Section 163(j) Impact on Cost Recovery

American Bar Association
Section of Taxation
Capital Recovery and Leasing Committee

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I. When is floor plan financing “taken into account”?
   a. Section 168(k)(9)(B): qualified property shall not include any property used in a trade or business that has had floor plan financing if the floor plan financing is taken into account under section 163(j)(1)(C).
      i. If the taxpayer’s floor plan financing does not exceed the sum of its business interest income and 30% of its adjusted taxable income, is the floor plan financing “taken into account” under section 163(j)(1)(C)?
         1. JCT Bluebook at p. 127: For example, assume that for 2018 a motor vehicle dealer does not meet the $25 million gross receipts test and has $20 of business interest income, $150 of business interest, $50 of floor plan financing interest, and $650 of adjusted taxable income. Because the $150 of business interest is less than the $215 interest limitation ($20 + ($650 * 30 percent)) determined without regard to the floor plan financing interest, the floor plan financing interest need not be taken into account under section 163(j)(1)(C) to increase the interest limitation because all business interest is deductible based on the interest limitation otherwise applicable. As a result, qualified property placed in service by the motor vehicle dealer’s trade or business during 2018 is eligible for bonus depreciation.
   b. Has the government considered providing a safe harbor for taxpayers whose floor plan financing is not material? For example, if a taxpayer’s floor plan financing interest does not exceed a specified percentage of its gross receipts or taxable income, the taxpayer is not precluded from claiming bonus depreciation.

II. How does a business determine whether it “has had floor plan financing”?
   a. Section 168(k)(9)(B): qualified property shall not include any property used in a trade or business that has had floor plan financing if the floor plan financing is taken into account under section 163(j)(1)(C).
   b. Does the existence of floor plan financing at any time permanently limit the ability of the business to claim bonus depreciation?
      i. JCT Bluebook at p. 127: Once a trade or business has taken floor plan financing interest into account under section 163(j)(1)(C) for a taxable year, any qualified property placed in service by that trade or business in such taxable year and subsequent taxable years is not eligible for bonus depreciation.

III. Are the provisions of Section 163(j) and resulting Section 168(k) impacts mandatory or elective?
   a. Section 163(j)(1): interest expense shall not exceed the sum of (A) business interest income for the tax year, (B) thirty percent of the adjusted taxable income of the year and (C) floor plan financing interest for such year.
b. Section 168(k)(9)(B): qualified property does not include any property used in a trade or business that has had floor plan financing “if” floor plan financing was taken into account under section 163(j)(1)(C).
   i. JCT Bluebook Footnote 873: Note, however, that if the taxpayer takes floor plan financing interest into account to increase the taxpayer’s interest limitation under section 163(j) for a taxable year, property placed in service by the taxpayer during such year and subsequent taxable years is not eligible for the additional first-year depreciation deduction under section 168(k)

IV. When is property considered to be “primarily used” in a regulated utilities business?
   a. Section 168(k)(9)(A): qualified property shall not include property which is primarily used in a trade or business described in section 163(j)(7)(A)(iv) (regulated utilities business)
   b. Has the government considered providing a safe harbor similar to those outlined in Prop. Reg. § 1.163(j)-10(c) that treats an asset as not primarily used in a utilities business if less than a specified percentage of the business’ output, income or basis are related to a regulated utilities business?
   c. Is utility property acquired prior to Sept. 27, 2017 and placed in service after Jan. 1, 2018 eligible for bonus depreciation?

V. Is a business that leases property to a trade or business such as a regulated public utility that is restricted from claiming bonus depreciation also prohibited from claiming bonus depreciation on the leased assets?
   a. Section 168(k)(9) provides that qualified property for bonus depreciation does not include property used in trades or businesses that are exempt from the interest expense limitations under section 163(j). Specifically, property primarily used in a regulated utilities business or a business with floor plan financing is not eligible for bonus depreciation.
   b. JCT Bluebook Footnote 551: It is intended that this exception only apply to regulated public utility or electric cooperative trades or businesses excluded from the interest limitation under section 163(j)(7)(A)(iv). For example, property leased by a leasing trade or business to a regulated public utility would not be precluded by section 168(k)(9)(A) from claiming bonus depreciation on its qualified property because the leasing trade or business is not excluded from the interest limitation

VI. How is a “trade or business” determined for purposes of applying the limitations on bonus depreciation in connection with the interest expense limitation provisions in Section 163(j)?
   a. Section 163(j)(7): Trade or businesses exempt from interest expense limitations include electing real property trades or businesses, electing farming business or the trade or business of the furnishing or sale of certain utility services if the rates are established or approved by governing agency
   b. Section 168(k)(9)(A): qualified property shall not include property which is primarily used in a trade or business described in section 163(j)(7)(A)(iv) (regulated utilities business)
   c. Section 168(k)(9)(B): qualified property shall not include any property used in a trade or business that has had floor plan financing if the floor plan financing is taken into account under section 163(j)(1)(C).
   d. How is a trade or business defined for purposes of applying these rules?
   e. Can taxpayers rely on the standards outlined in Section 162 for determining whether it has a trade or business and the standards under Section 446 for determining when it has separate trades or businesses? If the taxpayer has separate and distinct trades or
businesses under Section 446, some of which are subject to the limitations on bonus depreciation and some of which are not, can the taxpayer apply the limitations only on the assets held in the businesses that are not eligible for bonus depreciation?

VII. What are the procedures for depreciating assets used in electing real property or farming business under ADS?

i. Taxpayers may make an irrevocable election under section 163(j)(7)(B) and (C) to treat their real property and farming businesses, respectively, as not subject to the interest expense limitations under section 163(j).

ii. Section 168(g)(1)(F) provides that property defined in section 168(g)(8) is required to be depreciated using the alternative depreciation system. Section 168(g)(8) includes nonresidential real property, residential rental property and qualified improvement property used in an electing real property trade or business as defined in section 163(j)(7)(B).

1. Question: Is qualified leasehold improvement property, qualified retail improvement property and qualified restaurant property placed in service prior to Dec. 31, 2017, subject to the requirement to use the alternative depreciation system if the property also meets the definition of qualified improvement property under Section 168(e)(6)?

iii. Section 168(g)(1)(G) provides that any property with a recovery period of 10 years or more that is held by an electing farming business, as described in section 163(j)(7)(C), is required to be depreciated using the alternative depreciation system.

iv. Rev. Proc. 2019-08: A taxpayer making an election under Section 163(j)(7)(B) or (C) must begin depreciating properties in accordance with the alternative depreciation system. The taxpayer must use the alternative depreciation system for property placed in service prior to the year of the election (“existing property”) and property placed in service in the election year and subsequent years (“newly-acquired property”).

1. For existing property, depreciation for the property beginning in the year of the election is computed in accordance with Treas. Reg. § 1.168(i)-4(d). The change in computing depreciation is not a change in method of accounting under Section 446(e). If the property was qualifying property under Section 168(k), the bonus depreciation allowable on the property is not re-determined.

2. For newly acquired property, the depreciation is determined in accordance with the alternative depreciation system for the placed in service year and subsequent years.

3. If an electing real property or farming business does not depreciate any existing or newly-acquired property under the alternative depreciation system, the trade or business has adopted an impermissible method of accounting for those items of MACRS property. A change from that impermissible method to the straight-line method, the applicable recovery period and/or applicable convention is a change in method of accounting under Section 446(e). If the taxpayer is eligible to make the method change under the automatic change procedures, the method change for existing property is described in Section 6.05 of Rev. Proc. 2018-31 and the method change for newly-acquired property is described in Section 6.01 of Rev. Proc. 2018-31. The Section 481(a) adjustment is calculated as though the change in use occurred in the election year.
4. The alternative depreciation system recovery period for residential rental property is 30 years for residential rental property placed in service after December 31, 2017 and 40 years for property placed in service prior to January 1, 2018.

VIII. Other Section 163(j) issues
a. Timeline on finalizing or re-proposing regulations?
b. Common comments / questions being received?
   i. Any comments on the treatment of depreciation, amortization and depletion capitalized into inventory and included in COGS as excluded as an addback for purposes of computing adjusted taxable income?
c. Section 163(j) as an accounting method? Could the application of the Section 163(j) limitation constitute an accounting method? Are there some circumstances under which an improper application of Section 163(j) could constitute a method?

IX. Section 168(k) related
a. Timeline on finalizing or re-proposing regulations?
b. Common comments / questions being received?
c. Areas where we may see modifications in final regulations?
d. Technical corrections
   i. Could some corrections be passed and not others? What positions should taxpayers take if corrections are not passed?
   ii. Section 168(e)(3)(E) classification of QIP as 15-year property. Section 168(e)(6)(A) clarification that improvements must be “made by the taxpayer”.
   iii. Section 168(k)(8) effective date and treatment of property acquired prior to 9/28/2017 and placed in service after 9/27/2017. Clarification of “acquisition date” as date of written binding contract
   iv. Section 168(k)(9) clarification that restriction on claiming bonus depreciation applies only to property placed in service in tax years beginning after 12/31/2017
   v. Section 168(g)(3) modification to ADS table to include QIP as 20-year property. Section 168(g)(8) additional requirement to use ADS for QLIP, QRP or QRIP

e. Other open issues under the Proposed Regulations
   i. Used property issues
      1. Safe harbor lookback period for determining if taxpayer or predecessor previously used property Repurchase of property after substantial renovation or bankruptcy reorganization
   ii. Acquisition date
      1. Written binding contract application to specific fact patterns
      2. Treatment of property manufactured by a third party under a contract as self-constructed property
         a. Treatment of property constructed by a third party under a contract that is not a written binding contract
         b. Distinguishing between self-constructed and third party constructed property
      3. Limitations on damages
      4. Treatment of conditions and change orders