credit percentage equal to two-thirds of the applicable percentage allowable for the initial qualified basis.

D. **State volume limitation and other controls.** Low-income housing credits will be allocated to buildings by each state based on the category of the building.

1. **Tax-exempt bond-financed buildings.** For buildings that are constructed or rehabilitated using the proceeds of tax-exempt bonds, there is no separate volume limitation on the use of the credit within the state. However, the tax-exempt bonds themselves are subject to volume limitations contained in the Act.

2. **Buildings not financed with tax-exempt bonds.** For buildings that are constructed or rehabilitated without the use of tax-exempt bonds, the available credit is subject to a maximum volume limitation equivalent to $1.25 annually for each resident of the state. In addition, at least 10% of the credit authority of each state must be reserved for buildings that are developed by non-profit organizations which have as an exempt purpose the fostering of low-income housing. States have the authority to allocate less than the maximum level of credit provided.

E. **Minimum set-aside requirements for low-income individuals.** In order to qualify for the credit, at least 20% of the aggregate residential rental units must be rent-restricted and occupied by individuals having incomes of 50% or less of area median, adjusted for family size (the "20-50 test"), or at least 40% of the aggregate residential rental units must be rent-restricted and occupied by individuals having incomes of 60% or less of area median income, adjusted for family size (the "40-60 test"). Those income limits may be adjusted for areas with unusually low family income or high housing cost relative to family income in a manner consistent with the determinations under Section 8 of the United States Housing Act. A special exception to the general set-aside requirements is provided for New York City. The minimum set-aside requirement must be met within one year of the date the building is placed in service.
1. **Low-income status.** The determination of low-income status is made on a continuous basis (and not on the date a tenant initially occupies the unit), both with regard to the tenant's income and the qualifying area income. Thus, an increase in a tenant's income may result in a unit ceasing to qualify as occupied by a low-income person. However, the Act contains an exception for de minimis increases in a tenant's income. Under that rule, a tenant qualifying when initially occupying a rental unit will be treated as continuing to qualify, provided the tenant's income does not increase more than 40% in excess of the maximum qualifying income (adjusted for family size).

2. **Vacant units.** Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by a qualified low-income individual for purposes of the set-aside requirement (and for determining qualified basis), provided reasonable attempts are made to rent the unit and no other units of comparable or smaller size in the building are rented to nonqualifying individuals.

3. **Rent-restricted units.** The gross rent for qualifying low-income units may not exceed 30% of the applicable qualifying income for a family of its size. Gross rent includes the costs of any utilities, other than telephone.

**G. Compliance period and penalty for noncompliance.**

1. **Introduction.** Throughout the compliance period described below, residential rental property must remain residential rental property, the minimum set-aside and rent restriction requirements must be satisfied, and the income requirements for low-income tenants must be satisfied.

2. **Compliance period.** The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.
3. Taxpayer certification.

a. Within 90 days of the end of the first taxable year for which the credit is claimed, the taxpayer must certify to the Secretary:

i. the taxable year and calendar year in which the building was placed in service;

ii. the adjusted basis and eligible basis of such building as of the close of the first year of the credit period;

iii. the maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate credit agency;

iv. the election to qualify a building as a low-income housing project by satisfying either the 20-50 test or the 40-60 test described above in section E.; and

v. such other information as the Secretary may require.

In the case of a failure to make the certification described above in a timely manner, no credit will be allowed with respect to such building for any taxable year ending before the certification is made, unless it is shown that such failure is due to reasonable cause and not willful neglect.

b. The Conference Report accompanying the Act states that the certification described above must be made for each taxable year during the compliance period and the taxpayer must certify that the project has complied continuously throughout the year with the set-aside requirement. H. R. Rep. No. 841, 99th Cong., 2d Sess. (1986) at II-96.

4. Penalty for noncompliance. The penalty for noncompliance is recapture of the accelerated portion of the credit, as described below, for
all prior years. However, if any noncompliance is corrected within a reasonable period, there is no recapture.

a. In the year of a recapture event, no credit is allowable for the building. In addition, the accelerated portion of credits claimed in earlier years is recaptured with interest (at the overpayment rate under section 6621) from the date the recaptured amount was claimed. The accelerated portion of the credit in any year is the amount of total credits allowable through the year in question less the amount which would have been allowed through such year if the total amount of all credits had been allowed ratably over the 15-year compliance period.

b. Generally, any change in ownership of a building also is a recapture event. An exception is provided if the seller posts a satisfactory bond, provided it reasonably can be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period. For partnerships consisting of 35 or more individual taxpayers, at the partnership's election, no change in ownership will be deemed to occur provided that within a 12-month period at least 50% (in value) of the original ownership is unchanged.

H. **Transferability.** A new owner of a building during its 15-year compliance period is eligible to continue to receive the credit as if the new owner were the original owner, using the same qualified basis and credit percentages as used by the original owner. However, the accelerated portion of credits claimed in previous years will be recaptured by the original owner, subject to the election to post a bond, as indicated above.

I. **Passive loss limitation.** The ability of an individual taxpayer to claim the low-income housing credit is subject to the application of the passive loss rule introduced by the Act. However, with respect to the low-income housing credit, a taxpayer is entitled to claim the credit in an amount equivalent to a $25,000 deduction (subject to a phase-out
between $200,000 and $250,000 of adjusted gross income) regardless of whether the taxpayer actively participates in the activity generating the credit.

J. Effective date. The credit will be available for property placed in service after December 31, 1986, and before January 1, 1990. Property placed in service after 1989 is eligible for the credit (and the passive loss exception) if expenditures of 10% or more of the total project cost are incurred by January 1, 1989, and the property is placed in service before January 1, 1991.

VI. Finance Leases


VII. Natural Resources

A. Oil, gas and geothermal deposits.

1. Intangible drilling costs.

   a. Corporations.

      i. Under the Act, 30% (instead of 20%) of domestic intangible drilling costs ("IDCs") of a corporation must be amortized ratably over a 60-month period (instead of a 36-month period), beginning with the month in which the costs are paid or incurred. The remaining 70% of such costs may be expensed in accordance with current law.

      ii. The provision applies to costs paid or incurred after December 31, 1986.

   b. Foreign IDCs.

      i. The Act introduces a new rule for IDCs paid or incurred with respect to an oil, gas, or geothermal well located outside the United States:
(a) at the taxpayer's election, foreign IDCs may be capitalized for purposes of computing depletion; or

(b) if no such election is made, foreign IDCs will be allowed as a deduction ratably over the 10 taxable year period beginning with the taxable year in which such costs were paid or incurred.

ii. The provisions apply to costs paid or incurred after December 31, 1986, in taxable years ending after such date.

2. Percentage depletion. The Act denies percentage depletion for lease bonuses, advance royalties, or other payments without regard to actual production from an oil, gas, or geothermal property, effective for amounts received or accrued after August 16, 1986.

3. Gain on disposition of interests in oil, gas, or geothermal property.

a. Recapture. The Act provides that expensed IDCs and depletion which reduce basis are recaptured as ordinary income upon sale or other disposition of the property.

b. Effective date. The provision applies to any disposition of property placed in service after December 31, 1986, unless the property was acquired pursuant to a written contract entered into and binding before September 26, 1985.

B. Hard minerals.

1. Mineral exploration and development costs.

a. Corporations. Under the Act, 30% (instead of 20%) of such costs of corporations must be amortized ratably over a 60-month period. The remaining 70% of such costs may be expensed.

b. Foreign mineral development costs. The Act introduces a new rule for any expenditures paid or incurred with respect to the
development of a mine or other natural deposit (other than an oil, gas, or geothermal well) located outside the United States:

i. at the taxpayer's election, such costs may be capitalized for purposes of computing depletion; or

ii. if no election is made, be allowed as a deduction ratably over the 10 taxable year period beginning with the taxable year in which such expenditures were paid or incurred.

c. Foreign mineral exploration costs. In the case of any mineral exploration expenditures paid or incurred with regard to any deposit of ore or other mineral (other than an oil, gas, or geothermal well) located outside the United States, the same rule discussed in subsection b., above, shall apply.

d. Effective date. The provisions described above in subsections a. through c. apply to costs paid or incurred after December 31, 1986.

2. Gain on disposition of interest in mining property. Expensed exploration and development expenses and depletion that reduce basis are recaptured as ordinary income. The provision applies to property placed in service after December 31, 1986, unless such property was acquired pursuant to a written contract entered into and binding before September 26, 1985.

3. Capital gains. Because of the repeal of the preferential taxation of net long-term capital gains discussed at Part III., above, income from coal, domestic iron, or section 631 leases will be taxed as ordinary income. See Act, § 311(b).

4. Percentage depletion.

a. Eligibility. Coal and iron ore royalties are eligible for percentage depletion for any taxable year in which long-term capital
gains are subject to tax at the same rate as ordinary income.

b. **Coal and iron ore.** The section 291 reduction in percentage depletion for coal and iron ore under current law (15%) is amended by increasing the reduction to 20%, effective for taxable years beginning after December 31, 1986.

C. **Timber.** Generally, the Act does not alter the taxation of timber, other than by way of eliminating the preferential long-term capital gain treatment under section 631. A special procedure for revoking section 631(a) elections is provided. See Act, § 311(b).

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EXHIBIT A

General Classifications of Property Under the Act*

3-year property  -- certain animals;
especial devices, tools, and equipment used
in certain industries such as the food and
beverage industry;

5-year property  -- automobiles**;
light trucks**;
buses;
trailers;
qualified technological equipment**;
computer-based telephone central office
switching equipment**;
research and experimentation equipment**;
data handling equipment, except computers
(for example, typewriters, calculators,
adding machines, and copiers);
offshore drilling equipment;
oil and gas drilling equipment;
construction equipment;
timber cutting equipment;
specified manufacturing equipment;
passenger and freight motor transport;

7-year property  -- single-purpose agricultural or horticultural
structures**;
railroad track**;
office furniture, fixtures, and equipment;
agricultural machinery and equipment;
mining equipment;
computers and peripheral equipment;
aircraft (commercial);
paper and wood product manufacturing assets;
railroad car, automobile, and ship and boat
manufacturing assets;

10-year property  -- assets used to manufacture certain products,
including gasoline and sugar;
vessels, barges and tugs;


** Based on a change in ADR mid-point class life by the Act.
15-year property  -- municipal wastewater treatment plants**; land improvements; pipeline transportation assets; combustion power plant assets; water transportation assets (other than vessels, barges, and tugs);

20-year property  -- municipal sewers**; water utility assets; gas and electricity distribution equipment; steam power plant assets;

27.5-year property -- residential rental property (including manufactured homes that are residential rental property and elevators and escalators)**;

31.5-year property -- nonresidential real property (including elevators and escalators)**.