

● Depreciation Under JCWAA 2002

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In Oklahoma, Not Arizona, What Does It Matter?

- Originally for Arizona Federal Tax Institute—so ignore Arizona references
- Will deal with Oklahoma—with help
- Slides available online at:
<http://www.cpematerials.com>

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Today's Topics

- §168(k) Bonus Depreciation
 - Qualifying Property Classes
 - Qualifying Dates
 - Modification to §280F for Autos
- New York Liberty Zone Property
- Oklahoma Nonconformity
 - General rules
 - Rushed observations from an outsider

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General Rule

- Class of Property Test (4 classes)
- New property first used after September 10, 2001
- Must meet one of two date of acquisition tests
- Put in service prior to January 1, 2005 (certain property January 1, 2006)

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General Rule: Excluded Property

- Property required to be depreciated under ADS, except for property subject to ADS by the election at §168(g)(7)
- Qualified New York Liberty Zone leasehold improvement property
- Any property the taxpayer elects not to have these rules apply to

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Asset Class Qualification

- Recovery Property with a Life of 20 Years or Less
- Computer Software (except for §197 intangible)
- Water utility property
- Qualified Leasehold Property

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Recovery Period Test

- MACRS Life of 20 years or less
- Definition at IRC §168(e)(1)
- Specifically includes all property in 3, 5, 7, 10, 15 and 20 year classes
- Major “missing” items
 - Water utility property
 - Railroad grading or tunnel bore
 - Real property

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Recovery Period Test

- This rule will catch most property
- **Planning note:** be aware of potential to separate out shorter recovery period property from real property (*Hospital Corporation of America* case)
- Be careful not to confuse anything in this class with a leasehold improvement

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Recovery Period Test

- Specific problem area—land improvements
- Are 15 year MACRS property and not real property
 - Would be in the included class
 - Are not leasehold improvements
- See Revenue Procedure 87-56, Class 00.3

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Recovery Period Test

- **00.3 Land Improvements:**
Includes improvements directly to or added to land, whether such improvements are Section 1245 property or Section 1250 property, provided such improvements are depreciable. Examples of such assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping,...

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Recovery Period Test

...shubbery, or radio and television transmitting towers. Does not include land improvements that are explicitly included in any other class, and buildings and structural components as defined in Section 1.48-1(e) of the regulations. Excludes public utility initial clearing and grading land improvements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102

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Recovery Period Test

- Farm buildings (Class 01.3)
- Single purpose agricultural facilities (Class 01.4)
- “Modern” golf greens as opposed to traditional “push-up” greens Revenue Ruling 2001-60

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Recovery Period Test

- Hospital Corporation of America case
 - Cite 109 TC 21
 - Issue was whether certain portions of costs represented §1245 property or §1250 property
 - Parties stipulated before trial that if §1245 property would be five year MACRS property
 - Court looked to old ITC cases

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Recovery Period Test

- In *Hospital Corporation of America* case, some of the items allowed as five year *in the fact of the case*:
 - Primary and secondary electrical distribution system
 - Wiring related to telephone equipment
 - Carpeting, vinyl floor & wall coverings
 - Kitchen water piping & plumbing for X-ray equipment
 - And more...

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Recovery Period Test

- Conclusion—these items would meet the recovery period test for §168(k)
- Note that the IRS has announced nonacquiescence with this case (see Announcement 99-116)

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Recovery Period Test

- Somewhat related issue—be sure it cannot be currently expensed
- Case of the post worker's rental property roof
 - Campbell v. Commission, TC Summary Opinion 2002-117
 - Cites to Oberman Manufacturing Co. v. Commissioner, 47 TC 471

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Computer Software

- Software that can otherwise be depreciated under §168
- Excludes software amortized under §197
- However, the definition of what is software references §197(e)(3)(B)
- Are we confused yet???

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Computer Software

- Two classes that are “in”
 - Off the shelf software
 - Available to General Public for Purchase
 - Subject to Nonexclusive License
 - Not Substantially Modified
 - All Other Software Not Acquired in Acquisition of a Business
- Above list is found at §197(e)(3)(A)

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Water Utility Property

- 25 year property per §168(e)(5)
- Specifically included as a special class
- Generally property described in asset classes 49.3 and 51 of Revenue Procedure 87-56

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Qualified Leasehold Property

- Subgroup of real property
- Most complex definition found for property qualifying for the 30% special depreciation allowance
- Remember, you only get here with property that has a MACRS life greater than 20 years

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Qualified Leasehold Property

- Inclusion tests—must be in this group
- Exclusion tests—otherwise included property is thrown out if it fails one of these tests

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Inclusion Tests

- Interior Improvement
 - So immediately can ignore exterior improvements
 - Don't confuse land improvements
- Property Subject to Lease
 - Lessee, sublessee or lessor of property
 - Subject to a lease as defined in this section
- Three Year Test

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What is a Lease

- Standing commitment to lease is included
- Leases to certain related parties are excluded
- The latter is probably the most important problem for closely held entities

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Related Parties

- Looks to affiliated group definitions of §267 as modified
 - §267(b) modified
 - Use "80% or more" each time you find "50% or more"
 - Means is easier to avoid than general §267 rules
 - Fail this test, only get standard depreciation

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Related Parties

- Members of a family (§267(c)(4))
- Individual and corporation where individual owns (directly or indirectly) 80% of value of stock
- Corporations part of same controlled group (§267(f))
- Grantor and fiduciary of any trust

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Related Parties

- Fiduciaries of different trusts if trusts share a common grantor
- Fiduciary of trust and beneficiary of same trust
- Fiduciary of one trust and beneficiary of another trust if trusts share a common grantor

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Related Parties

- Fiduciary of trust and corporation 80% owned by trust or by or for person who is a grantor of the trust
- Person and a §501 tax exempt organization if organization is controlled directly or indirectly by such person or members of that person's family

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Related Parties

- Corporation and partnership if same person owns more than 80% of both
- Two S corporations if same persons own more than 80% of both
- S corporation and C corporation if same persons own more than 80% of both
- Executor of estate and beneficiary of same estate

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Three Year Rule

- Improvements made more than three years after the property was placed in service
- Cliff test—a day too early and you are out of luck
- **Planning Point:** Be careful of when modifications will be made to relatively new buildings

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Exclusion Tests

- Qualified New York Liberty Zone Leasehold Property (gets shorter recovery period and not the bonus)
- Enlargement of Building
- Elevators or Escalators

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Exclusion Tests

- Structural Component Benefiting Common Area
See Regulation §1.48-1(e)(2) for a potential definition and long list including (among other things):
 - Walls, partitions, floors & ceilings
 - Windows and doors
 - Central heating and air conditioning

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Exclusion Tests

- Internal Structural Framework
(See Regulation §1.48-12(b)(3)(iii) for a potential definition)
 - Load bearing internal walls
 - Internal structural supports (columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building)

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Original Use

- Old ITC rules get dusted off
- Technical Explanation directs us to Regulation §1.48-2
- Reconditioned Property “Gotcha”
 - See examples 2 and 4
 - If you buy it reconditioned, is used and get no bonus
 - If buy it not reconditioned, get bonus on expenses incurred to recondition

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Date Rules

- A number of important dates—not just date “placed in service”
- Original use date
- Acquisition/binding contract date
- Deadline for placing in service

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Original Use Date

- Original use (as defined earlier)
- After September 10, 2001
- IRC §168(k)(2)(A)(ii)

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Acquisition Test

- General Acquisition
 - After September 10, 2001
 - Before September 11, 2004
 - No binding contract before September 11, 2001
- Binding Contract
 - After September 10, 2001
 - Before September 11, 2004

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Placed in Service Date

- Most Property—Before January 1, 2005
- Special Classes
 - Before January 1, 2006
 - Recovery period of 10+ years or is transportation property
 - Subject to capitalization under §263A(f)(1)(B)(ii) or (iii)

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§263A Definitions

- Expected Production Period of 2+ Years
- Other Property
 - Expected production period of 1+ Years
 - Cost of \$1,000,000+
- Only costs prior to September 11, 2004 eligible for 30%
- JCT Explanation—look at rules under pre 1986 §46(d)(3)

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Depreciation Computation

- Regular income tax depreciation
- Alternative minimum tax issues

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Regular Tax Depreciation

- 30% of Basis of Asset after adjusting for following provisions
 - §179
 - §190 (barriers to elderly & disabled)
 - §44 (disabled access credit)
 - §43 (enhanced oil recovery)
 - §50(c) (ITC basis adjustment)
- Luxury auto rules

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§280F Luxury Auto

- §280F still continues to apply to limit depreciation
- Additional \$4,600 added to limit for first year depreciation for luxury autos
- Note that you compute the regular depreciation and then compare to the updated §280F limit—so may not get entire \$4,600

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Recapture

- Treated just like any other depreciation
- Subject to recapture under the rules of §1245, §280F, etc.

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Alternative Minimum Tax

- Assets covered by §168(k) have *no* AMT for *any depreciation*
 - 30% bonus
 - MACRS depreciation
 - Not just limited to year of acquisition
- Appears that if elect out of §168(k), also lose this benefit

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New York Liberty Zone

- Special rules
- Rules found at §1400L
- Generally more liberal treatment
- Totally different rules for leasehold improvements

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New York Liberty Zone

- Coordination with §168(k)
 - Generally §168(k) overrides Liberty Zone Treatment if both apply
 - Big exception—leasehold improvements in Liberty Zone governed by §1400L
 - Adds more property eligible for 30%
 - Extends time periods for 30%

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Liberty Zone Added Property Class

- Certain real property
 - Remember, real property is not generally covered by §168(k)
 - Residential or commercial property damaged due to events of September 11, 2001
 - Expenses to rehabilitate
 - Expenses to replace

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Liberty Zone Time Periods

- Original use commences after September 10, 2001
- Acquired by purchase after September 10, 2001
- Placed in service by:
 - December 31, 2006 or
 - December 31, 2009 for real property

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Liberty Zone Leasehold Improvements

- Excluded from §168(k)
- Defined as 5 year property
- Must use straight line depreciation
- No special 30% first year depreciation
- Cannot elect out to use the “standard” 30%

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IRS Guidance

- Revenue Procedure 2002-33
 - Reproduced in Appendix
 - Deals with the problem of already filed returns
 - Return must have been filed on or before June 1, 2002

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Revenue Procedure 2002-22

- If filed and did not claim 30%, will be deemed to have elected out unless
 - Amend return on or before original due date (not including extensions) of the following year's return or
 - File 3115 as a change of accounting method with following year's return

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Amended Return Method

- Report correct amount of depreciation
- Important—extending return does not extend the deadline to file this return
- If miss date, lose the ability to claim the 30% on the first year's return

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Form 3115

- Error in manual—actually, per Revenue Procedure 2002-9, would pick up entire adjustment in year of change
- Automatic change, but must file copy with National Office
- Planning option—can select year to take the bonus
- Only works for those who filed prior to June 1, 2002 and did not claim 30% and did not file an election out

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Arizona Nonconformity

- Law finally passed in late May
- Law simply doesn't make sense in many ways—so don't try to make sense of it
- Generally, appears Legislature was trying to put Arizona taxpayers back on the old federal law—only they didn't quite do that

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General Arizona Rules

- Addition to income for 30% bonus under §168(k) (though not always)
- Subtraction from income of 3/7 of other depreciation taken on asset under the IRC (though modified somewhat for luxury autos)
- No adjustment allowed in year of sale—so if sell before asset fully depreciation it's tough luck for the taxpayer

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Arizona Income Tax Law

- Starts with IRC AGI or Taxable Income
- Statutory additions
 - §43-1021 (Individuals)
 - §43-1121 (Corporations)
- Statutory subtractions
 - §43-1022 (Individuals)
 - §43-1122 (Corporations)

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Addition to Income

- Individuals—Arizona Revised Statutes (ARS) §43-1021(30)
- Corporations—ARS §43-1121(1)
- This one pretty much works except for a couple of long standing Arizona law quirks

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Subtraction from Income

- Annual additional allowance
 - 3/7 of depreciation allowed under federal law for assets that had used §168(k) additional depreciation
 - For most assets algebraically puts you back on old law depreciation
 - Individuals—ARS §43-1022(28)
 - Corporations—ARS §43-1122(1)

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The Ridiculous: ARS §43-1022(29)

- Proof the Legislature has a sense of humor
- An incredibly long sentence that boils down to a very simple rule—you get no subtraction in the year of sale

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The Ridiculous: ARS §43-1022(29)

- Depreciation allowed pursuant to IRC §167(a) computed without regard to §168(k) not already taken for Arizona purposes
- §168(k) was what Congress added
- Old law accumulated depreciation—exactly where you normally will be
- Therefore, no subtraction

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The Ridiculous: ARS §43-1022(29)

- Arizona Department of Revenue indicated there effectively is no subtraction
- Notice posted on website July 24, 2002
- Reproduced in appendix

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Arizona Special Cases Luxury Autos

- 3/7 also doesn't generally work
- Still get 3/7 addition each year
- However, per ADOR must stop depreciating if have recovered entire cost
- ADOR cites ARS §43-102(B) to stop the deduction

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Arizona Special Cases S Corporations

- Arizona Individual Income Tax Ruling 94-1
- No provision in Arizona law for variance from federal S corporation pass-through
- July 24 notice confirms that the same result applies in this case
- S corporations shareholders get the 30% bonus

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Arizona Special Cases Non-Arizona Partnerships

- No add back for partners of partnerships with no Arizona operations
- Again, Arizona law doesn't contain provisions requiring or allowing such adjustments
- Again, was first brought up in ITR 94-1, confirmed in July 24 notice

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Arizona Special Cases Passive Activities

- No explicit guidance on issues related to IRC §469
- Appears may require an add back since depreciation is allowed by §168(k) and then blocked by §469
- However, can also argue the opposite, so it's an open call

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Oklahoma Nonconformity

- Oklahoma does not conform for
 - C Corporations
 - Fiduciaries
- 80% of bonus added back in year of acquisition
- 25% of disallowed amount allowed as a subtraction in each of next 4 years

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Oklahoma Nonconformity

- Oklahoma §68-2358.6 A
"For income tax returns filed after September 10, 2001, by corporations and fiduciaries, federal taxable income shall be increased by eighty percent (80%) of any amount of bonus depreciation received under the federal Job Creation and Worker Assistance Act of 2002, under Section 168(k) or Section 1400L of the Internal Revenue Code of 1986, as amended, for assets placed in service after September 10, 2001, and before September 11, 2004."
- Add back the bonus depreciation
- What about short life §1400L assets?

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Oklahoma Nonconformity

- Oklahoma §68-2358.6 B

"For a corporation with a unitary business having activity both inside and outside the state, the increase shall be apportioned to Oklahoma in the same manner as income is apportioned to the state under Section 2358 and Section 2362 of Title 68 of the Oklahoma Statutes."

- Standard sections for Oklahoma taxation (interesting aside—two versions of §68-2358???)

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Oklahoma Nonconformity

- Oklahoma §68-2358.6 C

"The amount of bonus depreciation added to federal taxable income by this section shall be subtracted in a later taxable year as herein provided. Twenty-five percent (25%) of the total amount of bonus depreciation added back may be subtracted in the first taxable year following the year of the addition and twenty-five percent (25%) may be subtracted in each of the next three following taxable years."

- Get denied deduction ¼ each subsequent year

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Oklahoma Nonconformity

- Oklahoma §68-2358.6 D

"A corporation or fiduciary filing a return for which federal taxable income is not increased as provided in this section prior to October 1, 2002, shall file an amended return reflecting such increase not later than June 30, 2003. The Oklahoma Tax Commission shall not assess penalties or interest with respect to the failure to reflect such increase if a correct amended return is filed as required herein."

- Have until next June 30 to amend if original return filed by 10/01/02

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Oklahoma Tax Commission Guidance

- Found on web at:

<http://www.oktax.state.ok.us/bonusdep.html>

- S corporations do *not* make this adjustment
- LLCs electing to be taxed as a corporation do not add back
- Fiduciary holding interest in LLC does not add back


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Quick View of an Arizonan

- Add back is selective—some taxpayers get conformity
- Did not see any provision to change gain/loss if sell asset before end of five year period
- Still some benefit for assets with life of more than five years
- Will someone from Oklahoma explain this??

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Any Questions



Arizona Special Cases Luxury Autos

- IRC first allows the 30%, and next allows regular depreciation
- Therefore for auto costing more than \$25,333, the entire depreciation allowed for federal purposes is due to §168(k)
- All such depreciation added back by ARS §43-1022(28) or §43-1122(1)

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