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Applying the Averaging Conventions

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APPLYING THE AVERAGING CONVENTIONS

— by Neil E. Harl*

Two recently published Notices¹ have focused attention on the application of the mid-year and mid-month conventions to depreciable property.² Notice 2001-70 and Notice 2001-74³ have provided a one-time break for property placed in service during the fourth quarter of 2001.

General rule

The half-year convention (permitting a half-year of depreciation to be deducted in the year property is placed in service) applies to three, five, seven, 10, 15 and 20-year property.⁴ Thus, a half-year of depreciation is allowed for the year eligible property is placed in service and a half-year the year the property is disposed of or retired from service if not already depreciated out.⁵ Note that the half-year convention applies to 20-year property which includes farm buildings.⁶ Under ACRS depreciation placed in service before 1987, farm buildings were subject to a mid-month convention.⁷

If more than 40 percent of the basis of property placed in service during a taxable year (other than depreciable rental property⁸ and nonresidential real property⁹) is placed in service during the last three months of the taxable year, a mid-quarter convention applies to all property placed in service during the taxable year.¹⁰ That means property placed in service during the fourth quarter would normally receive one-eighth of a year's depreciation.¹¹ It also means that property placed in service during the first quarter of the year would receive seven-eighths of a year's depreciation, that placed in service during the second quarter would receive five-eighths of a year's depreciation and property placed in service during the third quarter would be in line for three-eighths of a year's depreciation.

Two recently published Notices have focused attention on the application of the mid-year and mid-month conventions to depreciable property. Notice 2001-70 and Notice 2001-74 have provided a one-time break for property placed in service during the fourth quarter of 2001.

For residential rental property and nonresidential real property, a mid-month convention applies in the month the property is placed in service and in the month the property is disposed of or retired from service if not already depreciated out.¹²

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**The next issue of the Digest will be published on
January 4, 2002. Happy Holidays to you and yours
from the Agricultural Law Press**

Notice 2001-70, Notice 2001-74

In late October of 2001, the Internal Revenue Service announced a one-time relaxation of the mid-year or half-year convention for 2001 only.¹³ Under that notice, if the third quarter of a taxpayer's 2001 year includes September 11, 2001, The notice recognizes that the terrorist attacks on September 11 have disrupted plans to place property in service before October 1 and thus be assured of a half-year of depreciation in 2001.

The notice specifies that, to invoke the relief provision, a taxpayer should print or type on Form 4562, "Election Pursuant to Notice 2001-70."¹⁵

A few days after publication of Notice 2001-70,¹⁶ IRS published Notice 2001-74¹⁷ which specified that the mid-year or half-year convention would be available in 2001 for property placed in service during the year if September 11 falls within the fourth quarter of the taxable year and added that the election could be made on Form 2106, *Employee Business Expenses*, when appropriate rather than on Form 4562.

Other depreciation convention rules

For partnerships and S corporations, the 40 percent test is applied at the partnership or S corporation levels except for those formed or availed of to avoid the mid-quarter convention or having the mid-quarter convention apply where it otherwise would not.¹⁸ In applying the 40 percent test, nonresidential real property and residential property are disregarded.¹⁹

Any property placed in service and disposed of in the same taxable year is disregarded for purposes of applying the 40 percent rule.²⁰ No depreciation is allowed for property placed in service and disposed of the same year.²¹ However, if such property is subsequently reacquired and again placed in service during the same tax year, depreciable basis as of the later of the dates placed in service is included.²²

The mid-quarter convention rules apply to alternative depreciation as well as regular depreciation.²³

"Listed property"²⁴ is included in applying the mid-quarter convention rules.²⁵

In determining the income tax basis of property for purposes of the 40 percent test, any expense method depreciation purchased during the last three months of the year that is properly expensed is excluded from the aggregate basis of property placed in service.²⁶ Any personal use of property is reflected in the calculation, also.

If property is subject to the half-year or mid-quarter convention in the year placed in service, the property is also subject to the half-year or mid-quarter convention in the year disposed of.²⁷

Nonrecognition transactions

In the event depreciable property is transferred in a nonrecognition transaction²⁸ in the same taxable year that the property is placed in service by the transferor, the 40 percent test is applied by treating the transferred property as placed in service by the transferee on the date of the transfer.²⁹ Thus, if the aggregate basis of property (including the transferred property) placed in service by the transferee during the last three months of its taxable year exceeds 40 percent of the aggregate basis of property (including the transferred property)

placed in service by the transferee during the taxable year, the mid-quarter convention applies to the transferee's depreciable property including the transferred property.³⁰ The depreciable basis of the transferred property is not taken into account by the transferor in applying the 40-percent test for the taxable year in which the transferor placed the property in service.³¹

FOOTNOTES

- ¹ Notice 2001-70, I.R.B. 2001-45, 437; Notice 2001-74, I.R.B. 2001-49, ___.
- ² See generally 4 Harl, *Agricultural Law* § 29.05[2][d][iii][A] (2001); Harl, *Agricultural Law Manual* § 4.03[4] (2001).
- ³ See note 1 *supra*.
- ⁴ I.R.C. § 168(d)(1).
- ⁵ I.R.C. § 168(d)(4)(A).
- ⁶ See I.R.C. § 168(e)(1).
- ⁷ See 4 Harl, *supra* note 2, § 29.05[2][C][ii] (2001).
- ⁸ I.R.C. § 168(e)(2)(A).
- ⁹ I.R.C. § 168(e)(2)(B).
- ¹⁰ I.R.C. § 168(d)(3).
- ¹¹ See I.R.C. § 168(d)(4)(C).
- ¹² I.R.C. § 168(d)(2), (d)(4)(B).
- ¹³ Notice 2001-70, I.R.B. 2001-45, 437.
- ¹⁴ *Id.*
- ¹⁵ Notice 2001-70, I.R.B. 2001-45, 437.
- ¹⁶ I.R.B. 2001-45, 437.
- ¹⁷ I.R.B. 2001-49, ___.
- ¹⁸ Treas. Reg. § 1.168(d)-1(b)(6). See General Explanation of the Tax Reform Act of 1986 105 (1987).
- ¹⁹ I.R.C. § 168(d)(3)(B)(i).
- ²⁰ I.R.C. § 168(d)(3)(B)(ii).
- ²¹ Treas. Reg. § 1.168(d)-1(b)(3)(ii).
- ²² See Treas. Reg. § 1.168(d)-1(b).
- ²³ See I.R.C. § 168(d).
- ²⁴ I.R.C. § 280F(d)(4).
- ²⁵ Treas. Reg. § 1.168(d)-1(b)(2).
- ²⁶ Ltr. Rul. 9126014, March 29, 1991.
- ²⁷ Treas. Reg. § 1.168(d)-1(c)(1).
- ²⁸ See I.R.C. § 168(i)(7)(B)(i).
- ²⁹ Treas. Reg. § 1.168(d)-1(b)(7).
- ³⁰ *Id.*
- ³¹ *Id.*