2008 Bonus Depreciation

The general federal income tax rules for depreciation deductions are found in IRC Sec. 168. In addition, IRC Sec. 179 allows eligible taxpayers to expense (immediately deduct) the cost of depreciable personal property (including software) used for business. For tax years beginning in 2008, the maximum Section 179 allowance is a generous $250,000. (Next year, the maximum Section 179 writeoff will drop back to $125,000, adjusted for inflation, unless our beloved Congress takes further action.)

The Economic Stimulus Act of 2008 ("the Stimulus Act") establishes a temporary 50% first-year bonus depreciation break. Under this super-beneficial provision, taxpayers can claim a first-year depreciation writeoff equal to 50% of a qualified asset's cost. [See IRC Sec. 168(k).] The remainder of this *Tax Action Memo* explains how to take advantage of the new bonus depreciation break. This is all according to the statute and Reg. 1.168(k)-1, which was issued back in 2004 in conjunction with an earlier version of first-year bonus depreciation. (The guidance in the old regulation should still be valid, since Congress basically only changed the magic dates in arriving at the current version of bonus depreciation.)

Observation: Interested clients should be advised to take action before it's too late. The bonus depreciation privilege will expire at the end of this year, unless Congress takes further action (which could happen if the economy continues to decelerate).

Basic Eligibility Rules for Bonus Depreciation

To be eligible for 50% first-year bonus depreciation, an asset must pass all three of the following tests.

- It must be "qualified property."
- The original use of the asset must commence with the taxpayer after 12/31/07.
- It must be acquired after 12/31/07 and by no later than 12/31/08.
- In general, the asset must be placed in service by no later than 12/31/08. However, an extended placed-in-service deadline of 12/31/09 applies to certain longer-lived assets.

What Is Qualified Property?

To be qualified property, the asset must fit within one of the following definitions.

1. Eligible Section 168 recovery property with an MACRS recovery period of 20 years or less. This definition encompasses most tangible personal property. (Rev. Proc. 87-56 includes a list of depreciation recovery periods for various types of assets.) Most real estate assets will fail to meet the definition. However, new general purpose buildings used in agriculture have a 20-year recovery period and, thus, qualify for bonus depreciation. As explained later, certain leasehold improvements also qualify. The statute says qualified property does *not* include any asset subject to the alternative depreciation system (ADS) under IRC Sec. 168(g), *unless* the taxpayer voluntarily elected to use ADS for the asset in which case it can still be eligible property. ADS depreciation is generally required for property used predominately outside the United States, used by a tax-exempt entity, and financed by tax-exempt bonds. Therefore, such property will be ineligible for bonus depreciation. Also, farmers who elect of the UNICAP rules under IRC Sec. 263A(d)(3) are required to use ADS, which makes them ineligible for bonus depreciation. The "normal" MACRS recovery period is used to determine

if an asset has a recovery period of 20 years or less—even if the taxpayer elects to depreciate the asset over the longer ADS period. [See Reg. 1.168(k)-1(b)(2)(i)(A)).]

2. Depreciable computer software that is *not* amortizable over 15 years under IRC Sec. 197. Most purchased software is depreciable using the straight-line method over 36 months [IRC Sec. 167(f)(1)]. This software is thus eligible for bonus depreciation. Software is amortizable under IRC Sec. 197 only when: (1) it is acquired as part of an overall business acquisition transaction and (2) it is *not* readily available for purchase by the general public. [See IRC Sec. 197(e)(3).]

3. Water utility property, as defined in IRC Sec. 168(e)(5).

4. Qualified leasehold improvement property.

Certain Leasehold Improvement Costs Qualify

The 50% first-year bonus depreciation break is available for the cost of "qualified leasehold improvement property." To meet this definition, *all* of the following tests must be passed [IRC Sec. 168(k)(3)]:

- The improvement must be to the interior portion of a building.

- The building must be nonresidential real property.

- The improvement must be made pursuant to or under a lease by either the lessee (or sublessee) or the lessor to property that will be occupied exclusively by the lessee (or sublessee).

- The improvement must be placed in service more than three years after the date the building was first placed in service.

Certain improvements are ineligible by definition. These include the following:

- Expenditures to enlarge a building.

- Costs for any elevator or escalator, any structural component benefiting a common area, and any internal structural framework of a building.

- Improvements made pursuant to leases between certain related parties. For this purpose, members of an affiliated group as defined by IRC Sec. 1504 are considered related, as are related parties as defined by IRC Sec. 267(b) by substituting "80% or more" ownership for "more than 50%" ownership.

Example 1: Bonus depreciation for leasehold improvement costs.

RobinCo, a retailer, leases space in an existing mall. Pursuant to the lease, RobinCo spends $100,000 during 2008 on various leasehold improvements (new walls and dividers, a ceiling, lighting fixtures, and gates and decorative improvements to the front of the retail space) that are placed in service by 12/31/08. RobinCo can claim 50% first-year bonus depreciation on the entire $100,000 cost of the leasehold improvements (assuming the mall building was placed in service more than three years prior to the placed-in-service date for RobinCo's leasehold improvements).

Only New Assets Are Eligible (But "New" Will Probably Be Defined Liberally)

As mentioned earlier, an asset is eligible for first-year bonus depreciation only if its original use commenced with the taxpayer after 12/31/07. In other words, the asset must be "new" rather than "used."

A special exception applies to assets that are sold and leased back. If the asset in question is originally placed in service after 12/31/07 by a person and is then sold to the taxpayer for leaseback to that same person within three months after being placed in service, the asset is treated as a new asset placed in service by the taxpayer on a date not earlier than the date it is used first by the lessee under the leaseback arrangement. [See IRC Sec. 168(k)(2)(E)(ii).]

The additional cost incurred to recondition or rebuild a used asset will apparently satisfy the original-use requirement. The cost of the used asset itself generally will not satisfy the requirement. However, the old regulation provided a safe-harbor rule to determine when an asset can be considered entirely new after substantial reconditioning or rebuilding. According to the safe harbor, an asset that contains used parts will be considered an entirely new asset if the cost of the used parts is 20% or less of the total cost. [See Reg. 1.168(k)-1(b)(3)(i).]

Example 2: Reconditioning cost will apparently qualify for bonus depreciation.

During 2008, CheapCo buys a used machine for $20,000 and spends $5,000 to recondition it. The $20,000 purchase price is ineligible for bonus depreciation. The $5,000 additional cost to recondition the machine is eligible for bonus depreciation—assuming all the other requirements are also met for the $5,000 expenditure. [See Reg. 1.168(k)-1(b)(3)(v), Example 1.]

Example 3: Entire cost of substantially rebuilt asset apparently qualifies for bonus depreciation.

During 2008, CheapCo buys another machine for $25,000. Of the total cost, $20,000 (80%) is attributable to new parts while only $5,000 (20%) is attributable to used parts. Under the safe-harbor rule, the machine is deemed to be new. Therefore, the entire $25,000 cost is apparently eligible for bonus depreciation—assuming all the other bonus depreciation requirements are met.

In addition, new property initially used by a taxpayer for personal use and subsequently converted to business use will apparently meet the original-use requirement. [See Reg. 1.168(k)-1(b)(3)(ii).]

Example 4: Asset converted from personal to business use can apparently qualify for bonus depreciation.

In 2008, Joe Bobcat bought a new Suburban, which he uses only for personal purposes until 7/1/08. On that date, Joe begins using the vehicle exclusively in his sole proprietorship landscaping business. Because Joe converted the Suburban to business use on 7/1/08, its original use is considered to begin on that date. Therefore, the Suburban qualifies for the bonus depreciation privilege.

Observation: When a taxpayer converts an asset from personal to business use, the basis for depreciation purposes is the lesser of: (1) the taxpayer's adjusted basis in the asset or (2) its fair market value of as the conversion date. Also, note that the Section 179 deduction cannot be claimed for an asset converted from personal to business use. [See Reg. 1.167(g)-1, IRC Sec. 179(d), and Rev. Rul. 77-448.] Since no Section 179 deduction can be claimed for Joe's Suburban, its eligibility for the bonus depreciation break is truly a bonus for Joe!

Last but not least, the initial buyer of a demonstrator auto held primarily for sale in the ordinary course of business will apparently be treated as the original user [Reg. 1.168(k)-1(b)(3)(v), Example 2].

Acquisition Date Must Be within Applicable Period

To be eligible for bonus depreciation, an asset must be acquired after 12/31/07 (with no written binding contract for acquisition in effect before 1/1/08). The asset must also be acquired by no later than 12/31/08. In the case of self-constructed property, the acquisition date rule is met if the taxpayer begins manufacturing, constructing, or producing the property after 12/31/07, and by no later than 12/31/08.

Placed-in-service Date Must Be within Applicable Period

To be eligible for bonus depreciation, the asset generally must be placed in service after 12/31/07 and before 1/1/09. The full amount of the bonus depreciation is allowed for qualified property placed in service at any time within the applicable period. For example, no proration of the deduction is required even if an asset is placed in service on 12/31/08.

Under a special exception, the placed-in-service deadline is extended to 12/31/09 for the following longer-lived property. [IRC Sec. 168(k)(2)(B)]:

- Certain self-produced MACRS property with a recovery period of 10 years or longer or MACRS property with a recovery period of 10 years or longer that is acquired for resale. Such an asset must have an estimated production period of more than one year and a cost of more than $1 million.

- Certain transportation property.

- Certain aircraft.

Warning: Under the extended placed-in-service rule, only the portion of an asset's basis that is allocable to costs incurred before 1/1/09 is eligible for bonus depreciation. [See IRC Sec. 168(k)(2)(B)(ii).]

Coordination with Other Depreciation Rules

As you know, the midquarter convention (instead of the mid-year convention) is required to be used to calculate first-year depreciation when more than 40% of the aggregate basis of the taxpayer's depreciable property additions (excluding most real property) is placed in service during the last three months of the tax year. For this purpose, however, the amount of basis deducted under IRC Sec. 179 is not counted. [See Reg. 1.168(d)-1(b)(4).] Thus, a common tax planning technique is to use the Section 179 privilege to expense the cost of assets added during the last three months of the year in order to fall beneath the 40% threshold and thereby avoid getting stuck with the midquarter convention.

Unfortunately, however, the full amount of basis for which bonus depreciation is claimed must be counted for purposes of the 40% test. This is because the bonus depreciation rule is part and parcel of IRC Sec. 168. [See IRC Sec. 168(d)(3).] In other words, claiming bonus depreciation won't help the taxpayer avoid the midquarter convention. Sorry!

Bonus depreciation is claimed *after* reducing basis by the amount of any Section 179 deduction claimed for the same asset, but *before* calculating regular MACRS depreciation for the same asset.

Example 5: Interaction of bonus depreciation and Section 179 deduction.

Beta Corp. places a new $600,000 machine in service on 5/1/08. Beta elects to use its full $250,000 Section 179 allowance on the machine, which also qualifies for 50% first-year bonus depreciation. Assume the machine has a seven-year MACRS recovery period and that Beta uses the half-year convention for 2008. Beta's 2008 depreciation deduction for the machine is calculated as follows.

Section 179 deduction	$ 250,000
50% bonus depreciation [($600,000 – $250,000) × .50)]	175,000
MACRS depreciation ($600,000 – $250,000 – $175,000) × .1429	25,008
Total first-year depreciation	$ 450,008

Favorable Treatment under AMT Rules

Bonus depreciation applies for both regular tax and AMT purposes. In addition, there's no AMT adjustment with respect to regular MACRS depreciation deductions for the remaining 50% of the cost of qualified property. [See IRC Sec. 168(k)(2)(G).]

Bottom Line: The depreciation rules are the same for both regular tax and AMT purposes when 50% first-year bonus depreciation is claimed for the asset in question. Great!

Example 6: No AMT adjustment required for qualified property.

Willie owns a very profitable single-member LLC. However, Willie has been a frequent AMT victim. Part of the reason is because his business requires significant investments in depreciable equipment which trigger AMT depreciation adjustments. Also, Willie pays high personal income and property taxes, which exacerbate his AMT situation. Fortunately, there's no AMT depreciation adjustment for new equipment for which bonus depreciation is claimed. In other words, there's no adjustment with respect to the 50% bonus depreciation, nor is there any adjustment for the regular MACRS depreciation claimed for the remaining 50% of basis, even though there would be AMT adjustments with respect to Willie's regular MACRS deductions in the absence of the bonus depreciation rule.

Observation: In effect, claiming bonus depreciation for qualified assets exempts them from any and all AMT depreciation adjustments.

Impact of Bonus Depreciation on New Passenger Autos and Light Trucks

For a new passenger auto used over 50% for business and subject to the dreaded luxury auto depreciation limitations, bonus depreciation increases the maximum first-year depreciation deduction by a healthy $8,000. [See IRC Sec. 168(k)(2)(F).] For new passenger autos acquired and placed in service in 2008, the maximum first-year depreciation deduction is now $10,960 ($2,960 + $8,000). For new light trucks acquired and placed in service in 2008, the maximum first-year depreciation deduction is now $11,160 ($3,160 + $8,000). (See Rev. Proc. 2008-22.) Of course, the full amount is only available when the passenger auto or light truck is used 100% for business. For instance, say a light truck is used 80% for business. The maximum first-year depreciation deduction would be only $8,928 (.80 × $11,160).

Warning: Passenger autos and light trucks used 50% or less for business must be depreciated under the alternative depreciation system (ADS) rather than under the regular MACRS rules. Such autos are therefore ineligible for bonus depreciation. Also, when bonus depreciation is

claimed and business use drops to 50% or less in a subsequent year, the bonus depreciation amount is subject to recapture in the same manner as regular MACRS depreciation is subject to recapture. [See IRC Sec. 168(k)(2)(F)(ii).]

Impact of Bonus Depreciation on New Heavy SUVs

The maximum Section 179 deduction for heavy SUVs is limited to $25,000. However, combining the $25,000 Section 179 deduction with the new bonus depreciation break can lead to potent tax-saving results.

Example 7: Massive first-year write-off for heavy SUV.

In 2008, Frank buys a new $60,000 Escalade and uses it 100% in his SMLLC's business. On his 2008 Form 4562, Frank can claim a $25,000 Section 179 deduction. Next, he can deduct $17,500 worth of bonus depreciation [($60,000 – $25,000) × .50]. Finally, he can probably deduct another $3,500 worth of "regular" MACRS depreciation [($60,000 – $25,000 – $17,500) × .20]. So, Frank's first-year depreciation deductions add up to a whopping $46,000, which amounts to about 76% of the Escalade's cost. Sweet!

Note: To qualify for both the Section 179 deduction and bonus depreciation, the SUV must be new, used 50% for business, and have a gross vehicle weight rating (GVWR) over 6,000 pounds.

"Electing Out" of Bonus Depreciation

A taxpayer can "elect out" of bonus depreciation with respect to any class of property. [See IRC Sec. 168(k)(2)(D)(iii).] The term *class of property* refers to the 3, 5, 7, 10, 15, and 20-year MACRS recovery classes. The election out must be made for all additions within the class for which the election is made that are placed in service during the tax year for which the election is made. Presumably, the 2008 Form 4562 instructions will specify exactly how to elect out.

Observation: Electing out can be advisable for taxpayers with expiring NOLs or self-employed individuals who want to preserve a certain level of earned income to make larger contributions to their retirement plans. However, electing out also increases the taxpayer's exposure to AMT. So, be careful out there!

Tax Planning Implications

Although electing out of the bonus depreciation privilege makes sense in limited circumstances, taxpayers will usually benefit by claiming as much bonus depreciation as the law allows to minimize taxable income. Remember also that claiming bonus depreciation for an asset effectively exempts it from AMT depreciation adjustments, which is generally a good thing.

When the objective is to minimize taxable income, the Section 179 deduction should be used first to expense assets that are *not* eligible for bonus depreciation. That way, a greater amount of basis can be depreciated under the bonus depreciation rules, which increases the taxpayer's overall depreciation write-off. The most obvious example of this strategy is to use as much of the Section 179 allowance as possible for used equipment additions that are ineligible for bonus depreciation. Next, the Section 179 deduction should be used to expense assets with longer recovery periods. That way, a greater amount of basis can be written off faster. Bonus depreciation deduction then can be claimed for the remaining basis (after subtracting the Section 179 deduction).

References:

IRC Secs. 167, 168, 179, 197, 267, and 1504.
Reg. 1.168(k)-1.
Rev. Rul. 77-448, 1977-2 CB 78.
Rev. Procs. 87-56, 1987-2 CB 674, and 2008-22, 2008-12 IRB.

This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

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