Office of Chief Counsel
Internal Revenue Service
memorandum

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from: Branch Chief, Branch 7
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subject: Business interest expense deduction allowed under section 163(j) and the adjustment required under section 481(a) for a change in method of accounting for depreciation

This memorandum addresses whether any adjustments required under section 481(a) of the Internal Revenue Code due to a change in method of accounting for depreciation should be added to tentative taxable income for purposes of determining adjusted taxable income under section 163(j). This memorandum should not be used or cited as precedent.

ISSUE

To determine the amount allowed as a deduction under section 163(j) for a taxable year, does the adjusted taxable income under section 163(j)(8) for such taxable year include those adjustments that are required under section 481(a) by a change in method of accounting for depreciation?

CONCLUSION

Yes, to determine the amount allowed as a deduction under section 163(j) for a taxable year, the adjusted taxable income under section 163(j)(8) for such taxable year includes those adjustments that are required under section 481(a) by a change in method of accounting for depreciation.

FACTS

Taxpayer A, a calendar year taxpayer, timely filed a Form 3115, *Application for Change in Accounting Method*, under Rev. Proc. 2015-13, 2015-5 I.R.B. 419, to change its method of accounting for depreciation with respect to certain depreciable property, beginning with the taxable year beginning in January 1, 2020, and ending December 31, 2020 (year of change). The items of property that are subject to Taxpayer A's Form 3115 were placed in service by Taxpayer A in 2017. Under the prior method, Taxpayer A classified the property as 7-year property under section 168(e)(1), depreciating it under the general depreciation system of section 168(a). During 2020, Taxpayer A determined that these items of property are properly classified as 5-year property under section 168(e)(1). Upon determining that the 7-year recovery period is incorrect, Taxpayer A filed a Form 3115 to change from an impermissible to a permissible method of depreciating over a 5-year recovery period under section 168(c). The change in the method of accounting for depreciation resulted in a $100x net negative adjustment required by section 481(a) (section 481(a) adjustment) for the year of change. Taxpayer A timely made an election not to deduct the additional first year depreciation under section 168(k) for 5-year and 7-year property placed in service in the 2017 taxable year.

LAW AND ANALYSIS

In general, section 167(a) provides that there is allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or held for the production of income. The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168, which prescribes two methods for determining depreciation allowances: (1) the general depreciation system in section 168(a); and (2) the alternative depreciation system in section 168(g).

Section 1.446-1(e)(2)(ii)(*d*)(*2*)(*i*) of the Income Tax Regulations provides that a change in the recovery period of a depreciable asset under section 168 is a change in method of accounting. *See also* Example 14 under § 1.446-1(e)(2)(iii).

Section 1.446-1(e)(2)(ii)(*d*)(*5*)(*iii*) provides a change from an impermissible method of computing depreciation to a permissible method of computing depreciation for an asset results in a section 481(a) adjustment.

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year, if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which section 481 does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. *See also* § 1.481-1(a) and section 2.06 of Rev. Proc. 2015-13.

The net adjustment required under section 481(a) is computed as of the beginning of the year of the change in method of accounting. The section 481(a) adjustment for a change in method of accounting for depreciation generally is the difference between: 1) the total amount of depreciation for the depreciable property taken by the taxpayer for taxable years beginning with the taxable year the property was placed in service by the taxpayer and before the taxable year of the change in method of accounting; and 2) the total amount of depreciation allowable for the depreciable property under the new method of accounting for depreciation for taxable years beginning with the taxable year the property was placed in service by the taxpayer and before the taxable year of change in method of accounting.

Section 163(j) generally limits the amount of business interest expense that can be deducted in the current taxable year for taxable years beginning after December 31, 2017. Under section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of: (1) the taxpayer’s business interest income for the taxable year; (2) 30 percent, or 50 percent where applicable, of the taxpayer’s adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer’s floor plan financing interest expense for the taxable year (section 163(j) limitation).

Under section 163(j)(8), ATI is the taxable income of the taxpayer computed without regard to certain items, including any deduction allowable for depreciation, amortization, or depletion for taxable years beginning before January 1, 2022. Section 1.163(j)-1(b)(1) further clarifies that ATI is the tentative taxable income of the taxpayer for the taxable year adjusted by certain items. Section 1.163(j)-1(b)(1) provides a list of items to be added to or subtracted from tentative taxable income to determine ATI.

Under § 1.163(j)-1(b)(43), the term “tentative taxable income” with respect to a taxpayer and a taxable year, generally is determined in the same manner as taxable income under section 63 but for section 163(j) purposes is computed without regard to the application of the section 163(j) limitation.

Under § 1.163(j)-1(b)(1)(i), for taxable years beginning before January 1, 2022, the amounts of the following items that were included in the computation of the taxpayer’s tentative taxable income (if any) are added to tentative taxable income to determine ATI:

- any depreciation under section 167, section 168, or section 168 of the Internal Revenue Code (Code) of 1954 (former section 168);
- any amortization of intangibles (for example, under section 167 or 197) and other amortized expenditures (for example, under section 174(b), 195(b)(1)(B), 248, or 1245(a)(2)(C)); and
- any depletion under section 611.

Under § 1.163(j)-1(b)(1)(iii), for purposes of § 1.163(j)-1(b)(1)(i), amounts of depreciation, amortization, or depletion that are capitalized under section 263A during the taxable year are deemed to be included in the computation of the taxpayer's tentative taxable income for such taxable year, regardless of the period in which the capitalized amount is recovered.

In the current situation, the net negative section 481(a) adjustment ($100x) is the difference between the total amount of depreciation for the depreciable property at issue taken by Taxpayer A from 2017 (taxable year the property was placed in service) to 2019 (before the year of change) using a 7-year recovery period and the total amount of depreciation allowable for the property under the new method of accounting (using a 5-year recovery period) from 2017 to 2019. Furthermore, $100x is the amount of depreciation computed under section 168 and included in the computation of tentative taxable income for 2020 as a section 481(a) adjustment. Consequently, Taxpayer A adds $100x to its tentative taxable income to determine ATI for 2020 taxable year and, thus, the addback of the depreciation amount for purposes of determining Taxpayer A's ATI for the 2020 taxable year includes the net negative section 481(a) adjustment of $100x for Taxpayer A's change in method of accounting for depreciation.

OTHER CONSIDERATIONS

In the current situation, Taxpayer A's section 481(a) adjustment is a net negative amount. However, should a change in method of accounting for depreciation result in a net positive section 481(a) adjustment due to the taxpayer's prior method of deducting depreciation that is greater than depreciation allowable, the addback to tentative taxable income under section 163(j) is a negative amount equal to the net positive section 481(a) adjustment. However, if the taxpayer takes such net positive section 481(a) adjustment into account in computing taxable income ratably over 4 taxable years, beginning with the year of change, the taxpayer should add back only the ratable portion of the net positive section 481(a) adjustment taken into account for the taxable year.

Also note that the addback of the depreciation amount, including any section 481(a) adjustment for the year of change, for purposes of determining ATI is allowed only for taxable years beginning before January 1, 2022. Therefore, if, for example, a calendar-year taxpayer's net positive section 481(a) adjustment due to a change in method of accounting for depreciation is $200x and the taxpayer takes $50x into account in computing taxable income each taxable year beginning in 2020 through 2023, the taxpayer should include negative $50x in taxable years beginning in 2020 and 2021 for purposes of determining ATI. The taxpayer may not include the remaining $50x in each taxable year beginning in 2022 and 2023.

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Please call Bruce Chang at (202) 317-4870 or Elizabeth Binder at (202) 317-4869 if you have any further questions.

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