SECTION 168(N) DEPRECIATION: NAVIGATING THE NEW POWERFUL TAX INCENTIVE FOR U.S. PRODUCTION FACILITIES

The One Big Beautiful Bill Act (OBBBA) introduced several long-anticipated legislative changes, including the so called “Big 3”:
(1) restoring the deductibility of domestic research and experimental expenditures (§174A), (2) extending 100% bonus depreciation (§168(k)), and (3) reverting to an interest deduction limitation under §163(j) based on earnings before interest, taxes, depreciation, and amortization (EBITDA).[1] In addition, the OBBBA offers another opportunity with potentially even greater cash tax savings for capital investments: §168(n) depreciation, a 100% deduction for certain domestic production facilities Unlike the Big 3 provisions —made permanent by the OBBBA — the new §168(n) depreciation allowance is available only for a limited period.

Companies—including multinational companies considering whether to bring manufacturing operations into the U.S.— wanting to take advantage of the full expensing option will need to consider numerous factors in deciding whether to make the election, including the current and expected tariffs by the U.S. and foreign jurisdictions. In addition, companies must evaluate eligibility for the §168(n) depreciation deduction with limited guidance and unresolved questions. In this alert, A&M Tax experts discuss how companies must navigate a myriad of rules under §168(n) and highlight practical considerations.

The §168(n) Election

Under the OBBBA, taxpayers may now claim a 100% depreciation deduction for Qualified Production Property (QPP) in the year it is placed in service. Instead of depreciating the cost of a building over 39 years, taxpayers who meet the requirements of §168(n) and make an election may fully depreciate qualifying property immediately, which would be a significant cash flow benefit. The §168(n) election is made annually with the filing of the tax return and must specify both the nonresidential property and the portion of that property that qualifies. Once made, the election is irrevocable.

1. https://www.congress.gov/119/plaws/publ21/PLAW-119publ21.pdf

What is QPP?

QPP is defined as the portion of nonresidential real property that:

- Is used as an integral part of a qualified production activity
- Is located in the U.S. or a U.S. territory
- Has original use that begins with the taxpayer (or meets a special acquisition rule)
- Begins construction begins after January 19, 2025, and before January 1, 2029
- Is placed in service before January 1, 2031

What is a Qualified Production Activity?

A qualified production activity is the manufacturing, production, or refining (MPR) of a qualified product, which is tangible personal property other than food or beverages prepared and sold in the same retail building. A key requirement is that the activity results in a *substantial transformation* of the property.

One important nuance is that “production” is limited to agricultural and chemical production, although §168(n) does not define those terms.

What Does “Substantial Transformation” Mean?

Although §168(n) requires a “substantial transformation” the statute does not define the term. Instead, Congress directed Treasury to issue guidance consistent with §954(d).

Understanding the scope of “substantial transformation” —and how limited it may be —is critical as taxpayers consider whether their domestic MPR facilities qualify as QPP under §168(n). Analyzing the §954(d) guidance is the first step, which provides three different ways in which an activity can rise to the level of manufacturing.

Under existing §954(d) regulations, property is treated as manufactured, produced, or constructed if one of three tests is satisfied.

1. The substantial transformation test:
Property goes through a substantial transformation if the property purchased is sufficiently distinguishable from the acquired property. Examples include turning wood pulp into paper, machining steel rods into screws and bolts, or processing raw tuna into canned tuna. In each case, the final product is not just a slightly altered version of the property purchased, but something that serves a completely different function. The substantial transformation test looks to whether property is changed into a new and different product.

2. The substantial operations test:
Significant assembly or processing activities may be treated as manufacturing, even if they do not meet the substantial transformation test. For example, assembling industrial engines or automobiles is treated as manufacturing under this test, even though the final product is not considered substantially transformed.

3. The substantial contribution test:
If a corporation’s employees make meaningful contributions to manufacturing activities, such as directing, overseeing, or providing critical input into the production process, the corporation is considered to have manufactured the product.

Because §168(n) specifically references substantial transformations under §954(d), with no reference to substantial operations or substantial contributions tests, taxpayers with mere “assembly” operations may not qualify. Thus, taxpayers will need to carefully analyze these provisions to ensure their activity satisfies the substantial transformation standard.

Other Considerations and Questions

Acquisition of Facilities

Generally, the original use of QPP must begin with the taxpayer. However, under special acquisition rules, companies acquiring facilities that will otherwise qualify under §168(n), could be eligible for the 100% depreciation deduction if certain requirements are met:

- The property was not used in a qualified production activity by any person at any time from January 1, 2021, through May 12, 2025.
- The property was not used by the taxpayer prior to acquisition.
- The acquisition of such property meets the requirements of a "purchase," meaning the property was acquired in a regular arm's-length transaction, not from a related person or entity, and the purchaser's basis in the property is not determined by reference to the seller's basis.

Taxpayers looking to acquire property rather than self-construct QPP should conduct appropriate due diligence and consider various representations and warranties in purchase agreements to ensure eligibility for bonus depreciation under §168(n) (e.g., whether a written binding contract existed before the relevant dates).

What is a "Portion of" Any Nonresidential Real Property?

Taxpayers must determine what portion of the MRE facility is an integral part of a qualified production activity. The statute excludes from QPP certain space used for offices, administration, parking, lodging, sales, research, software development, engineering, or other functions unrelated to MPR activities. This statutory exclusion raises additional questions for taxpayers to tackle, such as:

- How does a taxpayer identify and allocate a portion of the building to MPR and non-MPR activities?
- Is a cost segregation study necessary?
- If §168(n) is applied to "any portion" of the MPR facility, could an addition to an existing nonresidential real property potentially qualify?

Potential Changes in Business Plans and Recapture Provisions

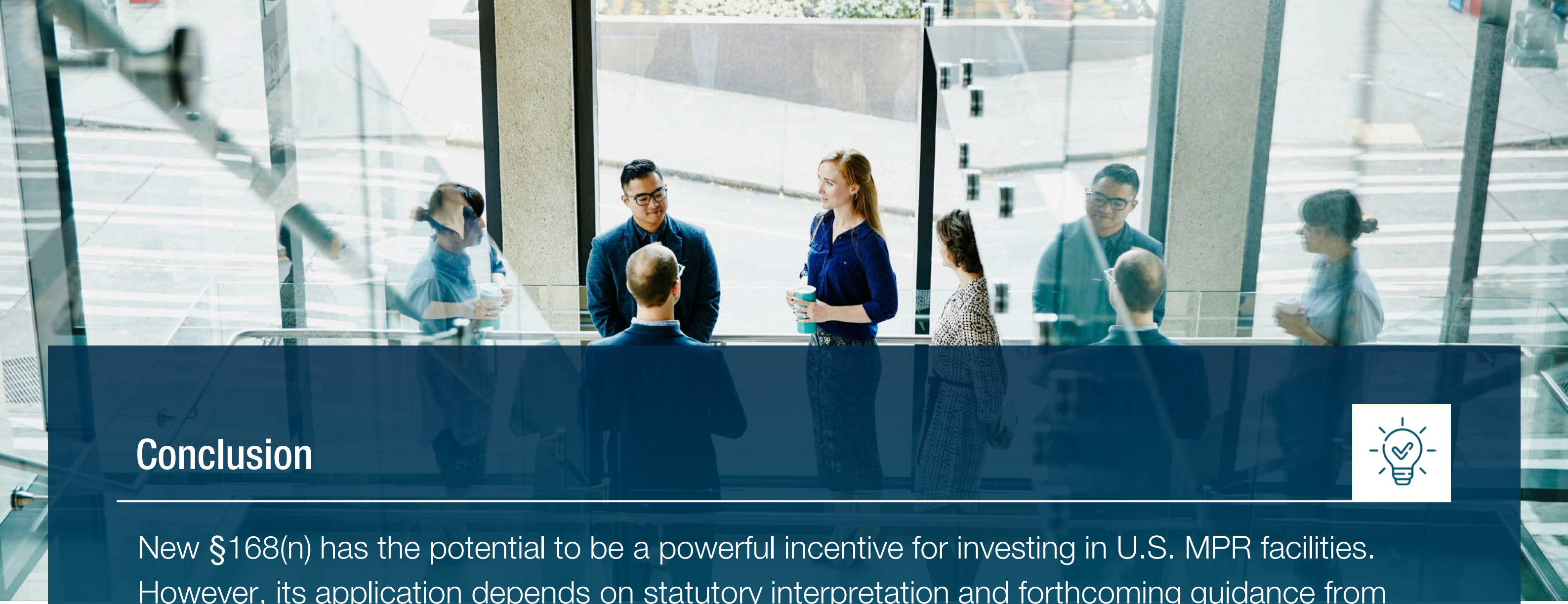
Taxpayers should evaluate the depreciation election in the context of long-term business planning and consider the tax implications if their business needs change. Under the §168(n)(5) recapture rules, if QPP ceases to be used in a qualified production activity within ten years after being placed in service, the property will be treated as having been disposed of at the time of such change in use, with gain recognized under §1245. The basis of the property is then increased by the amount of gain recognized.

Interaction with Other Tax Provisions

The 100% QPP deduction can provide eligible taxpayers with improved cash flow and a reduction in the after-tax capital expenditure. However, taxpayers should carefully analyze the impact and interplay with other provisions. For example:

- **Uniform capitalization (§263A)**
  The uniform capitalization rules under §263A require taxpayers to capitalize costs related to the manufacturing or resale of inventory. Because QPP relates to manufacturing, the 100% special depreciation may be capitalized as additional §263A costs and delay the timing of the benefit until the inventory is sold.
- **Interest-deduction limitation (§163(j))**
  Because depreciation is added back in computing adjusted taxable income for purposes of §163(j) (reinstated under the OBBBA), electing 100% depreciation under §168(n) will not negatively impact taxpayer's interest deduction cap.
- **International and other tax considerations**
  Increased depreciation may affect international and other tax positions, for example, the amount of foreign-derived deductible eligible income (FDDEI, formerly FDII), as well as the creation and utilization of net operating losses due to the 80% limitation under §172.

Taxpayers should carefully consider and model these and other tax implications in deciding whether to make the §168(n) depreciation election.



Conclusion

New §168(n) has the potential to be a powerful incentive for investing in U.S. MPR facilities. However, its application depends on statutory interpretation and forthcoming guidance from Treasury and the IRS. As written, the provision ties eligibility to substantial transformation of products, which may exclude many modern manufacturing activities that don't fit neatly into that definition, and also includes other restrictions and limitations that require some clarification. In the meantime, taxpayers planning new or expanded facilities should carefully evaluate the potential benefits of §168(n) and ensure they qualify for the 100% special depreciation allowance.

A&M Tax experts are available to assist you in evaluating cash-tax savings opportunities under §168(n) and ensuring compliance.

To explore additional insights on the OBBBA and its tax provisions beyond Section 168(n) depreciation, visit: The OBBBA Passed… Now What?

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