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To:	CITReview
Cc:	Bob Pierce
Subject:	CIT Review Comments
Attachments:	Fla CIT Comments re 1031 & Bonus Depreciation - Final 10-23-18.pdf

Please find comments attached regarding the Florida Department of Revenue's review of the 2017 federal Tax Cuts and Jobs Act.

Sincerely,
-Steve Hogan

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Via U.S. Mail and Electronic Mail
Corporate Income Tax Review
c/o Director of Legislative and Cabinet Services
Florida Department of Revenue
P.O. Box 5906
Tallahassee, Florida 32314-5906
Email: CITReview@floridarevenue.com

Re: Comments on Florida CIT Impacts from the Tax Cuts and Jobs Act of 2017
1031 Exchanges and Bonus Depreciation

Dear Sir or Madam:

The following comments are offered pursuant to the Florida Department of Revenue's request for public comment on the impact of the Federal Tax Cuts and Jobs Act of 2017, Public Law No. 115-97 (the "TCJA"), on Florida's corporate income tax. These comments focus on the changes made by the TCJA on exchanges of like-kind property under IRC 1031 and related issues involving bonus depreciation. We appreciate your consideration of these issues.

Summary

Section 1031 of the Internal Revenue Code allows taxpayers to defer recognizing gain on exchanges of like-kind property held for use in a trade or business. The TCJA limited section 1031 to exchanges of real property. This new limitation prevents taxpayers from deferring recognition of gain on exchanges of tangible property held for use in a trade or business.

This change in IRC 1031 will cause unexpectedly large short-term Florida corporate income tax liability for taxpayers that cannot avail themselves of the federal bonus depreciation rules under current Florida law. This short-term issue can be solved in a revenue-neutral way by allowing such taxpayers to use the federal bonus depreciation rules to calculate their Florida tax liability for a limited time.

The TCJA's Changes to Section 1031

Section 1031 of the Internal Revenue Code allows taxpayers to defer recognition of gain on sales of property held for productive use in a trade or business if certain conditions are met. The main condition under IRC 1031 is that the property sold must be "exchanged" for property of a "like kind" that is also to be held for productive use in a trade or business. The exchange must occur within specified timeframes. *See* IRC § 1031(a).

The TCJA amended section 1031 by restricting its use to real property. P.L. 115-97, § 13303(a) (striking the term "property" in IRC 1031(a)(1) and replacing it with the term "real property"). Before this change was made, section 1031 could be used for exchanges of real property as well as tangible and intangible property that otherwise met the requirements of the statute.

Because of this change, taxpayers that previously used section 1031 to defer recognition of gain when replacing tangible property used in their business will now have to recognize "gain" on those sales. For taxpayers that turn over a large volume of tangible property in the course of their business, the gain that must now be recognized will be significant.

The Impact of Section 1031 and Bonus Depreciation on Florida CIT

Florida imposes corporate income tax ("CIT") on the "net income" of certain taxpayers. § 220.11(1), Fla. Stat.[1] This "net income" figure is calculated based on the taxpayer's "adjusted federal income." § 220.12, Fla. Stat. The taxpayer's "adjusted federal income" is calculated pursuant to section 220.13, Florida Statutes. The starting point for the calculation is the taxpayer's "taxable income" as defined under the Internal Revenue Code. § 220.13(1), (2), Fla. Stat.

Section 1031 previously allowed taxpayers to defer recognition of gain from exchanges of like-kind tangible property held for productive use in a trade or business. Under the TCJA, taxpayers can no longer use section 1031 to defer gains on such exchanges. This means that taxpayers in this situation will have a larger amount of "taxable income" under the Internal Revenue Code. Because of this, these taxpayers will begin their calculation of the "net income" subject to Florida CIT with a larger figure. This will lead to a larger Florida CIT liability.

Though the section 1031 deferral has been eliminated for tangible property, the effect of this change at the federal level is mitigated somewhat by the "bonus depreciation" deductions allowed under IRC 168. However, taxpayers cannot apply the same bonus depreciation deductions in Florida when calculating their "net income" for Florida CIT purposes. § 220.13(1)(e)1., Fla. Stat. The taxpayers must instead "stretch" the depreciation deduction from their Florida net income over seven years. *Id.* Use of this "one-seventh" depreciation method results in a short-term "bubble" of Florida CIT liability where no corresponding liability exists at the federal level.

This problem can be solved in a revenue-neutral way by allowing such taxpayers to use federal bonus depreciation, rather than the "one-seventh" method, when calculating their net income for Florida CIT purposes.

A. Federal Bonus Depreciation Deductions

The Internal Revenue Code allows taxpayers to take "depreciation deductions" to reduce their federal adjusted gross income. These deductions generally constitute "a reasonable allowance" for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. IRC § 167(a).

For certain tangible property, taxpayers can take an additional first-year depreciation deduction pursuant to section 168. This additional first-year depreciation deduction is commonly referred to as "bonus depreciation."[2]

The TCJA increased the amount of bonus depreciation that taxpayers may deduct. Depending on the date the tangible property is placed in service, the bonus depreciation deduction may be as much as

[1] Discussion of the types of entities subject to Florida CIT is outside the scope of this comment.
[2] Taxpayers may elect not to take the bonus depreciation deduction if they so choose. IRC § 168(k)(7).

100% of the cost of the property. This means that the taxpayer can take as a deduction an amount equal to the <u>entire cost</u> of the tangible property in the year it is placed in service. IRC § (k)(1), (6).[3]

B. Florida's "One-Seventh" Depreciation Method

Any amounts deducted by a taxpayer under the bonus depreciation rules must be "added back" to the taxpayer's federal taxable income for Florida CIT purposes. § 220.13(1)(e)1., Fla. Stat. ("There shall be added to such taxable income an amount equal to 100 percent of any amount deducted for federal income tax purposes as bonus depreciation for the taxable year pursuant to ss. 167 and 168(k) of the Internal Revenue Code, as amended[.]").

Because of this provision, taxpayers that reduce their federal adjusted gross income through bonus depreciation deductions must inflate their income for Florida CIT purposes by adding those deductions back into their calculation of the "net income" subject to Florida CIT.

Florida then creates a "one-seventh" depreciation deduction method for taxpayers affected by this provision. Instead of bonus depreciation, taxpayers may deduct one-seventh of the bonus depreciation amount each year over a seven year period. § 220.13(1)(e)1., Fla. Stat. ("For the taxable year and for each of the 6 subsequent taxable years, there shall be subtracted from such taxable income an amount equal to one-seventh of the amount by which taxable income was increased pursuant to this subparagraph, notwithstanding any sale or other disposition of the property that is the subject of the adjustments and regardless of whether such property remains in service in the hands of the taxpayer."). In this way, the bonus depreciation deduction is "stretched out" over seven years.

C. Federal Bonus Depreciation and 1031 Exchanges

Under the old 1031 exchange rules, a normal transaction would involve a taxpayer selling tangible property and purchasing new tangible property of a "like kind" to that which was sold. Section 1031 would allow the taxpayer to defer recognizing gain on the sale of the tangible property. The taxpayer could also take a depreciation deduction under the old versions of sections 167 and 168 for part of the cost of the replacement property.

With the TCJA changes to 1031 exchanges, taxpayers that sell old tangible property used in their business cannot defer recognition of the gain on those sales even if those taxpayers immediately purchase new tangible property to replace it.

However, such taxpayers can take a bonus depreciation deduction at the federal level of up to 100% of the cost of the replacement property in the year the property is placed in service.[4] In most cases, the cost of the replacement property will be greater than the gain realized on the sale of the old property. Because of this, such taxpayers would normally be able to offset all, or nearly all, of the gain recognized on the sale of the old property through bonus depreciation deductions.[5]

For taxpayers in this situation, the TCJA's changes to section 1031 were offset by the corresponding increase to the bonus depreciation deduction. Such taxpayers will therefore not be subject

[3] Taxpayers may elect to deduct 50% of the cost rather than 100% if they so choose. IRC § 168(k)(10).
[4] This comment presumes that the tangible property at issue qualifies for section 168 bonus depreciation.
[5] This dynamic occurs when all or most of the "old" tangible property is replaced by "new" tangible property. If more old property is sold than is replaced, the bonus depreciation deductions may not be sufficient to offset the entire gain.

to an unexpectedly large increase to their adjusted gross income at the federal level. This offset does not exist, however, in Florida.

D. Increase in Florida CIT Due to Section 1031 Changes & Florida's One-Seventh Rule

Under the TCJA, taxpayers that routinely sell old tangible property used in their trade or business while replacing it with new tangible property can no longer use section 1031 to defer recognition of their gain on the sale of the old property. However, due to the federal bonus depreciation rules, the deduction allowed on the cost of the new property is available to offset the increase in adjusted gross income at the federal level that the taxpayer would otherwise have to pay tax on.

The bonus depreciation offset available at the federal level is not available for Florida CIT purposes. Because Florida replaced the bonus depreciation rule with the "one-seventh" rule, taxpayers must stretch the deduction out over seven years.

This means that taxpayers will have to recognize the gain on their sales of tangible property that occurred during the taxable year Such taxpayers can only offset those gains by one-seventh of the price of the replacement property. This will result in a "bubble" of tax liability in "year one" with no way for taxpayers to offset it.

In this way, Florida is imposing tax on a larger amount of income now, while imposing tax on a much smaller (or nonexistent) amount of income in the future. The TCJA has therefore caused a bubble of immediate Florida CIT liability for taxpayers in this position.

E. A Revenue-Neutral Solution

The fact that the bonus depreciation deduction is not eliminated by Florida, but is instead spread out over time, means that the taxpayer is not actually losing the amount of this deduction. As the deduction is taken in one-seventh increments over subsequent years, the taxpayer will have correspondingly lower Florida CIT liability in those subsequent years. For taxpayers that regularly turn over their business property at a rapid rate, the one-seventh deduction increments will eventually eliminate all, or nearly all, of the gain recognized in future years.

Though the tax reality of this situation is revenue-neutral over time, the business reality is that a spike in Florida CIT liability in the current year will be extremely difficult for taxpayers to pay. The promise of future deductions, and perhaps an elimination of Florida CIT in future years, is of little comfort to taxpayers that are caught in the bubble created by the TCJA. The immediate liability may cause serious cash-flow problems for Florida businesses in this situation.

A revenue-neutral solution could be found through a legislative change allowing taxpayers in this situation to use bonus depreciation under sections 167 and 168 to offset their "net income" calculations for Florida CIT for a limited amount of time. Correspondingly, such taxpayers would not be able to use any fraction of this bonus depreciation amount in future years. Therefore, Florida's CIT tax basis would remain the same over the course of time, while easing the cash-flow problems Florida businesses may otherwise have to contend with.

This solution is revenue-neutral because no new deductions are being added. Instead, the timing of the Florida depreciation deductions would be changed to match federal law for taxpayers impacted by the TCJA changes described in this comment.

Conclusion

The TCJA's changes to section 1031 and the bonus depreciation rules, when read together with Florida's CIT statutes, has put taxpayers in a situation where they have a large Florida CIT liability in the short-term, with the deductions only "catching up" over a seven year period. This presents a cash-flow problem for Florida businesses that will impede their ability to invest in new jobs and economic growth, while generating no new revenue for the state. This short-term problem can be solved in a revenue-neutral way by allowing taxpayers to use the federal bonus depreciation rules to calculate their Florida tax liability for a limited amount of time.

Thank you for your consideration of these issues.

Sincerely,

/s/ Robert A. Pierce

Robert A. Pierce
Steven M. Hogan

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