When Can Depreciation First Be Claimed?

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Overview

A recent Tax Court opinion starts out with, "During 2015-2017 petitioners were actively engaged in the farming business, growing and selling corn and soybeans. In July 2015, after seeing an advertisement in a farming magazine…". That statement gave me the feeling that the court's opinion was going to quickly head south for the farmer. I was right. While the case did not involve the purchase of farm equipment or a farm building, with the onset of fall comes the onset of agribusinesses promoting year-end "deals" on equipment and farm buildings – and the provision of bad tax "advice." The common ploy is for the sale to be made in 2022 with the farmer thinking that they will be able to take a sizable deduction on their 2022 taxes for depreciation. But, the tax year in which depreciation can first be claimed on an asset depends on when an asset is "placed in service."

When can an asset that is used in the farming business begin to be depreciated? The "placed in service" issue – it's the topic of today's post

"Placed in Service"

A taxpayer can claim a depreciation deduction for assets that are used in the taxpayer's trade or business or held for the production of income. *I.R.C §167(a).* Any depreciable business asset is only depreciable if it has been placed in service during the tax year. *Treas. Reg. §1.167(a)-10(b).* "Placed in service" means that the asset is in a state of readiness for use in the taxpayer's trade or business. *See, e.g., Brown v. Comr., T.C. Sum. Op. 2009-71.* In the year that an asset is placed in service, all or part of the income tax basis can be deducted currently. Taxpayers generally prefer an earlier placed-in-service date due to the time value of money. The IRS generally prefers the opposite position. So, when is a building placed in service? What about machinery or equipment? What if equipment was acquired this year but not first used until next year?

Code, Regulations and Interpretations of IRS and the Tax Court

A key point is that it is not actually necessary that the asset be used in the taxpayer's trade or business for the taxpayer to begin claiming depreciation attributable to that asset. Treas. Reg. §1,167(a)-(11)(e)(1) says that property is considered to be placed in service when it is "first placed in a condition or state of readiness and [available] for a specifically assigned function."

As noted above, property that is "placed in service" means that it is placed in a state of readiness or availability for use in the taxpayer's trade or business, regardless of the time of year that the asset is placed in service. *Treas. Reg. §1.167(a)-10(b).* That means that the asset must be ready for the taxpayer to use by the end of the tax year if the taxpayer so desires. It *doesn't* mean that the taxpayer must have begun using the asset in the taxpayer's trade or business by the end of the tax year. Unfortunately, the IRS has not been consistent in applying the regulation. For example, in *F.S.A. 199916040 (Apr. 23, 1999),* the IRS construed the regulation to require actual operational use in the taxpayer's trade or business. The taxpayer purchased compressors to maintain gas pressure in pipelines. The IRS said deprecation couldn't begin until the compressors were installed in the pipelines. In *Consumers Power Co. v. Comr., 89 T.C. 710 (1987),* the said that an electricity-generating unit should not be deemed to be placed in service until it could operate at

rated capacity. *See also Oglethorpe Power Corp., v. Comr., T.C. Memo. 1990-505; Rev. Rul. 73-518, 1973-2 C.B. 54.*

However, the IRS has also utilized a less restrictive view on what constitutes placed-in-service. In *Rev. Rul. 76-238, 1976-1 C.B. 55,* IRS determined that a building was placed in service when its construction was complete, and it was ready for machinery and equipment to be installed. Likewise, in *Livingston v. Comr., T.C. Memo. 1966-49,* the Tax Court held that depreciation was allowable on the completed portions of a building for use in the taxpayer's business regardless of whether the entire building was completed.

The *Stine* Case

In *Stine, LLC v. United States, No. 2:13-03224, 2015 U.S. Dist. LEXIS 9850 (W.D. La. Jan. 27, 2015), non-acq., 2017-02 (Apr. 10, 2017), t*he taxpayer operated a retail business that sold home building materials and supplies. The taxpayer built two new retail stores. As of December 31, 2008, the buildings were substantially complete and partially occupied and the taxpayer had obtained certificates of completion and occupancy and customers could enter the stores. However, the stores were not open for business as of the end of 2008. The taxpayer claimed the 50 percent GoZone depreciation allowance for 2008 on the two buildings which created a tax loss for 2008 and allowed the taxpayer to carry back the losses to the 2003-2005 tax years and receive a refund. The IRS disallowed the depreciation deduction on the basis that the taxpayer had not placed the buildings in service and assessed a deficiency of over $2.1 million for tax years 2003-2008. The taxpayer paid the deficiency and sued for a refund. The IRS argued that allowing the depreciation would offend the "matching principle" because the taxpayer's revenue from the buildings would not match the depreciation deductions for a particular tax year. The court held that this argument was "totally without merit."

On the placed-in-service issue, the IRS maintained that the two buildings were not "open for business" as of the end of the tax year so no depreciation could be claimed for that year. The court disagreed, noting the government's own regulation that defied that argument. The court noted that Treas. Reg. §1.167(a)-11(e)(1) says that placed in service means that the asset is in a condition of readiness and availability for its assigned function. With respect to a building, the court noted that this meant that the building must be in a state of readiness and availability without regard to whether equipment or machinery housed in the building has been placed in service. The court held that there was no requirement that the taxpayer's business must have begun by year-end. Cases that the IRS cited involving equipment (in one case an airplane) being placed in service were not applicable, the court determined. The court also noted that the IRS's own Audit Technique Guide for Rehabilitation Tax Credits stated that "[A] 'Certificate of Occupancy' is one means of verifying the 'Placed in Service' date for the entire building (or part thereof)". The court noted that the IRS had failed to cite even a single authority for the proposition that "placed in service" means "open for business," and that during oral arguments IRS had admitted that no authority existed. Thus, the court granted summary judgment for the taxpayer and also specified that the taxpayer could pursue attorney fees against the government if desired.

The IRS reaction. The court's decision in *Stine* was based precisely on the regulation. It's common sense, also. For retail businesses that are constructing stores, once the product is received to be placed into the display shelves at the constructed building, the building will be considered to have been placed in service. That's what the regulation seems pretty clear about. The court sure believed so.

The IRS did not file an appeal with the U.S. Court of Appeals for the Fifth Circuit. That's not surprising, considering how badly the IRS lost the case. Recently, however, the IRS issued a non-acquiescence to the court's decision. *A.O.D. 2017-02.* That means that the IRS disagrees with the court's decision and will continue to audit the issue outside of the Western District of Louisiana. Unfortunately, the IRS didn't give any reason(s) why it disagreed with its own regulation and audit technique guide on the matter. That's understandable – they have none.

Application to Farm Asset Purchases

So, what can we learn from this for a farmer's later in the tax year purchase of machinery, equipment or a farm building? An item of property is *not* deemed to be placed in service if it is simply manufactured and is sitting at the dealership, or if an order has been placed but the property has not yet been built. Simply signing a purchase contract or taking delivery of a depreciable materials (such as for the construction of a pole barn, etc.) to be used in the taxpayer's business does not mean that those assets are depreciable – they aren't yet ready for use in the taxpayer's business. It doesn't matter that the taxpayer has paid for the asset. The key is whether the asset is ready for use in the taxpayer's business. But remember, actual use by the end of the current tax year doesn't matter either. For a building in which the taxpayer's retail business is conducted, for example, the store doesn't have to be open for business in order for the building by the end of the tax year for the building to be deemed to be placed in service for depreciation purposes for that tax year. *Treas. Reg. §1.167(a)-11(e)(1)(i).* The building is considered to be placed in service on the date that its construction is considered to be substantially complete or in the state or readiness and availability regardless of whether depreciable items in the building meet the placed in-service test. *Id.*

Conclusion

Be on the lookout for end-of-year promotional ads in farm magazines stating that a contract could be signed, or delivery be taken before year-end to which will allow a depreciation deduction to be available for that year. That's not correct. While the asset need not be "used" by the taxpayer to be placed in service, it still has to be ready and available for use. Merely signing a contract or taking delivery of parts and materials that have to be assembled is not enough. Thus, for a farmer that buys equipment this year that will not be ready for use in the farming business until next year, no depreciation deduction will be allowed until 2023. This is particularly a big issue this year because first-year "bonus" depreciation, while 100 percent for 2022, is schedule to drop to 80 percent for next year and supply chain issues may cause delays.

Make sure you know the rules and don't get lured into a bad tax result by inaccurate sales information. Remember, retailers are trying to sell products in a down economy. They aren't in the business of providing sound tax advice.

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