

Depreciation Quickfinder® Handbook (2023 Tax Year)

Updates for Recent Guidance

Instructions: This packet contains “marked up” changes to the pages in the *Depreciation Quickfinder® Handbook* that were affected by recent guidance, which was enacted after the *Handbook* was published. To update your *Handbook*, you can make the same changes in your *Handbook* or print the revised page and paste over the original page.

- The basis of Jane's new property is \$100,000, the adjusted basis of her property given up. The basis is allocated based on the relative FMVs as follows:
 - Building: $(\$95,000 \div \$120,000) \times \$100,000 = \$79,167$
 - Land: $(\$25,000 \div \$120,000) \times \$100,000 = \$20,833$

INVOLUNTARY CONVERSIONS

Taxpayers can elect to defer gains realized from involuntary conversions of property resulting from (IRC Sec. 1033):

- Destruction.
- Theft.
- Seizure.
- Condemnation, or threat thereof.

The taxpayer must purchase property that is similar or related in service or use to the original property (similar-use property). The replacement property must cost at least as much as the amount realized upon conversion to defer the entire gain.

Observation: Gain deferral is elective if the taxpayer receives cash or property that is not similar or related in service or use to the converted property and then acquires replacement property [IRC Sec. 1033(a)(2)]. If the taxpayer receives only similar-use property in the conversion transaction, gain deferral is mandatory if it is a like-kind exchange (which is usually the case).

Similar-Use Property

The replacement property must be similar or related in service or use (similar-use property) to qualify for gain deferral. This is a functional test, based on the taxpayer's end use of the replacement property. The similar-use rule is much more stringent than the "like-kind" rule for Section 1031 like-kind exchanges.

Similar-Use Property	
Properties that ARE similar-use	
Description	Authority
Farmland used for truck farming and raising cattle, and an orchard.	Stevenson, John, 14 AFTR 2d 5917 (DC CA 1964)
Residential property in one city and residential property in another city.	PLR 8132121
Two buildings used for a particular purpose and one building used for that purpose.	Cotton Concentration Co, 4 BTA 121 (1926)
A standing crop of grain and another standing or harvested crop of the same grain.	Rev. Rul. 59-8
The costs of planting and raising a similar new crop (to the extent needed to bring the crop to the same level of maturity as the converted crop) and a standing crop, if the farmer uses the crop method of accounting.	Rev. Rul. 81-279
Properties that AREN'T similar-use	
Improved and unimproved real property.	Reg. 1.1033(a)-2(c)
Mobile home park and a motel.	Rev. Rul. 76-390
Bowling alley and a billiard center.	Rev. Rul. 76-319
Property held for investment and other investment property already owned by taxpayer.	PLR 7842090

Owner-user. For an owner-user, similar-use property must function in the same way as the property it replaces.

Owner-investor. For an owner-investor, similar-use property must have the same relationship of services or uses to the taxpayer as the property it replaces, based on all the following information (Rev. Rul. 64-237):

- Whether the properties are of similar service to the taxpayer.
- The nature of the business risks connected with the properties.
- What the properties demand of the taxpayer in the way of management, service, and relations to tenants.

Example: Walter owned land and a building rented to a manufacturing company. The building was condemned. During the replacement period, Walter had a new building built on other land he already owned. He rented out the new building for use as a wholesale grocery warehouse. The replacement property is also rental property, so the two properties are considered similar-use property if there is a similarity in all the following areas:

- Walter's management activities.
- The amount and kind of services provided to his tenants.
- The nature of his business risks connected with the properties.

Federally declared disaster area. If business or investment property is located in a disaster area and destroyed by a federally declared disaster, tangible replacement property acquired for use in *any* business is treated as similar-use property to the destroyed property [IRC Sec. 1033(h)(2)]. The list of federally declared disaster areas can be found at www.fema.gov.

Note: Under the special rules for property located in a federally declared disaster area, inventory is included in the definition of *property held for use in a trade or business*. This is the opposite of the rules for like-kind exchanges, which specifically exclude inventory from qualifying for gain deferral (TAM 201111004).

Replacement Period

The replacement period begins on the earlier of [IRC Sec. 1033(a)(2)(B)]:

- The date the property is disposed of or
- The date of the threat or imminence of requisition or condemnation of the property.

The replacement period ends two years after the end of the first year any gain on the conversion is realized. *Exception:* A longer replacement period is allowed for certain condemned real estate. See *Condemned Real Estate* on Page 9-15.

Observation: Taxpayers can request additional time to acquire the replacement property by filing a statement with the IRS showing that the failure to obtain the replacement property during the required time period was due to reasonable cause [Reg. 1.1033(a)-2(c)(3)].

Advance payment. Paying a contractor in advance to build replacement property is not treated as buying replacement property, unless the property is finished before the end of the replacement period.

Federally declared disaster area. For a principal residence that was involuntarily converted as a result of a federally declared disaster, the replacement period ends four years after the close of the tax year that any gain on the conversion is realized [IRC Sec. 1033(h)].

Note: The IRS may grant disaster relief by extending the periods to perform certain tax-related acts, including the replacement period, by up to one year. Go to www.irs.gov and search for "Tax relief in disaster situations" for information about specific disasters.

Livestock. The replacement period is four years, rather than two, for draft, breeding or dairy livestock sold due to drought, flood or other weather-related conditions in an area eligible for federal assistance [IRC Sec. 1033(e)].

If the weather-related conditions continue for longer than 3 years, the replacement period is extended until the end of the taxpayer's first year ending after the region's first drought-free year. Each year, the IRS publishes a list of counties in a state of drought for the preceding 12 months. An area is drought-free beginning in the year it is no longer on the IRS list. Notice [2022-43 2023-67](#) lists the counties in a drought state for the 12-month period ending August 31, [2022 2023](#).

returns timely filed (including extensions) after September 11, 2017 and to taxpayers that:

- 1) Have assets of \$10 million or more.
- 2) Have U.S. GAAP-based certified audited financial statements.
- 3) Comply with certain certification requirements provided in the directive.

For more information, search www.irs.gov for "News Release and Fact Sheet Archive", then access IR-2017-158 in the 2017, September section.

Computing the credit. The RC equals the sum of [IRC Sec. 41(a)]:

- 1) 20% of the QREs for the current tax year exceeding the base amount for that year, plus
- 2) 20% of the basic research payments over the qualified organization base period amount, plus
- 3) 20% of amounts paid to an energy research consortium.

The *base amount* equals the fixed base percentage [as defined in IRC Sec. 41(c)(3)] multiplied by the average annual gross receipts of the taxpayer for the four tax years preceding the tax year for which the credit is being determined [IRC Sec. 41(c)]. However, the base amount cannot be less than 50% of its QREs for the year. This means no more than half of the current year's QREs can qualify for the RC. Basic research payments are cash payments made to qualified organizations such as educational institutions and certain scientific research organizations if the basic research is to be performed by the organization. Cash payments to scientific tax-exempt organizations and certain grant organizations also qualify, but these organizations do not have to perform the research directly.

Alternative Simplified Credit (ASC). Taxpayers may elect to take the Section 41(c)(4) Alternative Simplified Credit (ASC). This is equal to 14% (12% before 2009) of the excess of the qualified research expenses for the tax year over 50% of the average qualified research expenses for the three preceding tax years. A taxpayer may make an ASC election on an amended return (Reg. 1.41-9). A taxpayer who is a member of a controlled group in a tax year may not make an election under IRC Sec. 41(c)(4) for that tax year on an amended return if any member of the controlled group for that year claimed the credit using a method other than the ASC.

Reduction of expenses. Any deductions for R&E claimed under IRC Sec. 174 must be reduced by the amount of the RC [IRC Sec. 280C(c)(1)]. For capitalized research expenditures, the amount chargeable to a capital account is reduced by the excess of the RC over the amount of QREs allowable as a deduction for the year. The taxpayer may avoid these reductions by electing a reduced credit. Under the election, the credit is reduced by an amount equal to the top corporate income tax rate multiplied by the full credit.

Reporting requirements. Form 6765, *Credit for Increasing Research Activities*, is filed to claim the RC. The taxpayer may elect to reduce the credit by completing the appropriate lines on Form 6765. If the taxpayer does not elect a reduced credit, a statement must be attached to Form 6765 showing the QREs reduced by the research credit.

Controlled groups. The credit is allocated to a member of a controlled group on a proportionate basis consistent with its share of total QREs and other factors [IRC Sec. 41(f)(1)(A) and Reg. 1.41-6].

Specified R&E expenditures. The TCJA requires capitalization and amortization (over 60 months beginning at the midpoint of the year) for specified R&E expenditures, which are R&E costs paid or incurred, in tax years beginning after 2021, by the taxpayer in connection with the taxpayer's trade or business. **Presumably specified R&E expenditures are defined the same as pre-TCJA by Reg. 1.174-2. Practitioners should watch for IRS guidance on this matter.** In Notice 2023-63, the IRS provided interim guidance on specified R&E expenditures and announced its intent to issue proposed regulations. The forthcoming proposed regulations are expected to apply to tax years ending after September 8, 2023. Before the proposed regulations are released, a taxpayer may choose to rely on Notice 2023-63, except for the rules in section 7, provided the taxpayer relies on all the rules and applies them consistently. R&E expenditures attributable to foreign research will be amortized over a 180-month period beginning at the midpoint of the year.

Specified R&E expenditures do not include costs incurred for:

- Land.
- Depreciable or depletable property (but they do include the depreciation or depletion allowed on such property).
- Exploration of mineral (including oil and gas) or ore deposits.

Note: Research and experimental property disposed of, retired or abandoned during its amortization period is not allowed immediate expensing of the unamortized balance. Instead amortization continues over the remaining amortization period.

Change in accounting method. Applying this new rule is a change in accounting method treated as initiated by the taxpayer, made with IRS's consent and applied on a cut-off basis. Therefore, there is no IRC Sec. 481(a) adjustment **with respect to R&E expenditures paid or incurred in tax years beginning before 2022**. See Rev. Proc. 2023-4424, as modified and clarified by Rev. Proc. 2024-9, and *Requesting an Accounting Method Change* on Page 10-2.

INCOME FORECAST METHOD

The income forecast method uses an estimate of income to recover the cost of certain assets. Under this method, each year's deduction is equal to:

$$\frac{(\text{Cost} - \text{Salvage Value})}{\text{Estimated Total Income From Property}} \times \text{Current Year Net Income From Property}$$

The denominator is the total income anticipated from the property through the end of the 10th tax year following the tax year the property is placed in service [IRC Sec. 167(g)].

Look-back calculation. Taxpayers who use the income forecast method for property with a cost of more than \$100,000 are subject to a look-back calculation that may result in the receipt or payment of interest if actual income differs from anticipated income. Any interest computed under the look-back method is reported on Form 8866, *Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method*.

Eligible assets. The following intangibles can be amortized under either the straight-line method or the income forecast method:

- 1) Motion picture films or video tapes.
- 2) Sound recordings.
- 3) Copyrights.
- 4) Books.
- 5) Patents.
- 6) Other property to be specified in regulations.

Caution: The income forecast method cannot be used for Section 197 intangibles. Thus, to the extent any of the intangibles listed above is a Section 197 intangible (because it was acquired in connection with acquiring assets making up a trade or business), it cannot be amortized under the income forecast method.

Example: Easygoing Inc. produces a new record for a cost of \$250,000. Salvage value of the recording at the end of 10 years is expected to be \$10,000. Expected net income for the first 11 years of sales is \$500,000. The record generates \$150,000 of net income in the first year of sales.

Current year amortization is \$72,000 $[(\$250,000 - \$10,000) \times \$150,000 \div \$500,000]$.

Participations and Residuals

Participations and residuals are costs that, by contract, vary with the amount of income earned in connection with the property. The participations and residuals that relate to income to be derived from the property before the end of the tenth tax year after the property is placed in service are eligible for two optional tax treatments [IRC Sec. 167(g)(7)]:

- The participations and residuals can be included in the property's adjusted basis for calculating the amortization deduction for the year.
- The participations and residuals can be deducted in the tax year they are paid.

Reporting Income Forecast Method Deductions

Expense for assets depreciated under the income forecast method is reported on Form 4562, line 16, *Other depreciation (including ACRS)*.