

## YEAR-END PLANNING: MAKE BEST USE OF QUICK WRITEOFFS FOR CAPITAL GOODS PURCHASES—PART I, BONUS DEPRECIATION

An expanding and strengthening economy may mean that Dec. 31, 2013 will be the end of the line for some stimulus-type tax breaks. Unless Congress acts, additional depreciation deductions under Code Sec. 168(k) in the placed-in-service year equal to 50% of the adjusted basis of qualified property (often referred to as bonus depreciation) generally won't be available for property placed in service after this year. Also slated for disappearance is the 15-year writeoff and special expensing allowance for qualified leasehold improvement property, retail improvements, and restaurant property. Finally, the overall Code Sec. 179 expensing limit is set to plummet to \$25,000 for property placed in service next year. Thus, enterprises planning to purchase machinery and equipment or invest in eligible real estate assets during the remainder of this year or early the next should try to accelerate their buying plans, if doing so makes sound business sense. This is the first installment of a three-part article on how businesses may be able to lock in accelerated deductions by buying qualifying assets this year and placing them in service before year-end.

Part I, in this article, concentrates on how to make the most of the 50% bonus first-year depreciation allowance for qualified assets placed in service this year.

### **Buy Depreciable Property and Place It in Service This Year to Lock in 50% Bonus First-Year Depreciation**

Under current law, a 50% bonus first-year depreciation allowance applies to qualified property acquired and placed in service after Dec. 31, 2011, and before Jan. 1, 2014 (before Jan. 1, 2015 for certain specialized property). (Code Sec. 168(k); Reg. § 1.168(k)-1(d)(1))

The adjusted basis of qualified property is reduced by the additional 50% depreciation deduction before computing the amount otherwise allowable as a depreciation deduction for the tax year and any later

tax year. If Code Sec. 179 expensing is claimed on qualified property, the amount expensed “comes off the top” before the additional 50% first-year depreciation allowance is computed. Then the taxpayer computes regular first-year depreciation (and depreciation for future years) with reference to the adjusted basis remaining after expensing and after the additional 50% first-year allowance. There is no alternative minimum tax (AMT) depreciation adjustment for property written off under Code Sec. 168(k), which provides for the additional 50% first-year depreciation allowance.

**RIA illustration 1:** XYZ, Inc., a calendar-year business, needs to buy \$1,000,000 of five-year MACRS property. If it does so before Jan. 1, 2014, and places the property in service before that date, XYZ may claim a first-year depreciation allowance of \$600,000 [ $(\$1,000,000 \times .50 = \$500,000$  bonus depreciation) +  $(\$1,000,000 - \$500,000 \times .20 = \$100,000$  regular first-year depreciation)]. This assumes that the half-year convention applies for 2013 (conventions are discussed below). If it waits until 2014 to buy the assets, and bonus first-year depreciation isn't extended, XYZ's regular first-year depreciation allowance using the half-year convention would be only \$200,000 (20% of \$1,000,000).

**RIA observation:** The bonus depreciation deduction is determined without any proration based on the length of the tax year. As a result, accelerated first-year deductions are available even if qualifying assets are in service for only a few days in 2013.

**RIA caution:** Accelerating a purchase into 2013 may not always be a good idea. For example, it may not produce good results for a taxpayer that has an about-to-expire net operating loss. On the other hand, a taxpayer for whom accelerating the purchase will produce a net operating loss for 2013 that can be carried back to 2011, and who had income taxed at the highest rate in that year, has a good reason to make the purchase in 2013.

**How to qualify for bonus depreciation.** In general, an asset purchased in 2013 qualifies for the bonus depreciation allowance under Code Sec. 168(k) if:

- It falls into one of the following categories: property to which the modified accelerated cost recovery system (MACRS) rules apply with a recovery period of 20 years or less; computer software

other than computer software covered by the amortization of goodwill and other intangibles rules of Code Sec. 197; qualified leasehold improvement property (i.e., certain interior improvements to nonresidential buildings); or certain water utility property.

- It is (a) acquired by the taxpayer after Dec. 31, 2007, and before Jan. 1, 2014 (but only if no written binding contract for the acquisition was in effect before Jan. 1, 2008), or (b) acquired by the taxpayer under a written binding contract which was entered into after Dec. 31, 2007, and before Jan. 1, 2014.
- It is placed in service by the taxpayer before Jan. 1, 2014 (certain aircraft and certain property with a long production period may be placed in service before Jan. 1, 2015).
- Its “original use” commences with the taxpayer. Original use is the first use to which the property is put, whether or not that use corresponds to the taxpayer's use of the property. (Code Sec. 168(k)(2))

The 50% additional first-year depreciation allowance applies to qualified property unless the taxpayer “elects out.” The election out may be made for any class of property for any tax year, and if made applies to all property in that class placed in service during that tax year. (Code Sec. 168(k)(2)(D)(iii))

**RIA caution:** A taxpayer that “elects out” of additional first-year depreciation for a specific class of property is subject to the AMT depreciation adjustment for property in that class. That means AMT depreciation is computed using the 150% declining balance method (switching to straight line in the year necessary to maximize the allowance), except that straight line is used for property for which straight-line depreciation must be used for regular tax purposes. The recovery period is the same for AMT and regular tax purposes.

For eligible qualified property (generally, qualified property eligible for bonus depreciation) that is originally used and acquired after Dec. 31, 2010 and placed in service before Jan. 1, 2014 (Jan. 1, 2015 for certain long-production period property and certain aircraft), corporations can elect to forego bonus depreciation **and** accelerated

depreciation in exchange for an increased AMT credit limitation. (Code Sec. 168(k)(4))

**Last year for extra-generous luxury auto depreciation limits?** If bonus first-year depreciation deductions come to an end at the close of 2013, so will the extra-generous first-year dollar limit on autos, light trucks, and vans subject to the Code Sec. 280F “luxury auto” rules. Under Code Sec. 168(k)(2)(F)(i), the first-year depreciation deduction for new vehicles that qualify for bonus depreciation is \$8,000 more than the first-year depreciation limit that would otherwise apply.

For new vehicles bought and placed in service in 2013, and that qualify for bonus first-year depreciation, the boosted first-year dollar limit is \$11,160 for autos (not trucks or vans), and \$11,360 for light trucks or vans (passenger autos built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis). The regular first-year luxury auto limits (e.g., for vehicles not eligible for bonus depreciation, or for which the taxpayer elects out of bonus depreciation) are \$3,160 for autos and \$3,360 for light trucks or vans. However, under current law, these boosted dollar amounts apply only for vehicles bought and placed in service before 2014. As a result, taxpayers thinking of buying a new auto, light truck or van for trade or business use should buy the vehicle and place it in service this year in order to lock in maximum first-year deductions.

**RIA observation:** Heavy SUVs—those that are built on a truck chassis and are rated at more than 6,000 pounds gross (loaded) vehicle weight—are exempt from the luxury-auto dollar caps because they fall outside of the Code Sec. 280F(d)(5) definition of a passenger auto. Under Code Sec. 179(b)(6), not more than \$25,000 of the cost of a heavy SUV may be expensed under Code Sec. 179. The balance of the heavy SUV's cost may be depreciated under the regular rules that apply to five-year MACRS property (e.g., a 20% first-year depreciation allowance if the half-year convention applies for the placed-in-service year). However, with the 50% first-year bonus depreciation available for qualified assets bought and placed in service in 2013 (in addition to the \$25,000 expensing allowance and regular depreciation), taxpayers buying and placing in service new heavy SUVs in 2013 may be entitled to write off most of the cost of the vehicle in the first year.

**Effect of half-year and midquarter conventions on year-end planning.** The half-year convention generally applies in the computation of depreciation deductions for property (other than real property) first placed in service during the current tax year. Under this convention, a business asset placed in service at any time during the tax year is generally treated as having been placed in service in the middle of that year. (Code Sec. 168(d)(1))

However, the half-year convention only applies if property depreciable under Code Sec. 168 and placed in service during the last three months of the tax year (other than property expensed under Code Sec. 179, residential rental property, nonresidential realty and certain other excluded categories) doesn't exceed 40% of all of such property placed in service during the entire year. If it does, then a midquarter convention applies. (Code Sec. 168(d)(3)) Under that rule, personal property placed in service during any quarter of the tax year is treated as if it had been placed in service at the middle of the quarter in which it was placed in service.

**RIA illustration 2:** Ace, Inc. buys one depreciable asset during 2013, a \$5,000 used machine that's five-year property under MACRS. Assume Ace isn't eligible for Code Sec. 179 expensing. If it places the asset in service during the first three quarters of its tax year, the first-year depreciation allowance is \$1,000 (20%). If it places the asset in service during its 4th quarter, the writeoff is slashed to \$250.

**RIA observation:** The availability of bonus first-year depreciation this year on most new machinery and equipment purchases (see discussion above) substantially diminishes the hazards of buying new assets in the last quarter. The 50% first-year bonus depreciation allowance is available even if the midquarter convention applies. In that case, the midquarter allowance is taken on the adjusted basis of the property after reduction for the bonus depreciation allowance.

**RIA illustration 3:** Able Inc., a calendar-year corporation, is close to buying \$500,000 of new five-year property. This will be its only equipment purchase for the year and Able isn't eligible for Code Sec. 179 expensing. Even though it waits until the last quarter to buy the assets and place them in service, Able's first-year depreciation allowance still will be \$262,500 [ $(\$500,000 \times .50 = \$250,000$  bonus

first-year allowance) + (\$500,000  $\square$  \$250,000  $\times$  .05 = \$12,500 regular first-year depreciation allowance under the midquarter convention)]. If the bonus depreciation rules didn't apply, its depreciation allowance would be only \$25,000 (5% of \$500,000). If it waits until 2014 to place the property in service, and Congress doesn't extend bonus depreciation, Able's depreciation allowance will be \$100,000 (20% of \$500,000).

**RIA observation:** Use of the bonus first-year depreciation allowance has no effect on the determination of whether or not the midquarter convention applies. The 40% test is computed with reference to the adjusted basis of non-realty assets placed in service during the year, without reduction for the bonus depreciation allowance.

**RIA observation:** It may be possible in some cases to avoid application of the midquarter convention by electing to expense under Code Sec. 179 property placed in service during the last quarter. On the other hand, deliberately exceeding the 40% limit to trigger the midquarter convention may be a sound strategy where the taxpayer has placed a large amount of property in service during the first quarter of the year. For instance, if a calendar-year taxpayer placed a large amount of five-year recovery property in service in March of 2013, triggering the midquarter convention for 2013 will produce a 10-1/2 month regular first-year depreciation deduction for that property.