Current Federal Tax Developments

Week of June 14, 2021

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JUNE 14, 2021
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Kaplan Financial Education

Contents

Section: 21 IRS Publishes Q&As on 2021 Enhanced Child Care Credit 1

Section: 61 Award Received by Taxpayer to Settlement Claim Against Divorce Attorney Must Be Included in Her Income 1

Section: 163 Impact of Depreciable Life Accounting Method Change on Adjusted Taxable Income for §163(j) Outlined by IRS 1

SECTION: 21
IRS PUBLISHES Q&AS ON 2021 ENHANCED CHILD CARE CREDIT

Citation: "Child and Dependent Care Tax Credit FAQs," IRS website, 6/11/21

The IRS has issued a set of questions and answers related to the enhanced and refundable child and dependent care credit for 2021 that was included in the American Rescue Plan Act of 2021.[1]

The 2021 Credit

The 2021 version of the credit operates much like the credit in prior years, except that the credit is refundable, applies to an increased amount of such expenses, and the maximum credit is 50% of such expenses.

Question 2 notes who is a qualifying person for whose care the credit can be claimed:

> **Q2. Who is a qualifying person? (added June 11, 2021)**
>
> A2. A qualifying person is:
>
> - Your dependent who is under age 13 when the care is provided;
> - Your spouse, if your spouse isn't mentally or physically able to care for himself or herself and lives with you for more than half the year; and
> - A person who isn't mentally or physically able to care for himself or herself, lives with you for more than half the year, and either:
>   - Is your dependent, OR
>   - Would have been your dependent except that (i) he or she receives more than a certain gross income amount ($4,300 in 2021), (ii) he or she files a joint return, or (iii) you (or your spouse in the case of a joint return) can be claimed as a dependent on someone else's return.[2]

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[1] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021, https://www.irs.gov/newsroom/child-and-dependent-care-tax-credit-faqs (retrieved June 12, 2021)

[2] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

Question 3 outlines the definition of being mentally or physically unable to care for oneself:

> **Q3. What does "physically or mentally not able to care for oneself" mean? (added June 11, 2021)**
>
> A3. Persons who can't dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Persons who must have constant attention to prevent them from injuring themselves or others also are considered not able to care for themselves.[3]

Unlike the credit in prior years, this credit phases out entirely at higher income levels.

> **Q5. Can this 50-percent amount of work-related expenses be reduced? (added June 11, 2021)**
>
> A5. Yes. The amount of your adjusted gross income determines the percentage of your work-related expenses that you are allowed as a credit. For this purpose, your income is your "adjusted gross income" shown on your Form 1040, 1040-SR, or 1040-NR.
>
> For 2021, the 50-percent amount begins to phase out if your adjusted gross income is more than $125,000, and completely phases out if your adjusted gross income is more than $438,000.[4]

Residency Rules for the Refundable Portion of the Credit

The FAQ contains information on the residency rules in place to be eligible to receive a refund of the credit in excess of the amount of tax paid by the taxpayer. Question 8 outlines the general rules:

> **Q8. Are there special residency requirements for the refundable portion of the credit? (added June 11, 2021)**
>
> A8. Yes. To be eligible for the refundable portion of the credit for 2021, you must have your main home in one of the 50 states or the District of Columbia for more than half of the tax year. Your main home can be any location where you regularly live. Your main home may be your house, apartment, mobile home, shelter, temporary lodging, or other location and doesn't need to be the same physical location throughout the taxable year. If you are temporarily away from your main home because of illness, education, business, vacation, or military service, you are generally treated as living in your main home during that time.[5]

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[3] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

[4] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

[5] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

But, as question 14 notes, those that live outside the United States (aside from special rules for those on assignment with the military) will not have access to the refundable portion of the credit:

> **Q14. For more than half of 2021, I will live overseas, but not in one of the five U.S. territories. Can I claim the refundable credit on my 2021 tax return? (added June 11, 2021)**
>
> A14. Generally, no. While you can claim the credit to offset your tax liability, the credit is refundable only if you have your main home in one of the 50 states or the District of Columbia for more than half of the tax year. Your main home can be any location where you regularly live. Your main home may be your house, apartment, mobile home, shelter, temporary lodging, or other location and doesn't need to be the same physical location or in the same state throughout the taxable year. If you are temporarily away from your main home because of illness, education, business, vacation, or military service, you are generally treated as living in your main home.[6]

Question 15 details the special rules for the military:

> **Q15. My main home is in one of the 50 states or the District of Columbia, and I am in the U.S. military and stationed outside the United States for an extended period of time. Am I treated as living in my main home during that time for purposes of the credit? (added June 11, 2021)**
>
> A15. Yes. U.S. military personnel who are stationed outside the United States on extended active duty are considered to have their main home in one of the 50 states or the District of Columbia for purposes of qualifying for the refundable portion of the credit. For this purpose, "extended active duty" means any period of active duty pursuant to a call or order to active duty for a period in excess of 90 days or for an indefinite period.

Work-Related Expenses

The FAQs also discuss the rules related to work-related expenses that count for purposes of the credit.

> **Q16. What qualifies as a work-related expense? (added June 11, 2021)**
>
> A16. A work-related expense is an amount you (or your spouse in the case of a joint return) pay for the care of a qualifying person, or for household services if at least part of the services is for the care of a qualifying person, in order for you to work or look for work. Your work can be for others or in your own business or partnership. It can be full or part-time. It also includes actively looking for work.

[6] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

However, if you don't find a job and have no earned income for the year, you can't take this credit. See A9 and A10 for more information about the earned income requirement.[7]

The work-related expenses can be paid to a relative if certain requirements are met:

Q17. I pay my mother to watch my children during the day. Does this count as a work-related expense? (added June 11, 2021)

Q17. Yes, unless you can claim your mother as a dependent.

You can also count some work-related payments you make to other relatives, even if they live in your house. However, don't count any amounts you pay to:

- A person you (or your spouse in the case of a joint return) can claim as a dependent;
- Your child who was under age 19 at the end of the year, even if the child isn't your dependent; A person who was your spouse at any time during the year; or
- The parent of your qualifying person if your qualifying person also is your child and under age 13.[8]

The FAQ discusses requirements that must be met for care outside of the home to count as such work-related expenses for this credit:

Q18. My child receives care outside my home so that I can work. Does this count as a work-related expense? (added June 11, 2021)

A18. Maybe. To count as a work-related expense, the care must be for your dependent under the age of 13 or any other qualifying person who regularly spends at least 8 hours each day in your home. If the care is provided by a dependent care center, the center must comply with all state and local regulations that apply to centers. A dependent care center is a place that provides care for more than 6 persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit. For an exception to this rule, see Q19.[9]

[7] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

[8] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

[9] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

The IRS specifically rejects the use of payments to overnight camps for this credit in Question 19:

> **Q19. My child will be attending a week of overnight camp. Does that camp count as a work-related expense? (added June 11, 2021)**
>
> A19. No. The cost of overnight camp does not count as a work-related expense.[10]

As well, the IRS provides that private kindergarten does not qualify as a work-related expense.

> **Q20. My child is enrolled in private kindergarten. Are the expenses to attend the private kindergarten work-related expenses? (added June 11, 2021)**
>
> A20. No. Expenses to attend kindergarten or a higher-grade level are not expenses for care, and therefore are not work-related expenses.[11]

But the IRS provides that after-school programs can qualify if all other requirements are met:

> **Q21. I send my child to after-school care. Are these expenses work-related expenses? (added June 11, 2021)**
>
> A21. Maybe. Expenses paid for before- or after-school care of a child in kindergarten or in a higher-grade level are expenses for care, and therefore are work-related expenses, provided all other conditions are satisfied (for example, the expenses allow you to work or to look for work).

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[10] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

[11] "Child and Dependent Care Tax Credit FAQs," IRS website, June 11, 2021

SECTION: 61
AWARD RECEIVED BY TAXPAYER TO SETTLEMENT CLAIM AGAINST DIVORCE ATTORNEY MUST BE INCLUDED IN HER INCOME

Citation: Holliday v. Commissioner, TC Memo 2021-69, 6/7/21

While we've all heard the quip that the proper answer to any tax question is "it depends," that is especially true when legal settlements and awards are involved. In the case of *Holliday v. Commissioner*[12] the question was whether the amount Ms. Holliday received from an action against the attorney that represented her during her divorce was a nontaxable recovery of capital or a taxable award to her.

Ms. Holliday's Divorce

The court outlined the following facts related to Ms. Holliday's divorce:

> In March 2010 petitioner's former spouse filed for divorce. As part of the divorce proceedings, petitioner and her divorce attorney participated in mediation.
>
> It resulted in petitioner's executing a mediated settlement agreement. Petitioner objected to the mediated settlement agreement, but her objections were not sustained by the divorce court.
>
> In April 2012 the divorce court entered the Agreed Final Decree of Divorce between petitioner and her former spouse.
>
> In May 2012 petitioner's divorce attorney filed a motion for a new trial and stated that petitioner received $74,864 less than her equal share of the community estate. The motion for a new trial was denied. Petitioner's divorce attorney told petitioner he would appeal, but he failed to do so.[13]

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[12] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/malpractice-settlement-proceeds-included-in-income/76kw5 (retrieved June 13, 2021)

[13] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

Action Against the Attorney

Ms. Holliday was not happy with this result and believed the attorney had failed to properly handle her case. She filed a malpractice case against the attorney in October of 2013:

> She claimed that her divorce attorney's representation constituted negligence and gross negligence and that he breached the duty of fair dealing and his fiduciary duties "by influencing * * * [her] to mediate and enter into a transaction that was not fair to * * * [her] under the circumstances" and by not pursuing an appeal. She later amended the malpractice petition in July and August 2014 to add claims for deceptive trade practices, treble damages, and attorney's fees.[14]

The Court continues, outlining what Ms. Holliday alleged were facts demonstrating the deficient nature of the attorney's representation:

> To support her claims, petitioner included facts in the malpractice petition about her former spouse's retirement plan, the divorce attorney's alleged failures, [*4] and her stressful experience during the mediation and other parts of the divorce litigation. Her August 2014 amendment to the malpractice petition added facts to support her deceptive trade practices claim, including that her divorce attorney failed to properly plead claims related to her former spouse's fraud on the marital estate.
>
> She sought damages for "pecuniary and compensatory losses", including "damages for past and future mental anguish, suffering, stress, anxiety, humiliation, and loss of ability to enjoy life", as well as punitive damages and disgorgement of the attorney's fees she paid in the divorce proceeding, resulting from the malpractice defendants' conduct.[15]

The Settlement

The malpractice claim was settled by the parties without the matter going to court. The opinion describes the settlement as follows:

> In October 2014 petitioner and the malpractice defendants entered into a settlement agreement. It recited that "while there remain significant disagreements as to the merit of the claims and allegations asserted by the Parties to this lawsuit, the Parties have agreed to compromise and settle such claims and allegations, without any admission of fault or liability on the part of any party." Under the section "Consideration", the malpractice defendants agreed to pay petitioner $175,000 "[i]n consideration for the mutual promises and obligations set forth in this Release". Under the section "Release", the parties released each other from all claims related to the malpractice

[14] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

[15] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

> lawsuit "in exchange for the * * * [settlement proceeds]". All claims included those "of whatever kind or character, known or unknown * * * which * * * [petitioner] may have against * * * [malpractice defendants] arising out of or related to the * * * [malpractice lawsuit]." The malpractice defendants did not admit liability or fault in the settlement agreement, and the parties did not allocate any of the settlement proceeds toward any particular claim or type of damages.[16]

The broad swath of potential claims alleged and wide breadth of "known and unknown" claims covered by the settlement are fairly standard in such cases. The plaintiff's counsel wishes to be sure all potential avenues for recovery of damages are raised just in case the trial court might find any of those matters a basis upon which to base an award. As well, the defendant clearly wants a settlement to be the end of the process, so in exchange for settling the matter out of court (saving the parties significant expense that would be incurred by going to trial), the defendant's counsel will demand that the payment cover all issues without exception, rather than being limited to specific issues.

In this case the amount of the settlement is outlined as follows:

> Petitioner received the settlement proceeds of $175,000, from which she paid her malpractice attorney's $73,500 fee; this was effected by the malpractice attorney's receiving the settlement check, deducting his fee, and transferring the remaining $101,500 to petitioner.[17]

The attorney representing Ms. Holliday issued her a Form 1099-MISC in the amount of $101,500, the proceeds reduced by the fee the attorney retained.

Ms. Holliday's Tax Reporting

While Ms. Holliday did include the $101,500 on a Form 1099-MISC summary and Line 21 statement, she also had a negative entry on the schedule labeled "Misclassification of Lawsuit recovery of marital assets" that resulted in removing the $101,500 from her return. As the label makes clear, Ms. Holliday's position is that the amount she received merely provided her with reimbursement for the amount of property settlement she failed to receive in her divorce due to the attorney's conduct.

The IRS noticed that Ms. Holliday had not included the $101,500 in her income, issuing a notice of deficiency for that amount. Ms. Holliday decided to take the matter to Tax Court, at which point the IRS noticed a separate issue:

> After reviewing the settlement agreement in preparation for trial of this case, respondent amended his answer, stating that all $175,000 of the settlement proceeds should have been reported on petitioner's 2014 Form 1040 with a corresponding miscellaneous itemized

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[16] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

[17] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

> deduction of $73,500 for the payment to her malpractice attorney. This amendment resulted in the increased deficiency of $44,939.[18]

The Court's Analysis and Decision

The Tax Court noted that a recovery of capital is generally not part of income, as it just makes the recipient whole for damages incurred:

> Generally, recovery of capital is not income. See *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 98 (1936); *Milenbach v. Commissioner*, 318 F.3d at 933 (noting that proceeds that represent compensation for lost value or capital generally are not taxable); *Freeman v. Commissioner*, 33 T.C. 323, 327 (1959) (noting that proceeds received "as the replacement of capital destroyed or injured rather than for lost profits" are a return of capital and not taxable"); see also *Wesson v. United States*, 48 F.3d at 899 (discussing that compensatory damages for personal injuries are excluded from gross income "because, in effect, they restore a loss to capital" (emphasis omitted) (quoting *Hawkins v. United States*, 30 F.3d 1077, 1083 (9th Cir. 1994))).[19]

But was this payment truly a recovery of capital? The Court outlines how the issue is approached when considering the nature of a legal settlement:

> Whether a payment received in settlement of a claim represents a recovery of capital depends on the nature of the claims that were the basis for the settlement. See *Spangler v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963), *aff'g* T.C. Memo. 1961-341; see also *Sager Glove Corp. v. Commissioner*, 36 T.C. 1173, 1180 (1961) ("The taxability of the proceeds of a lawsuit, or of a sum received in settlement thereof, depends upon the nature of the claim and the actual basis of recovery."), *aff'd*, 311 F.2d 210 (7th Cir. 1962). We have held previously that "an amount paid to a taxpayer in order to compensate the taxpayer for a loss that the taxpayer suffered because of the erroneous advice of the taxpayer's tax consultant generally is a return of capital and is not includible in the taxpayer's income." *Cosentino v. Commissioner*, T.C. Memo. 2014-186, at *31; see also *Clark v. Commissioner*, 40 B.T.A. 333, 335 (1939); *Concord Instruments Corp. v. Commissioner*, T.C. Memo. 1994-248, 1994 WL 232364, at *24-*25.
>
> To determine whether a settlement represents lost profit or lost value, we ask: "[I]n lieu of what was the . . . settlement awarded?" *Green v. Commissioner*, 507 F.3d 857, 867 (5th Cir. 2007) (quoting *Srivastava v. Commissioner*, 220 F.3d 353, 365 (5th Cir. 2000), *aff'g in part, rev'g and remanding in part* T.C. Memo. 1998-362), *aff'g* T.C. Memo. 2005-250. This is a question of fact. *Id.* at 866-867. "Ultimately, the character of the payment hinges on the payor's dominant reason for making the payment." Id. at 868. "We first look to the language of the agreement itself for indicia of purpose", focusing on "the origin and

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[18] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

[19] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

> characteristics of the claims settled * * * [in that agreement]". *Id.* at 867 (quoting *Pipitone v. United States*, 180 F.3d 859, 862 (7th Cir. 1999)). Where the agreement does not mention purpose, the Court may look at other facts that reveal the payor's intent, such as amount paid, evidence adduced at trial, and the factual circumstances that led to the agreement. *Id.* at 867-868; see also *Robinson v. Commissioner*, 102 T.C. 116, 126 (1994) (noting that the determination of the nature of the claims settled "is generally made by reference to the settlement agreement in light of the surrounding circumstances"), *aff'd in part, rev'd in part, and remanded on another issue*, 70 F.3d 34 (5th Cir. 1995).[20]

When the Court looked at this settlement, it concludes the agreement is for legal malpractice and not simply an award for the recovery of capital:

> The settlement agreement makes clear that the settlement proceeds were in lieu of damages for legal malpractice. The text of the settlement agreement indicates its purpose was "to compromise and settle * * * [petitioner's] claims and allegations" against malpractice defendants and that payment "in exchange for" release of claims related to petitioner's lawsuit against the malpractice defendants.[21]

The Court rejects Ms. Holliday's claim that this amount was a recovery of capital she should have received from the divorce, noting:

> …[T]he settlement agreement says that the settlement proceeds are for the release of "all claims * * * of whatever kind or character, known or unknown * * * which * * * [petitioner] may have against * * * [malpractice defendants] arising out of or related to the * * * [malpractice lawsuit]." Petitioner thus asks us to look through the settlement agreement and consider only her claims related to recovery of marital property. We decline to look beyond the plain terms of the settlement agreement, and we conclude that the settlement proceeds were to compensate her for her attorney's malpractice and therefore are taxable.
>
> … Petitioner similarly has failed to convince us that the settlement proceeds were meant only to replace her marital property, rather than generally to release the malpractice defendants from the various claims and types of damages listed in the malpractice petition.[22]

The Court explains that it will not attempt to convert a malpractice claim into awards wholly of a type that would be excludable income.

> We recently rejected a similar attempt to recharacterize the settlement of a legal malpractice claim arising from a personal injury lawsuit. In *Blum v. Commissioner*, T.C. Memo. 2021-18, the taxpayer filed a malpractice claim against her personal injury attorney, resulting in a

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[20] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

[21] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

[22] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

> settlement payment from the personal injury attorney. She asserted that the settlement payment represented a return of capital "in that it compensated her for a loss that she suffered because of the erroneous advice of her lawyers, viz, the nontaxable amount she would have received had she prevailed in her personal injury lawsuit." *Id.* at *12. Focusing on the text of the settlement agreement, which specified that it was entered into "for the purpose of compromising and settling the disputes", the Court concluded that the settlement payment was not a return of capital to the taxpayer but rather to compensate her "for distinct failings by her former lawyers." *Id.* at *9, *12.[23]

And, to add insult to injury, the Court agreed with the IRS that she is required to include the entire award in income, not just the net amount shown on the Form 1099MISC issued by her attorney:

> …[R]espondent has met his burden of proof with respect to the increased deficiency by showing that the $73,500 that yielded the increased deficiency was received by petitioner as settlement proceeds. The record includes uncontested evidence (and the parties have stipulated) that the settlement consisted of $175,000, of which petitioner's malpractice attorney retained $73,500 as a fee for representing her in the lawsuit. The full amount of the settlement proceeds, including the fee petitioner paid her malpractice attorney, is includible in gross income. *Commissioner v. Banks*, 543 U.S. at 430 (noting that the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee).[24]

[23] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

[24] *Holliday v. Commissioner*, TC Memo 2021-69, June 7, 2021

SECTION: 163
IMPACT OF DEPRECIABLE LIFE ACCOUNTING METHOD CHANGE ON ADJUSTED TAXABLE INCOME FOR §163(J) OUTLINED BY IRS

Citation: Chief Counsel Advice 202123007, 6/11/21

In Chief Counsel Advice 202123007[25] the IRS determined the impact of an IRC §481(a) adjustment related to depreciation on the calculation of adjusted taxable income (ATI) for purposes of the interest deduction limitation under IRC §163(j).

The advice deals with the following 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?[26]

The facts provided to use for the advice were as follows:

> 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.[27]

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[25] Chief Counsel Advice 202123007, June 11, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/depreciation-method-changes-included-in-ati-calculation/76lll (retrieved June 12, 2021)

[26] Chief Counsel Advice 202123007, June 11, 2021

[27] Chief Counsel Advice 202123007, June 11, 2021

IRC §163(j) imposes a limitation on the amount of interest a business can deduct. A key number computed in coming to this limit is *adjusted taxable income* (ATI). As the advice explains:

> 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.[28]

The limitation on deductible business interest for taxpayers to whom this rule applies is computed as follows:

> 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).[29]

An *accounting method* broadly involves an item that affects the timing but not the amount of an item that eventually enters into the taxation of taxable income. In this case, the issue is whether the cost of the item in question will be charged against income over 5 or 7 years. The total deduction will be the same, but the timing of that deduction will be different based on the MACRS class life used.

[28] Chief Counsel Advice 202123007, June 11, 2021

[29] Chief Counsel Advice 202123007, June 11, 2021

Taxpayers must obtain the IRS's permission to change a method of accounting once it has been adopted, even if that method is not appropriate, normally by filing a Form 3115. The "catch-up" to correct the cumulative amount of taxable income that should have been recognized in prior years is governed by IRC §481.

> 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.[30]

For years beginning before January 1, 2022, a taxpayer's ATI is computed by adding back any depreciation claimed in computing tentative taxable income. That add-back includes:

- Any depreciation under section 167, section 168 (of the Internal Revenue Code of 1986), or section 168 of the Internal Revenue Code of 1954 (the latter being 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.

[30] Chief Counsel Advice 202123007, June 11, 2021

The memorandum notes that, under the regulations, depreciation that gets diverted into inventory under the uniform capitalization rules of IRC §263A is taken into account at the time the depreciation is capitalized:

> 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.

The ruling concludes:

> 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.[31]

The advice also considers what would happen if the §481(a) adjustment were positive rather than negative.

> 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.[32]

[31] Chief Counsel Advice 202123007, June 11, 2021

[32] Chief Counsel Advice 202123007, June 11, 2021

As well, the advice notes what happens if the §481(a) adjustment continues into the first year beginning after January 1, 2022:

> 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.[33]

[33] Chief Counsel Advice 202123007, June 11, 2021