



INFORMATIONAL NOTICE PERSONAL INCOME TAX 2012-05

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Internal Revenue Code Section 179 Expense Deductions

Pennsylvania law allows taxpayers to treat the cost of "property commonly referred to as Section 179 Property" as a currently deductible expense to the extent described in this informational notice. This informational notice explains how to apply the rules of Section 179 of the Internal Revenue Code of 1986 (26 U.S.C. § 179) ("Section 179") for Pennsylvania personal income tax ("PIT") purposes, including:

- The property for which a taxpayer may make the Section 179 election (Part I);
- Elections to expense Section 179 Property (Part II);
- The dollar limitation on the amount a taxpayer may elect to expense in a taxable year (Part III);
- The taxable income limitation that may limit the allowable expense deduction in a taxable year (Part IV);
- The carryover of deductions disallowed by the taxable income limitations (Part V);
- The determination of the adjusted basis of Section 179 Property (Part VI);
- Rules applicable to partnerships and S Corporations (Part VII);
- Rules applicable to spouses (Part VIII);
- Examples (Part IX).

A Section 179 expense deduction is allowable for PIT purposes only to the extent allowable for federal income tax ("FIT") purposes. Accordingly, the taxpayer must have elected to take the Section 179 expense deduction for FIT purposes and the election and expensed property must satisfy all applicable FIT rules and limitations. **If you elect to expense Section 179 Property for FIT purposes, you are required to expense the property for PIT purposes.**

Important: Pennsylvania law is not tied to current federal Section 179 dollar limitations. Pennsylvania does not follow the federal rules that have periodically adjusted the amount of the Section 179 expense deduction. Therefore, the maximum amount a taxpayer may elect to currently expense for assets placed in service after tax year 2003 is \$25,000 per taxable year. This is less than the amount that is deductible for FIT purposes under the version of Section 179 that is presently in effect.

Because the maximum allowable PIT Section 179 election is less than the FIT Section 179 election, a taxpayer whose FIT election exceeds his or her PIT election is required to use straight-line depreciation for Section 179 Property to the extent described in Part V.

A trust or estate may not deduct Section 179 expenses from Pennsylvania taxable income. A trust or estate that is a partner or S Corporation shareholder may not deduct any Section 179 expense for partnership or S Corporation Section 179 Property (see Part VII).



PART I. SECTION 179 PROPERTY DEFINED

For PIT purposes, a taxpayer may elect to expense the cost of any property “commonly referred to as Section 179 Property.”¹ Section 179 Property is property for which a taxpayer may make a current FIT Section 179 election.

A taxpayer must expense the same property for PIT purposes as he or she is expensing for FIT purposes. If a taxpayer elects to expense the cost of only one Section 179 asset for FIT purposes, the taxpayer must expense the cost of the same asset for PIT purposes. The amount of the PIT deduction may not exceed the dollar limitation described in Part III and the taxable income limitation described in Part IV.

If Section 179 Property is used only partially for business use, the portion of the cost that may be expensed is the same as the amount that may be expensed for FIT purposes.

If a taxpayer elects to expense and deduct the cost of more than one Section 179 asset for FIT purposes, the taxpayer must expense the cost of the assets for PIT purposes in the same proportion as expensed for FIT purposes.

If the total amount expensed for FIT purposes is greater than the limitation described in Part III, the amount expensed for each asset shall be calculated proportionally as follows: multiply the PIT limit (*see* Part III) by a fraction, the numerator of which is the cost expensed for each asset for FIT purposes and the denominator of which is the total cost of all assets expensed for FIT purposes.

A Section 179 expense is an allowable deduction only against the **net** class of income that the Section 179 Property was placed in service to generate. Therefore, if an asset was placed in service to generate net profits, the cost of the asset may be deducted only from the taxpayer’s net profits (Schedule C income). Likewise, if the asset was placed in service to generate rental income, the cost of the asset may be deducted only from taxpayer’s net income from rents and royalties (Schedule E income).

A Section 179 expense deduction is disallowed if the deduction is related to an asset that was placed in service to generate income in a gross taxable income class (*e.g.*, interest or dividends). The expense associated with such assets may not be used to offset any other class of income and may not be carried forward.

PART II. ELECTION TO EXPENSE SECTION 179 PROPERTY

A taxpayer must follow his or her FIT Section 179 expense reporting position for PIT purposes. A taxpayer who has elected to expense the cost of Section 179 Property for FIT purposes is required to expense the cost of such Section 179 Property for PIT purposes. A taxpayer who has not made the election to expense Section 179 Property for the taxable year for FIT purposes may not expense the cost of such property for PIT purposes.

A partner or shareholder is required to follow a partnership’s or S Corporation’s election to expense Section 179 Property.

PART III. DOLLAR LIMITATIONS

A taxpayer may elect to currently expense and deduct the cost of Section 179 Property for PIT purposes to the extent allowable under the earlier of:

1. The version of Section 179 in effect at the time the Section 179 Property was placed in service; or,
2. The version of Section 179 in effect in 2003.

For property placed in service after 2003, this means that the *maximum* amount that a taxpayer may elect to currently expense in a taxable year is \$25,000.²

The amount of deductible expense in a given tax year may be less than \$25,000 if the taxpayer has elected to expense less than this amount in the taxable year for FIT purposes.

Likewise, the amount of allowable deductible expense allowable under the dollar limitation will be less than \$25,000 if a taxpayer's federal active trade or business income for the taxable year is less than \$25,000 (see Part IV for taxable income limitations).

Further, the amount of a taxpayer's Section 179 deduction is reduced dollar-for-dollar to the extent the aggregate cost of Section 179 Property exceeds \$200,000. If the aggregate cost of Section 179 Property placed in service in a taxable year equals or exceeds \$225,000, a taxpayer's PIT Section 179 deduction is entirely phased out.

PART IV. CALCULATING THE "TAXABLE INCOME LIMITATION" AND DETERMINING THE APPROPRIATE PIT INCOME CLASS

A taxpayer calculates the amount of his or her allowable Section 179 deduction by applying FIT rules and regulations. Under FIT rules, a taxpayer may deduct Section 179 expenses only to the extent of income from an active trade or business. This is known as the "taxable income limitation."

In applying the federal taxable income limitation, the taxpayer must use federal taxable income that is derived from the active conduct by the taxpayer of a trade or business during the taxable year (including any guaranteed payment to the extent the guaranteed payment constitutes active trade or business income for FIT purposes).

Any Section 179 expense in excess of FIT active trade or business income is carried forward to future tax years. Section 179 deductions may not be used to create a loss for FIT purposes, although a Section 179 deduction may create a loss for PIT purposes. If a PIT loss results from a Section 179 deduction, the loss may not be carried forward to future tax years. Part V describes how a Section 179 expense is carried forward.

If a taxpayer engages in an activity that is a trade or business for FIT purposes but not for PIT purposes, the deduction is allowable for PIT purposes only in the appropriate net



taxable class of income. For example, a Section 179 expense deduction relating to rental property must be taken against PIT net rental income even if the deduction is allowable as a trade or business deduction for FIT purposes.

A Section 179 expense deduction is disallowed if the deduction is related to an asset that was placed in service to generate income in a gross taxable income class (*e.g.*, interest or dividends). The expense associated with such assets may not be used to offset any other class of income and may not be carried forward.

PART V. CARRYOVER OF DISALLOWED DEDUCTION

Section 179 permits taxpayers to carry forward any Section 179 expense that was not allowed as a deduction because of the income limitation rules described in Part IV.

If a taxpayer has a carry-forward, the amount of the carry-forward is added to the amount of any Section 179 expenses incurred in future taxable years. No more than \$25,000 may be expensed in any tax year and no more than \$25,000 may be carried forward for any tax year, although carry-forwards from prior tax years may exceed \$25,000 in the aggregate.

A taxpayer will be allowed to use a carry-forward in a tax year in which his or her Section 179 expense deduction is less than \$25,000, or when the taxpayer does not place any assets in service.

PART VI. THE ADJUSTED BASIS OF SECTION 179 PROPERTY

A taxpayer must immediately reduce the cost basis of Section 179 property by the amount of PIT Section 179 expense elected for that property. The immediate basis reduction is required even if taxpayer was unable to utilize the full amount of the election in the year the election is made.

The basis for property will be different for FIT and PIT purposes when a taxpayer's FIT Section 179 expense election is greater than \$25,000. For example, if a taxpayer's FIT Section 179 election results in expensing of the cost of \$30,000 of an asset, the taxpayer's PIT Section 179 expense deduction is limited to \$25,000. The basis of the Section 179 asset will be reduced by \$30,000 for FIT purposes and by \$25,000 for PIT purposes; **because the basis will differ for FIT and PIT purposes, the taxpayer must adopt the straight-line method of depreciation for that asset.**

The basis of Section 179 Property is increased by the amount of any outstanding carryover upon a sale or other disposition of Section 179 Property, or in a non-recognition transaction such as a gift. No increase is allowable to the extent straight-line depreciation would have required a basis reduction had the Section 179 election not been made. For example, assume a taxpayer elects to expense \$1,000 of a \$5,000 asset. The asset has a 5-year useful life and no net salvage value. Taxpayer is unable to utilize any of the \$1,000 Section 179 expense to offset taxable income. In year 6, when the asset is fully depreciated, taxpayer sells the property for \$2,000. Applying straight-line depreciation to the full value of the asset at the time of purchase would have resulted in a basis of \$0. While taxpayer has not utilized the \$1,000 of Section



179 expense, taxpayer may not increase the basis of the asset because under straight-line depreciation the asset basis would have been reduced to \$0 but for the Section 179 expense.

PART VII. PARTNERSHIPS AND S CORPORATIONS

The dollar limitation applies to partners and partnerships, and to S Corporations and its shareholders. In applying the **dollar limitation**, a partner's share of Section 179 expense is aggregated with any non-partnership Section 179 expenses of the taxpayer for the taxable year. Likewise, a shareholder's share of Section 179 expense is aggregated with any non-S Corporation Section 179 expenses of the taxpayer for the taxable year.

The **taxable income limitation is applied at both the partnership and partner level, and at both the S Corporation and shareholder level**. If the partnership has insufficient active trade or business income in a tax year, it must carry forward the disallowed deductions to future tax years and make allocations as allowed under federal Section 179 rules and regulations. Similar rules apply to S Corporations.

The taxable income limitation must be applied again at the partner and shareholder level for any partner or shareholder that is allocated a Section 179 expense deduction. A partner may deduct a partnership Section 179 expense only to the extent of the partner's meaningful participation in the partnership. A Section 179 expense deduction is not allowable simply because the expense is reflected on a partner's Schedule K-1; the partner must establish that the partner meaningfully participated in the management or operations of the partnership in order to take the deduction.

A partner that meaningfully participates in the management or operations of a partnership may add the partner's allocable share of partnership active trade or business income to the partner's other trade or business income when calculating the taxable income limitations.

The partner or shareholder is required immediately to reduce his or her outside basis in the partnership interest or stock basis by the amount of Section 179 expense allocated to the partner. If a partner or shareholder was allocated a Section 179 expense deduction that is not utilized on account of taxable income limitations, the partner may increase outside basis in the partnership interest or stock basis by the amount of allocated, unutilized Section 179 expense at the time the partnership interest is disposed of or transferred.

A basis increase is not allowable to the extent it would result in a greater outside basis than would have resulted if the partnership had utilized straight-line depreciation for the property. Therefore, if a partner would have been required to reduce his outside basis by \$10,000 if the partnership had applied straight-line depreciation, and if the partner has \$15,000 in unutilized Section 179 carry-forwards in the year the Section 179 Property is disposed of, the partner may only increase his or her outside basis by \$5,000. Please refer to the *PENNSYLVANIA PERSONAL INCOME TAX GUIDE Chapter 16 Pass Through Entities* for more information on the department's tax benefit rule. Similar rules apply to shareholders in an S Corporation.



The basis of partnership or S Corporation property must be reduced by the amount of the partnership's or S Corporation's Section 179 expense election. The basis reduction is required even if a partner or shareholder is prevented from deducting all or a portion of the amount of the Section 179 expense allocated by the partnership or S Corporation. The partnership or S Corporation may not increase the adjusted basis of a Section 179 asset if disposed of prior to utilization of the entire amount of Section 179 expense elected for that property.

A partner or shareholder that is a trust or estate may not deduct its allocable share of Section 179 expense elected by the partnership or S Corporation. The Section 179 election is not available for trusts and estates. Accordingly, the basis of partnership or S Corporation property in Section 179 Property is not reduced to reflect any portion of Section 179 expense that would have been allocable to a trust or estate.

PART VIII. SPOUSES

Dollar limitation

With respect to spouses, the \$25,000 dollar limitation is applied on a joint basis regardless of whether spouses file separately or jointly for PIT or FIT purposes.

If the spouses filed separately for FIT purposes and elected to allocate the \$25,000 between them, the spouse must follow the election for PIT purposes and therefore must allocate the deduction applying the same percentage for PIT purposes as applied for FIT purposes. If for any reason the spouses have not elected a percentage allocation for FIT purposes, or if the percentages elected do not equal 100%, the default allocation for PIT purposes is 50/50.

If the spouses filed jointly, the \$25,000 dollar limit is allocated proportionately looking to the ratio of each spouse's Section 179 expense to the combined Section 179 expense taken in the tax year on the FIT joint return. See Part IX, Example 7, Scenario 3.

When calculating the dollar limitation phase-out, property placed in service by both taxpayers is aggregated to determine whether the \$200,000 threshold is exceeded. For example, if both spouses place in service \$200,000 of Section 179 Property, the \$200,000 threshold is exceeded and the deduction is entirely phased out.

Income limitation

When determining whether the deduction is allowable under the active trade or business income limitations, the manner of calculating the income limitation depends on how the spouses filed their returns for FIT purposes. For spouses filing separately, the department looks to the FIT active trade or business income of each spouse on a separately-filed basis. For spouses filing jointly, the taxable income limitation is applied by aggregating the FIT active trade or business income of the spouses.



PART IX. EXAMPLES

Example 1: Apportioning PIT Section 179 expense among multiple assets when FIT election exceeds PIT dollar limitation.

Taxpayer elects to expense \$50,000 of the cost of two assets for FIT purposes, each asset having a cost basis of \$100,000. For FIT purposes, the taxpayer has elected to expense \$25,000 of each asset, reducing the basis of each asset to \$75,000. For PIT purposes, the taxpayer's Section 179 election is limited to \$25,000. The \$25,000 is applied 50/50 to each asset, in proportion to the percentage of the \$50,000 expense applied to each asset for FIT purposes. This means that \$12,500 of the PIT expenses is applied to each asset, reducing the PIT basis of each asset to \$87,500.

Example 2: FIT trade or business income greater than PIT trade or business income.

Taxpayer reports \$20,000 of FIT trade or business income for Tax Year 1. Taxpayer makes a Section 179 election in the amount of \$20,000. The full \$20,000 of the elected expense is allowable for FIT purposes.

Taxpayer has \$15,000 of Pennsylvania taxable income from a trade or business in Tax Year 1. Taxpayer's Pennsylvania income is less than federal taxable income on account of \$5,000 in meals and entertainment expenses that are allowable for Pennsylvania income tax purposes only.

For Pennsylvania personal income tax purposes, taxpayer has an allowable Section 179 deduction of \$20,000 in Tax Year 1. The \$5,000 in unused Section 179 expense creates a PIT loss, and is not carried forward to future tax years.

Example 3: FIT trade or business income less than PIT trade or business income.

Taxpayer reports \$20,000 of FIT active trade or business income for Tax Year 1. Taxpayer completed a like-kind exchange for federal income tax purposes, resulting in FIT deferral of \$10,000 of income. Taxpayer makes a Section 179 election in the amount of \$20,000. For federal income tax purposes, he may offset taxable income by \$20,000 of the elected expenses.

Taxpayer has \$30,000 of Pennsylvania taxable income from a trade or business in Tax Year 1, including income recognized in the like-kind exchange. For PIT purposes, taxpayer has an allowable Section 179 expense of \$20,000 in Tax Year 1, equal to the amount of allowable expenses for FIT purposes.

While taxpayer has \$30,000 of Pennsylvania taxable income from a trade or business, the taxpayer's expense deduction is limited to the amount of the deduction for FIT purposes.

Example 4: Carry-forwards.

In Tax Year 1, taxpayer elects to expense \$25,000 of the cost of Section 179 Property. Taxpayer has \$20,000 of FIT active trade or business income; as a result, taxpayer has an allowable Section 179 deduction of \$20,000. He carries forward the remaining \$5,000 to future tax years.

Scenario 1: In Tax Year 2, taxpayer makes no Section 179 election. He or she has trade or business income of at least \$10,000. Taxpayer may deduct the full \$5,000 of the carried forward deduction against trade or business income for PIT purposes.

Scenario 2: In Tax Year 2, taxpayer elects to expense \$20,000 of the cost of Section 179 Property. He or she has FIT trade or business income of at least \$25,000 in Tax Year 2. Taxpayer deducts \$25,000, consisting of the current-year Section 179 election expenses and consisting of the carried forward expenses from Tax Year 1.

Scenario 3: In Tax Year 2, taxpayer makes a Section 179 election of \$25,000. He or she has FIT trade or business income of \$10,000. Taxpayer deducts \$10,000 in the current year. Taxpayer's aggregate amount of Section 179 expenses that are carried forward to future tax years is \$20,000.

Example 5: Partners.

A taxpayer is a 50% partner in a partnership who meaningfully participates in partnership management. In Tax Year 1, the partnership purchases \$25,000 of Section 179 Property and makes a \$25,000 Section 179 election for FIT purposes. Partnership generates FIT active trade or business income of \$20,000 in Tax Year 1.

For dollar limitations, taxpayer is treated as having elected to expense \$12,500 of partnership Section 179 Property. Taxpayer's allocable share of active trade or business income is \$10,000. Applying the dollar limitations to the taxpayer, taxpayer's allocable share of the allowable Section 179 expense deduction for Tax Year 1 is \$10,000, equal to 50% of the \$20,000 allowable deduction.

Taxpayer operates a trade or business as a sole proprietor. This business generates \$5,000 in active trade or business income. Taxpayer purchases \$25,000 of Section 179 Property for the sole proprietorship. Taxpayer may not elect to expense the full amount of this property. The dollar limitation applies to limit the Section 179 expense to \$12,500. When this amount is added to the \$12,500 in partnership property placed in service, taxpayer is treated as having elected to expense \$25,000 of Section 179 Property.

Taxpayer's aggregate allowable Section 179 expense in Tax Year 1 is \$15,000 (allowable deductions are limited to the total of \$10,000 of FIT partnership active business income and \$5,000 individual active business income).

Example 6: Determining the appropriate PIT class of income.

Taxpayer has FIT active trade or business income of \$25,000. Taxpayer makes a \$25,000 Section 179 expense election and the entire \$25,000 is an allowable FIT expense. The Section 179 expense consists of \$10,000 of property used to generate rental income, \$10,000 of property used to generate trade or business income, and \$5,000 of property used to generate dividend income for PIT purposes.

Taxpayer's Section 179 expense is allowable in full as a deduction against the rental and trade or business income classes. However, taxpayer's Section 179 expense is not an allowable deduction against dividend income; dividend income is a gross income class.

Example 7: Spouses.

Scenario 1: Spouse H is an investor in Partnership H, and is allocated \$20,000 of Section 179 expense in Tax Year 1. Spouse W is an investor in Partnership W, and is allocated \$10,000 of Section 179 expense in Tax Year 1.

Spouses H and W file separately for FIT and PIT purposes, and do not make an election affecting the FIT 50/50 default allocation. Both spouses have enough active trade or business income in taxable income in Tax Year 1 to support the full Section 179 deduction.

For PIT purposes, Spouse H may deduct \$12,500 of the Section 179 expense in Tax Year 1, and carries forward the remaining \$7,500 of the Section 179 expense. Spouse W may deduct \$10,000 of Section 179 expense in Tax Year 1.

Scenario 2: Partnership H allocates Spouse H \$20,000 of Section 179 expense in Tax Year 1. Partnership W allocates Spouse W \$20,000 of Section 179 expense in Tax Year 1.

Spouses H and W file separately for FIT and PIT purposes, and for FIT purposes they make an election to allocate the Section 179 deduction 80% to Spouse H and 20% to Spouse W.

For PIT purposes, Spouse H may deduct \$20,000 of the Section 179 expense in Tax Year 1. Spouse W may deduct \$5,000 of the Section 179 expense in Tax Year 1, and carries forward the remaining \$15,000 of the Section 179 expense.

Scenario 3: Partnership H allocates Spouse H \$10,000 of Section 179 expense in Tax Year 1. Partnership W allocates Spouse W \$40,000 of Section 179 expense in Tax Year 1. The spouses claim \$50,000 of total Section 179 expense on their joint return in Tax Year 1.

[Scenario 3 continues on the following page.]



Spouses H and W file jointly for FIT purposes. The spouses allocate the \$25,000 PIT expense as follows:

- o Spouse H may deduct \$5,000 in Tax Year 1 ($10/50 * \$25,000$). Spouse H carries forward the remaining \$5,000 of the Section 179 expense.
- o Spouse W may deduct \$20,000 in Tax Year 1 ($40/50 * \$25,000$). Spouse W carries forward the remaining \$20,000 of the Section 179 expense.

¹ 72 P.S. § 7303(a.3).

² The dollar limitations for property placed in service prior to 2003 are as follows:

- 1997...\$18,000;
- 1998...\$18,500;
- 1999...\$19,000;
- 2000...\$20,000;
- 2001 or 2002...\$24,000.