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Inside The IRS' Final First-Year Depreciation Tax Regulations

By **Daniel Kiely and Minju Kim** (October 9, 2020, 6:01 PM EDT)

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On Sept. 21, the U.S. Department of the Treasury and the Internal Revenue Service released a second set of final regulations[1] implementing the 100% additional first-year depreciation deduction under Section 168(k), which allows businesses to fully deduct the cost of most depreciable business assets in the year they are placed in service by the business.

The 2020 final regulations adopt, with modifications, the proposed regulations issued in September 2019[2] and provide clarifying guidance on issues that were not addressed in a set of final regulations released in September 2019.[3] In addition, the 2020 final regulations note certain areas where additional guidance will follow.

This article discusses some of the key issues and clarifications associated with the 2020 final regulations.

Background

The Tax Cuts and Jobs Act[4] made significant changes to Internal Revenue Code Section 168(k),[5] which include increasing the additional first-year depreciation deduction percentage from 50% to 100% and expanding the property eligible for the additional first-year depreciation deduction to include certain used depreciable property.

In addition, the TCJA changes to Section 168(k) extended the placed-in-service date from before Jan. 1, 2020, to before Jan. 1, 2027. For longer production period property and certain aircraft property, the changes extended the placed-in-service date from before Jan. 1, 2021, to before Jan. 1, 2028.

These changes to Section 168(k) apply to property acquired and placed in service after Sept. 27, 2017.

The 2020 final regulations provide rules applicable to taxpayers with floor-plan financing, guidance on predecessor ownership, and updates to definitions in the 2019 final regulations.

Floor-Plan Financing

The 2019 proposed regulations provided guidance for taxpayers that have floor-plan financing, which include most equipment and car dealerships. In exchange for more favorable treatment under the interest disallowance rules of Section 163(j), the TCJA provided that taxpayers with floor-plan financing were not eligible for the additional first-year depreciation.

Section 163(j) limits a taxpayer's interest deduction for any taxable year to the sum of interest income, 30% of its adjusted taxable income,[6] and floor-plan financing interest.[7] Property used in a trade or business that has floor-plan financing is not eligible for the additional first-year depreciation if the interest related to such indebtedness is taken into account under Section 163(j).

This raised several questions among taxpayers regarding when exactly such interest is taken into account. Specifically, can a taxpayer with floor-plan financing be denied the additional first-year depreciation if it does not have enough interest expense to trigger the limit in Section 163(j) even without taking account of the floor-plan financing interest? Similarly, if such a taxpayer triggers the Section 163(j) limit in some years but not others can it ever claim the additional first-year depreciation?

The 2019 proposed regulations addressed these questions with a taxpayer favorable rule that allows taxpayers to annually test whether or not the floor-plan financing interest is taken into account when determining whether the additional first-year depreciation is allowed for that taxable year. Thus, if in one taxable year, a taxpayer with floor-plan financing would not have been able to deduct all of its interest without using the floor-plan financing exception under Section 163(j), then the taxpayer cannot claim additional first-year depreciation on eligible equipment purchased in that year.

However, if in a subsequent year the taxpayer has floor-plan financing and can deduct all of its interest without using the floor-plan financing exception to Section 163(j), then the taxpayer can claim additional first-year depreciation on otherwise eligible equipment purchased in that year. Importantly, the 2019 proposed regulations did not allow a taxpayer with floor-plan financing interest to choose to limit its interest expense deductions in a given year to remain eligible for the additional first-year depreciation.

In response to the 2019 proposed regulations, commenters asked the Treasury and the IRS to permit a taxpayer with interest expenses, including floor-plan financing interest expenses, to choose to limit its interest expenses so as to avoid being ineligible to claim the additional first-year depreciation deduction.

The Treasury and the IRS rejected this proposal on the grounds that neither Section 163(j) nor the regulations thereunder provide an option for a taxpayer with floor-plan financing to include or exclude its floor-plan financing interest expense in determining the amount allowed as a deduction for business interest expense for the taxable year.

The Treasury and the IRS did, however, acknowledge that some transition relief should be provided to taxpayers with floor-plan financing who filed their 2018 federal income tax returns on the basis that Section 163(j) permitted such an option and for taxpayers who want to revoke their elections not to claim the additional first-year depreciation for property placed in service during 2018.

In the preamble to the 2020 final regulations, the Treasury and the IRS stated their intent to issue published guidance that will address these issues.

Predecessor Ownership

As previously noted, the TCJA expanded Section 168(k) to permit the additional first-year depreciation for used property. However, property that was used by the taxpayer or a predecessor prior to acquisition is not eligible.

The 2019 final regulations provided that property is treated as used by the taxpayer or a predecessor at any time prior to acquisition if the taxpayer or a predecessor had a depreciable interest in the property.

Extending the additional first-year depreciation to used property is a significant benefit for taxpayers, but raised complicated questions of how to determine whether the taxpayer or its predecessor previously had a depreciable interest in the property. The IRS issued the 2019 final regulations and 2019 proposed regulations to provide guidance on defining depreciable interest and to address partnerships and related party transactions. The 2020 final regulations address each of these issues.

Depreciable Interest

To determine if the taxpayer or a predecessor had a depreciable interest in the property, the 2019 final regulations included a five-year safe harbor, which provided that the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property are taken into account.

The adoption of the five-year safe harbor was a welcome relief for taxpayers. Without the safe harbor, taxpayers seeking the additional first-year depreciation on used property would have had to track the ownership of the property back to its original in-service date to confirm that neither it nor a predecessor had ever had a depreciable interest in the property. This would have introduced significant burdens on taxpayers and possibly limited the availability of the additional first-year depreciation.

However, the five-year safe harbor also left some areas of confusion. Specifically, commenters asked the IRS to clarify whether the current placed-in-service year is the taxpayer's taxable year or calendar year and whether the portion of the calendar year covering the period up to the placed-in-service date is taken into account.

In addition, commenters sought guidance regarding the application of the five-year safe harbor where either the taxpayer or a predecessor was not in existence for the entire five-year period.

The 2020 final regulations address the concerns of commenters by adopting helpful clarifying changes to the 2019 final regulations. In particular, the 2020 final regulations make clear that only the five calendar years immediately prior to the current calendar year in which the property is placed in service, and the portion of such current calendar year before the placed-in-service date of the property, are taken into account for the safe harbor.

In addition, the 2020 final regulations provide that each of the taxpayer and the predecessor is subject to a separate lookback period. Thus, if the taxpayer or a predecessor, or both, has not been in existence during the entire lookback period, then only the portion of the lookback period during which the taxpayer or a predecessor, or both, have been in existence is taken into account to determine if the taxpayer or the predecessor had a depreciable interest in the property.

Application to Partnerships

The 2019 proposed regulations introduced the partnership look-through rule, which addressed the extent to which a partner is deemed to have a depreciable interest in property held by a partnership.

The rule provides that a person is treated as having a depreciable interest in a portion of property prior to the person's acquisition of the property if the person was a partner at any time the partnership owned the property.

The partner's depreciable interest in the property is equal to its total share of depreciation deductions with respect to the property as a percentage of the total depreciation deductions allocated to all partners with respect to that property during the current calendar year and the previous five calendar years.

This rule is similar to the five-year safe harbor discussed above.

commenters noted the breadth of the partnership look-through rule and sought changes to limit its application only to taxpayers that had a controlling interest in a partnership that previously held the property, or to limit the rule to situations where the taxpayer's depreciable interest in an item of property is above a de minimis amount.

In a significant win for taxpayers, the Treasury and the IRS went beyond the requests of commenters and instead withdrew the partnership look-through rule after determining that the complexity of applying the rule would place a significant administrative burden on both taxpayers and the IRS. As a result, under the 2020 final regulations, a partner will not be treated as having a depreciable interest in partnership property solely by virtue of being a partner in the partnership.

Series of Related Transactions

The 2019 proposed regulations introduced the related transaction rule, which provided that the relationship between the parties in a series of related transactions was tested immediately after each step in the series, and between the original transferor and the ultimate transferee immediately after the last transaction in the series.

The 2020 final regulations simplify the related transaction rule by providing that each transferee tests its relationship with the immediate transferor, from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series.

The transferee is treated as related to the immediate transferor or the original transferor if the relationship exists either immediately before the first transfer of the depreciable property in the series or when the transferee acquires the property. Any transferor in a series of related transactions that ceases to exist during the series is deemed to continue to exist for purposes of testing relatedness.

The 2020 final regulations also provide a special rule that disregards certain transitory relationships created pursuant to a series of related transactions.

Definitions in the 2019 Final Regulations

The 2020 final regulations provide changes to certain definitions in the 2019 final regulations. The most significant change is to the definition of qualified improvement property.

The TCJA repealed Section 168(k)(3), with the result that qualified improvement property placed in service after Dec. 31, 2017, was not eligible for the additional first-year depreciation. The Coronavirus Aid, Relief and Economic Security, or CARES, Act amended Section 168(e)(3)(E) to provide that qualified improvement property is classified as 15-year property, thereby making such property eligible for the additional first-year depreciation deduction under Section 168(k).[8]

The 2020 final regulations amended the definition of qualified improvement property to reflect this change from the CARES Act. As a result, taxpayers can now deduct qualified improvement property, generally the improvements made to a business building's interior, when made by the taxpayer. The 2020 final regulations clarify the meaning of the phrase "made by the taxpayer."

Specifically, an improvement is made by the taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract.

In contrast, if a taxpayer acquires nonresidential real property in a taxable transaction and such nonresidential real property includes an improvement previously placed in service by the seller of such nonresidential real property, the improvement is not made by the taxpayer.

Looking Ahead

The TCJA made significant changes to the additional first-year depreciation deduction under Section 168(k), greatly expanding its applicability and impact, but leaving several important unanswered questions.

Prior to issuing the 2020 final regulations, the Treasury and the IRS had already issued two sets of proposed regulations as well as one set of final regulations, which provided initial clarity and structure for the expansion of Section 168(k).

The 2020 final regulations, which reflect comments received by the Treasury and the IRS, provide taxpayers with helpful guidance clarifying the remaining issues that were not fully addressed in the prior regulatory efforts.

On balance, the 2020 final regulations should be viewed favorably by many taxpayers since they further broaden the applicability of the additional first-year depreciation deduction by expanding the types of property that qualify for the benefit and simplifying rules regarding predecessor ownership for previously used property.

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[1] T.D. 9916.

[2] REG-106808-19.

[3] T.D. 9874.

[4] TCJA, 115 P.L. 97.

[5] IRC Section 168(k).

[6] Pursuant to Section 2306(a) of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), the adjusted taxable income percentage is increased from 30% to 50% for any taxable year beginning in 2019 or 2020, subject to certain exceptions.

[7] IRC Section 163(j).

[8] IRC Section 168(e)(3)(E).