

Directive 15-3: Determining Basis for Purposes of Calculating the Massachusetts Investment Tax Credit and Certain Economic Development Incentive Credits – Impact of Depreciation and Expensing Deductions

I. INTRODUCTION

Massachusetts law provides that corporations qualifying as (i) manufacturing corporations, (ii) research and development corporations, or (iii) corporations primarily engaged in agriculture or commercial fishing may claim an investment tax credit (ITC) against their corporate excise tax under G.L. c. 63 with respect to certain qualified investments, pursuant to the requirements of G.L. c. 63, § 31A and the regulations thereunder. The amount of such tax credit is generally 3% of the “cost or other basis for federal income tax purposes of qualifying tangible property acquired, constructed, reconstructed, or erected during the taxable year, after deduction therefrom of any federally authorized tax credit taken with respect to such property.” G.L. c. 63, § 31A(i).

In addition, Massachusetts law authorizes the Massachusetts Economic Assistance Coordinating Council to grant, for purposes of Massachusetts corporate excise and personal income taxes, certain economic development incentive credits to corporate and individual taxpayers with respect to certain qualifying investments (e.g., variously described as “certified expansion projects”, “certified enhanced expansion projects”, and “certified manufacturing retention projects”). G.L. c. 62, § 6(g); G.L. c. 63, § 38N. Such tax credits, authorized at varying rates depending on the type of investment project, are generally determined by applying the applicable rate to the “cost of any property that would qualify for the [investment] credit allowed by [G.L. c. 63,] section 31A”

This Directive explains and clarifies the extent to which expensing deductions under U.S. Internal Revenue Code (IRC) § 179 and depreciation and bonus depreciation deductions under IRC §§ 167 and 168 affect the basis upon which the ITC and the economic development incentive credits (herein together referred to as “Massachusetts investment credits”) are calculated. The Directive explains that the basis to be used for computing such credits is the taxpayer’s initial adjusted basis used for computing federal depreciation deductions upon the acquisition, construction, reconstruction, or erection of the property (herein the “federal depreciable basis”).

IRC § 179 and the regulations thereunder require that such federal depreciable basis reflect a reduction on account of any properly-elected IRC § 179 deduction to expense the cost of the property^[1]. Accordingly, such reduction is similarly required for Massachusetts tax purposes, as described below, and the Massachusetts investment credits may only be claimed with respect to any remaining basis of the property.

However, a question has been raised as to whether such federal depreciable basis for purposes of claiming these Massachusetts investment credits should also reflect a reduction on account of regular depreciation deductions under IRC § 167 and so-called “bonus depreciation” deductions properly claimed under IRC § 168(k)^[2] for federal income tax purposes for the year of acquisition, construction, reconstruction, or erection of the property. We conclude that no reduction in federal depreciable basis is required with respect to such first-year depreciation and bonus depreciation deductions for purposes of calculating these Massachusetts investment credits.

II. ISSUES

For purposes of determining the amount of Massachusetts ITC allowed pursuant to G.L. c. 63, § 31A, and the amount of Massachusetts economic development incentive credits allowed when granted pursuant to G. L. c. 62, § 6(g) and G.L. c. 63, § 38N, is the basis of qualifying property upon which these Massachusetts investment credits are calculated required to reflect a reduction for the first-year regular depreciation deductions allowed for federal and Massachusetts tax purposes under IRC § 167 or the bonus depreciation deduction allowed for federal income tax purposes pursuant to IRC § 168(k)?

For purposes of determining the amount of Massachusetts ITC allowed pursuant to G.L. c. 63, § 31A, and the amount of Massachusetts economic development incentive credits allowed when granted pursuant to G. L. c. 62, § 6(g) and G.L. c. 63, § 38N, is the basis of qualifying property upon which these Massachusetts investment credits are calculated required to reflect a reduction for any expensing deductions allowed under IRC § 179 for federal and Massachusetts tax purposes with respect to the qualifying property?

III. DIRECTIVE

For purposes of determining the amount of Massachusetts ITC allowed pursuant to G.L. c. 63, § 31A, and the amount of Massachusetts economic development incentive credits allowed when granted under G. L. c. 62, § 6(g) and G.L. c. 63, § 38N, the basis of qualifying property upon which these Massachusetts investment credits are calculated does not require a reduction on account of the first-year federal or Massachusetts “regular” depreciation deductions or the bonus depreciation deduction allowed for federal income tax purposes pursuant to IRC § 168(k).

For purposes of determining the amount of Massachusetts ITC allowed pursuant to G.L. c. 63, § 31A, and the amount of Massachusetts economic development incentive credits allowed when granted under G. L. c. 62, § 6(g) and G.L. c. 63, § 38N, the basis of qualifying property upon which these Massachusetts investment credits are calculated must reflect a reduction on account of the amount of the cost of property that is expensed under IRC § 179 for federal and Massachusetts tax purposes with respect to the qualifying property.

IV. DISCUSSION

General Laws chapter 63, § 31A allows corporations qualifying as (i) manufacturing corporations, (ii) research and development corporations, or (iii) corporations primarily engaged in agriculture or commercial fishing an ITC against corporate excise for “qualifying tangible property acquired, constructed, reconstructed, or erected during the taxable year.” G.L. c. 63, § 31A(i). The amount of the credit allowed is 3% of “the cost or other basis for federal income tax purposes of qualifying tangible property acquired, constructed, reconstructed, or erected during the taxable year, after deduction therefrom of any federally authorized tax credit taken with respect to such property”. *Id.*

In general, for property to be eligible for the Massachusetts ITC under G.L. c. 63, § 31A, the property must, among other things, satisfy each of the following criteria:

Eligible property is limited to tangible personal property and other tangible property including buildings and structural components of buildings acquired by purchase, as defined under IRC § 179(d);

- The property must not be taxable under G.L. c. 60A;
- The property must be used in Massachusetts and situated in Massachusetts on the last day of the taxable year; and
- The property must be depreciable under IRC § 167 and have a useful life of four years or more.

Section 31A also allows an ITC to a lessee corporation for qualifying tangible personal property leased pursuant to an operating lease. The amount of such credit allowed to a lessee corporation is 3% of the lessor’s adjusted basis in the property for federal income tax purposes at the beginning of the lease term, multiplied by a fraction, the numerator of which is the number of days of the taxable year during which the lessee corporation leases the tangible person property and the denominator of which is the number of days in the useful life of such property. The useful life is the same as that used by the lessor for depreciation purposes when computing federal income tax liability. G.L. c. 63, § 31A(a)[3].

General Laws chapter 62, section 6(g) and chapter 63, section 38N authorize a credit against the tax imposed by those chapters to taxpayers that participate in a certified economic development project as described in G.L. c. 23A, §§ 3A and 3F. The credit is available to a taxpayer only to the extent awarded by the Economic Assistance Coordination Council. Depending on the type of economic development project, the credit may be awarded at various levels, with a maximum credit for a limited category of projects of 40% of the cost of qualifying property that would otherwise qualify for the ITC under G.L. c. 63, § 31A if it were purchased by a manufacturing or research and development corporation. With regard to pass-through entities, the credit passes through to the owners of the entities. Because the credit authorized for these economic development projects is allowed for property that would otherwise qualify for the ITC, it follows that, like the ITC, these economic development incentive credits may be granted to a lessee for tangible personal property leased pursuant to an operating lease.

Both the ITC and the economic development credits are calculated by applying the pertinent credit’s percentage rate (e.g., 3% in the case of ITC) to “the cost or other basis for federal income tax purposes” of the qualifying property “acquired, constructed, reconstructed, or erected during the taxable year, after deduction therefrom of any federally authorized tax credit taken with respect to such property”. As further described below, the “cost or other basis for federal income tax purposes” referenced in G.L. c. 63, § 31A is the same basis used for computing the federal depreciation deduction allowed pursuant to IRC § 167, and accordingly the federal rules applicable in determining basis for purposes of depreciation are key in determining the basis to be used in calculating the Massachusetts ITC and any economic development incentive credits that may be awarded.

Effect of Regular Depreciation Deductions on Basis for Calculating Massachusetts Investment Credits

IRC § 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear, etc., of property used in a trade or business or property held for the production of income. IRC §§ 167 and 168 provide the general rules for determining the amounts of such depreciation deductions under IRC § 167. IRC § 167(c) provides, in general, the basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect to any property shall be the adjusted basis provided in IRC § 1011. The adjusted basis of property under IRC § 1011 is the cost or other basis prescribed in IRC § 1012 or other applicable provisions of the IRC, adjusted to the extent provided in IRC §§ 1016, 1017 and 1018 or as otherwise specifically provided for under the applicable provisions of the IRC. IRC § 1011; Treas. Reg. § 1.1011-1.

As discussed above, the Massachusetts investment credits are determined by applying the pertinent rate of tax credit (e.g., 3% in the case of ITC) to “the cost or other basis for federal income tax purposes of qualifying tangible property acquired, constructed, reconstructed, or erected during the taxable year, after deduction therefrom of any federally authorized tax credit taken with respect to such property.” G.L. c. 63, § 31A(i). As indicated, the Massachusetts investment credits may only be taken with respect to property that is, among other requirements, depreciable under IRC § 167. Accordingly, the basis used for computing the Massachusetts investment credits is the federal depreciable basis upon acquisition, construction, reconstruction, or erection of the property. No reduction in such federal depreciable basis is required on account of the first-year regular depreciation deductions that may subsequently be claimed with respect to such property, and accordingly no such reduction is required for purposes of G.L. c. 63, § 31A.

Effect of Federal “Bonus Depreciation” Deductions (Additional First-Year Depreciation Deductions under IRC § 168(k)) on Basis for Calculating Massachusetts Investment Credits

The basis determination is the same with respect to the effect of federal “bonus depreciation” deductions[4], where applicable, as it is with respect to regular depreciation deductions. IRC § 168(k) provides that, in the case of qualified property, the depreciation deduction provided by IRC § 167(a) for the taxable year in which the property is placed in service shall include an allowance equal to fifty percent of the adjusted basis of the qualified property. The allowance is simply a first and larger installment of the aggregate depreciation deductions that may be taken over the life of the property in recovering the cost of a qualifying capital investment through depreciation under IRC §§ 167 and 168. Like the regular depreciation deduction, the bonus depreciation deduction does not affect the initial

federal depreciable basis of property when acquired, constructed, reconstructed, or erected, and there is no provision in the IRC that would require a reduction on account of first-year depreciation that may subsequently be claimed. Accordingly, the cost or other basis of property for purposes of determining the amount of the Massachusetts investment credits is not required to reflect a reduction on account of the federal bonus depreciation deductions allowed for the year of acquisition, construction, reconstruction, or erection of the property.

Example 1:

On January 1, 2009, X, a calendar-year manufacturing corporation which engaged in business in Massachusetts, purchases and places in service qualified 10-year property that it purchased for \$100,000. X's initial basis in the property is \$100,000 for both federal and Massachusetts purposes. On its 2009 federal return, X claims a \$50,000 bonus depreciation deduction, i.e., 50% of its basis in the property, pursuant to IRC § 168(k).

In addition, on its 2009 federal tax return, X claims a regular federal depreciation deduction for 2009, applying the 200% Declining Balance method, in an amount of \$5,000 (i.e., \$50,000 (the \$100,000 initial basis less the \$50,000 bonus depreciation federal deduction) \times .20 = \$10,000, divided by 2 to account for the ½ year convention).

Since neither the federal bonus depreciation deduction nor the regular depreciation deduction reduces the federal basis upon which depreciation is calculated for tax year 2009^[5], the federal adjusted basis upon which the Massachusetts ITC for tax year 2009 is computed is \$100,000.

Effect of Section 179 Expensing Deductions on Basis for Calculating Massachusetts Investment Credits^[6]

IRC § 179 provides an election to expense in the year of acquisition certain business assets that would otherwise be depreciable, as an alternative to applying the usual cost recovery rules for capital investments (which provide for recovering cost through depreciation or amortization deductions over a period of years).

However, to the extent that an asset is expensed pursuant to an IRC § 179 election, the federal depreciable basis of that property must be reduced by the amount so expensed. Treas. Reg. § 1.179-1(f)(1).^[7] Since the IRC § 179 deduction reduces the property's federal depreciable basis, the basis upon which the Massachusetts investment credits are calculated must reflect the same reduction on account of the amount of the IRC § 179 deduction.

Example 2: IRC § 179 expensing deduction

On January 1, 2009, X, a calendar-year manufacturing corporation engaged in business in Massachusetts, purchases and places in service qualified 10-year property that it purchased for \$100,000. X's initial basis in the property is \$100,000 for both federal and Massachusetts tax purposes. On its 2009 federal and Massachusetts returns X claims a \$100,000 IRC § 179 deduction to expense the cost of the property.

Since the IRC § 179 deduction reduces the property's federal depreciable basis, the basis upon which the Massachusetts ITC and any economic development incentive credits for tax year 2009 is computed is zero. No such Massachusetts investment credits are available with respect to the \$100,000 cost that has been expensed pursuant to the IRC § 179 election.

Example 3: IRC § 179 expensing deduction, bonus depreciation and regular depreciation deductions

On January 1, 2012, X, a calendar-year corporation that is participating in a certified project and has been awarded an economic development incentive credit for calendar year 2012, purchases and places in service qualified 10-year property that it purchased for \$100,000. X's initial basis in the property is \$100,000 both for federal and Massachusetts tax purposes. On its 2012 federal return X claims a \$50,000 IRC § 179 deduction to expense that portion of the cost of the property.

In addition, X claims a \$25,000 federal bonus depreciation deduction in the property pursuant to IRC § 168(k). That bonus depreciation deduction is 50% of X's \$50,000 adjusted depreciable basis (i.e., the initial basis of \$100,000 less the section 179 expensing deduction of \$50,000).

Further, X claims a regular federal depreciation deduction for 2012, applying the 200% Declining Balance method, in the amount of \$2,500 (i.e., the remaining federal depreciable basis of \$25,000 \times .20 = \$5,000, divided by 2 to account for the ½ year convention).

While the property's federal depreciable basis is reduced on account of the IRC § 179 deduction, neither the bonus depreciation deduction nor the first-year regular depreciation deduction reduces the federal depreciable basis upon acquisition of the property. Accordingly, the basis upon which Massachusetts investment credits for tax year 2012 are computed is \$50,000.

/s/Mark E. Nunnelly

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[1] Expensing deductions properly claimed under IRC § 179 for federal income tax purposes generally are allowed for Massachusetts tax purposes as well, as Massachusetts law adopts the current IRC with respect to IRC § 179 for purposes of both corporate excise and personal income tax.

[2] While Massachusetts law generally follows the current IRC provisions with respect to depreciation for purposes of both corporate excise and personal income tax, it specifically decouples from and disallows the federal bonus depreciation provisions in IRC § 168(k). See G.L. c. 62, § 2(d)(1)(N) for the personal income tax decoupling provision, and G.L. c. 63, § 30.4(iv) for the corporate excise decoupling provision.

[3] The statute does not allow a taxpayer to take the ITC for tangible personal property or other tangible property, including buildings and structural components of buildings, which the taxpayer leases as a lessor. G.L. c. 63, § 31A(b).

[4] For purposes of both the corporate excise and the personal income tax, Massachusetts law does not adopt the bonus depreciation provisions in IRC § 168(k). See footnote 2, *supra*.

[5] The adjusted basis for tax year 2010 will reflect a reduction in basis for the depreciation deduction allowed for tax year 2009.

[6] For purposes of both the corporate excise and the personal income tax, Massachusetts generally follows the current Code for purposes of IRC § 179. See footnote 1, *supra*.

[7] Under IRC § 179(a), the effect of the IRC § 179 election is to treat the cost of the property as “an expense that is not chargeable to capital account”.