

# Special Depreciation Allowance for Qualified Production Property

## Cross References

- Notice 2026-16

The IRS recently issued guidance addressing the special depreciation allowance for qualified production property (QPP). This guidance is expected to be included in proposed regulations that will be released by the IRS later this year.

The One Big Beautiful Bill Act (OBBBA) introduced a new 100% special depreciation allowance (bonus depreciation) for qualified production property placed in service after July 4, 2025, and before January 1, 2031. QPP is defined as that portion of any nonresidential real property:

- 1) To which IRC section 168 applies (property eligible for MACRS depreciation),
- 2) That is used by the taxpayer as an integral part of a qualified production activity (QPA),
- 3) That is placed in service in the United States or any territory of the United States,
- 4) The original use of which commences with the taxpayer,
- 5) The construction of which begins after January 19, 2025, and before January 1, 2029,
- 6) That is designated by the taxpayer in an election under IRC section 168(n),
- 7) That is placed in service after July 4, 2025, and before January 1, 2031,
- 8) That is not property to which the alternative depreciation system (ADS) applies, and
- 9) That is not ineligible property.

The IRS guidance in Notice 2026-16 (which is expected to be included in the proposed regulations) provides the following details on how the above rules apply.

**Integral part requirement.** Property is used as an integral part of a QPA if a QPA is conducted in, or takes place within, the physical space of such property. If a QPA is conducted in, or takes place within, only a portion of the physical space of property, only such portion satisfies the integral part requirement. Each unit of property must satisfy the integral part requirement on its own (see unit of property below for an exception).

Under a de minimis rule, if 95% or more of the physical space of a property satisfies the integral part requirement, the taxpayer may elect to treat the entire property as satisfying the integral part requirement.

Property that is leased by the taxpayer is not treated as used by the taxpayer as an integral part of a QPA. An exception to this rule applies in the case of a consolidated group where one member owns and leases property to another member (intercompany lease). A similar exception applies to two or more commonly controlled pass-through entities where 50% or more is owned by the same person or group of persons. See Notice 2026-16 for details.

**Unit of property.** In general, each building, including its structural components, is a single unit of property. If the taxpayer places in service an improvement or addition to an

asset after the taxpayer placed the asset in service, the improvement or addition, including any of its structural components, is a separate unit or property.

Solely for purposes of satisfying the integral part requirement, in the case of multiple properties that operate as an integrated facility that are physically located or co-located on the same piece or contiguous pieces of land, all properties comprising the integrated facility may be treated as a single unit of property.

**Original use.** QPP must meet the original use requirement. The original use requirement and beginning of construction requirement are treated as met if the following are satisfied.

- The property was not used in a QPA by any person at any time during the period beginning on January 1, 2021, and ending on May 12, 2025,
- The property was not used by the taxpayer at any time prior to such acquisition,
- The acquisition of the property meets the requirements of IRC section 179(d)(2) (the property is not acquired from a related party or by a member of a controlled group from another member of the same group), and
- The acquisition of the property meets the requirements of IRC section 179(d)(3) (the taxpayer's basis in the property is not determined by reference to its basis in the hands of the transferor).

#### **Author's Comment**

In other words, original use does not necessarily require the property to be new property. Used property can qualify under the original use requirement if the above rules are met.

**Ineligible property.** Ineligible property includes any portion of property used for offices, administrative services, lodging, parking, sales activities, research activities, software development or engineering activities, or other functions unrelated to a QPA. Additionally, any portion of property used to store finished products and certain other items is not used as an integral part of a QPA.

**Allocation of basis to eligible property.** A taxpayer may use any reasonable method to allocate a property's unadjusted depreciable basis between eligible property and ineligible property. For this purpose, the use of square footage, cost segregation data, architectural or engineering plans, process diagrams, or construction invoices to allocate unadjusted depreciable basis may be a reasonable method.

In the case of property or a portion of property which contains infrastructure that serves both eligible property and ineligible property (for example, a central air conditioning system), a taxpayer may allocate the basis between eligible and ineligible property using any reasonable method.

**Designating the amount of QPP.** A taxpayer designates the dollar amount of eligible property by either designating the entire unadjusted depreciable basis of eligible property as QPP or designating a specific dollar amount (not to exceed the unadjusted depreciable basis of the eligible property) as QPP. The amount designated as QPP must be

included in the taxpayer's election statement. If the election statement does not designate a specific dollar amount, the entire unadjusted depreciable basis of eligible property will be treated as QPP.

**Author's Comment**

Similar to the section 179 election, bonus depreciation for QPP can be either for the entire cost of eligible property, or a portion of it with the rest being depreciated under MACRS.

**Election out of other special depreciation allowances.** Under IRC section 168(k), bonus depreciation for other qualified property is the default, unless the taxpayer makes an election out of bonus depreciation. Under IRC section 168(n), bonus depreciation for QPP is allowed if the taxpayer makes an election to use bonus depreciation. If the property qualifies for bonus depreciation under both IRC section 168(k) and section 168(n), the taxpayer is treated as electing out of IRC section 168(k) bonus depreciation when an IRC section 168(n) election is made.

**Disaster area.** An automatic one-year extension of the placed-in-service-date requirement is granted for any property that is located in a disaster area.

**Qualified production activity (QPA).** The term QPA means the manufacturing, production, or refining of a qualified product. A trade or business activity of a taxpayer does not constitute manufacturing, production, or refining of a qualified product unless the trade or business activity results in a substantial transformation of the property comprising the qualified product.

A manufacturing, production, or refining activity, or a related activity, that does not itself give rise to a substantial transformation of the property comprising a qualified product (such as a manufacturing or production subprocess activity) may nevertheless be included in a QPA, or will not cause a taxpayer to fail to have a QPA, if such activity meets the definition of an essential activity, or a related activity.

**Essential activities.** A QPA includes any manufacturing, production, or refining activity that does not result in a substantial transformation of the property comprising a qualified product if the activity is essential to the completion of the QPA. Such activity is essential to the completion of a QPA if:

- 1) The activity occurs within the same property, or within the same integrated facility in which the substantial transformation of the property comprising the qualified product occurs,
- 2) The activity does not occur within ineligible property, and
- 3) Without the activity, the substantial transformation of the property comprising the qualified product:
  - a) Cannot occur,
  - b) Would result in an end product that is different in quality than the intended qualified product, or
  - c) Would result in a quantity of qualified product that is different from the intended quantity.

The receiving and storage of raw materials or other inputs to be used or consumed during a QPA are activities essential to the QPA if they are conducted in, or take place within, the same property, or within the same integrated facility as the QPA. Storage of finished products is not an activity essential to a QPA.

**Related activities.** A taxpayer's trade or business activity will not fail to be a QPA if the individuals performing or supervising the manufacturing, production, or refining activities also perform, or are otherwise involved in activities related to the QPA if:

- The related activity occurs within the same property, or within the same integrated facility in which the substantial transformation of the property comprising the qualified product occurs, and
- The related activity does not occur within ineligible property.

The following activities are examples of other activities related to a QPA.

- Oversight and direction of the manufacturing, production, or refining activities that result in the substantial transformation of the property comprising a qualified product,
- Material selection, vendor selection, or control of the raw materials or work-in-process that are substantially transformed into a qualified product,
- Management of manufacturing, production, or refining costs or capacities attributable to the manufacturing, production, or refining activities that result in a substantial transformation of the property comprising a qualified product, or
- Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property used in conducting a manufacturing, production, or refining activity that results in a substantial transformation of the property comprising the qualified product.

For purposes of determining whether a taxpayer's trade or business activity is a QPA, whether or not the taxpayer is the tax owner of the qualified product resulting from the QPA is not taken into account in determining whether the taxpayer's trade or business activity is a QPA.

**Qualified product.** The term qualified product means any tangible personal property, except any food or beverage prepared in the same building as a retail establishment in which such food or beverage is sold.

**Manufacturing.** The term manufacturing means to materially change the form or function of tangible personal property, including parts and components, to create a new item of tangible personal property that is held for rent, lease, or sale to customers in the ordinary course of a trade or business. The form or function of the raw materials, elements, parts, components, or other tangible personal property used as inputs is considered to be materially changed if, at the completion of the processes giving rise to the new item of tangible personal property, the materials, elements, parts, components or other inputs have been transformed such that they are distinguishable from, and cannot readily be returned to, their original state. In no event will a change in form or function resulting solely from packaging, repackaging, labeling, minor assembly operations, or a combination thereof, be considered a material change to the form or function of tangible personal property.

**Refining.** The term refining means to purify a substance into a useful and higher-value product. Examples of refining include:

- Removing free fatty acids and other impurities from animal fats by degumming, decolorization, deacidification, and deodorization,
- Processing petroleum, liquid hydrocarbons and other products from crude oil by using fractionation, straight distillation of crude oil, and/or cracking,
- Purifying nonferrous metals (except aluminum) by electrolytic methods or other processes,
- Processing vegetable oils from plant material by removing free fatty acids, phospholipids, pigments, off-flavors, and other impurities,
- Processing vegetable, oilseed, and tree nut oils from purchased oils, such as by degumming and neutralization,
- Wet corn milling,
- Processing cane or beet sugar from raw cane or beet sugar,
- Removing remaining impurities and moisture from animal fat, bones, and meat scraps through techniques like filtration and bleaching,
- Processing tar paving, roofing, and saturated materials from crude petroleum and manufacturing asphalt,
- Extracting alumina (aluminum oxide) generally from bauxite ore,
- Processing liquified natural gas or chemical feedstocks from natural gas,
- Recovering copper or copper alloys from scrap, and
- Recovering nonferrous metals (except copper and aluminum) from scrap.

**Production.** The term production means either agricultural production or chemical production.

Agricultural production means the process of cultivating the ground, typically in fields or large acreage, and includes:

- Preparing the soil,
- Planting seeds,
- Raising, cultivating, irrigating, and harvesting crops for sale, rent, or lease to customers, and
- Breeding, rearing, feeding, and managing livestock for sale, rent, or lease to customers.

Agricultural production does not include:

- The raising of animals that are not livestock, or
- Activities that benefit persons engaged in agriculture when these activities are not agricultural production, such as food marketing.

Livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry.

Chemical production means a chemical process whereby a product is formulated from organic and inorganic raw materials, including preparing raw materials for reaction, combining materials in a reactor to form a new substance, isolating the final product from byproducts, intermediates, and other substances, and purifying the final product. See Notice 2026-16 for examples.

**Substantial transformation.** The term substantial transformation of the property comprising a qualified product means the further manufacturing, production, or refining of the constituent elements, raw materials, inputs, or subcomponents into a final, complete, and distinct item or property in the hands of the taxpayer that is fundamentally different from the original constituent elements, materials, inputs, or subcomponents.

Examples of substantial transformation of the property comprising a qualified product include the conversion of wood pulp to paper, steel rods to screws and bolts, and freshly caught tuna fish to canned tuna.

An example of an activity that does not result in a substantial transformation of the property comprising a qualified product is the grouping and packaging of multiple finished goods for sale as a single item, such as gift baskets, subscription boxes, and bundled electronics.

**Safe harbor for property placed in service during 2025.** Notwithstanding the definitions described above, for property placed in service after July 4, 2025, and on or before December 31, 2025, the taxpayer's trade or business activity will be treated as a QPA if the applicable NAICS code for the trade or business is listed under sectors 31, 32, or 33, or under subsectors 111 or 112. See pages 5-4 through 5-6 of *TheTaxBook 1040/Deluxe Edition*.

**Other special rules.** See Notice 2026-16 for references to existing regulations that deal with property placed in service and disposed of in the same taxable year, redetermination of basis, and like-kind exchanges and involuntary conversions.

**Time and manner of making election.** Unlike other bonus depreciation, a taxpayer must elect to use bonus depreciation for QPP. A taxpayer makes a designation and an election by attaching a statement to its Federal income tax return for the tax year in which the eligible property is placed in service.

The statement should be entitled: "STATEMENT PURSUANT TO SECTION 7 OF NOTICE 2026-16." The statement must include the following information.

- 1) The name and taxpayer identification number of the taxpayer making the election,
- 2) For each property placed in service in the tax year for which the election is being made:
  - a) The street address, city, state, zip code, and a description of the property,
  - b) The total unadjusted depreciable basis of the property,
  - c) If the eligible property is less than the entire property, the dollar amount of unadjusted depreciable basis allocable to the eligible property, and a description that identifies the eligible property, and
  - d) The dollar amount of the unadjusted depreciable basis of eligible property the taxpayer is designating as QPP (or a statement that the taxpayer is designating the entire unadjusted depreciable basis of the eligible property as QPP),
- 3) If the taxpayer is applying the de minimis rule described in Notice 2026-16 to an eligible property, a declaration that the taxpayer is applying the de minimis rule and identification of each eligible property to which the de minimis rule is applied, and
- 4) If the taxpayer is using the automatic one-year extension of the placed-in-service date requirement for a qualified disaster:

- a) A declaration that the taxpayer is using the automatic one-year extension and each property for which the taxpayer is using the automatic one-year extension was located in a disaster area for all or a portion of 2030, and
- b) Identification of each eligible property listed in Notice 2026-16 for which the taxpayer is using the automatic one-year extension of the placed-in-service-date requirement, and identification of the federally declared disaster that established the disaster area applicable to each eligible property.

The above election may be revoked only by filing a request for a private letter ruling and obtaining the written consent of the IRS. The IRS will provide consent only in extraordinary circumstances. If the request for revocation would allow a taxpayer to use hindsight, the extraordinary circumstances standard is not met.

**Depreciation recapture.** If there is a QPP change in use, it results in the property becoming disqualified property, subject to IRC section 1245(a)(1) and is treated as having been disposed of by the taxpayer as of the first time the property had a QPP change in use. Upon such QPP change in use, the excess of the recomputed basis of the disqualified property over the adjusted basis of the disqualified property is treated as ordinary income in the year of change. The taxpayer's adjusted basis in the disqualified property is then increased by the amount of gain recognized.

A QPP change in use occurs if, at any time within the 10-calendar-year period beginning on the date a taxpayer places QPP in service, the QPP ceases to satisfy the integral part requirement, and is used by the taxpayer in another productive use that results in the property that was previously QPP constituting disqualified property. A QPP change in use has not occurred when a taxpayer ceases to use QPP as an integral part of one QPA and begins to use it as an integral part of another QPA, provided the QPP was not used in another productive use in the interim. If only a portion of QPP undergoes a QPP change in use, depreciation recapture only applies to the portion that underwent a change in use. Special rules apply for consolidated groups and leases to commonly controlled persons. Property that has been placed in service but is temporarily idle does not cease to satisfy the integral part requirement and does not have a QPP change in use.

The depreciation allowance for disqualified property in the year of change and all subsequent tax years is determined as though the disqualified property was placed in service by the taxpayer as a new separate asset on the first day of the year of change, taking into account the applicable convention.

See Notice 2026-16 for ways to determine recomputed basis when the QPP underwent a partial change to which depreciation recapture applies.

**Examples.** See Notice 2026-16 for examples and other details that illustrate the above rules.