Depreciation after the 2003 Tax Act—Part 1

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THE JOBS AND GROWTH TAX RELIEF RECONciliation Act of 2003 (JGTRRA) made significant changes to the rules affecting capitalization and depreciation of business assets. Code §179 additional first-year expensing limits were increased from $25,000 to $100,000 for 2003, and Code §168(k) was amended to increase bonus depreciation from 30% to 50% (for qualified assets placed in service after May 5, 2003). Part one of this two-part article discusses the basic changes made in these provisions. Part two will cover more specific situations and suggest some planning opportunities.

The basic issue of whether an expenditure is a direct expense allowing a write-off in the current year or is an asset benefiting more than the current year and, thus, requiring capitalization and expensing over its statutory life, was not directly affected by the JGTRRA's new provisions. The effect of these provisions will be to allow substantially larger amounts of asset expenditures to be expensed by businesses in the year of purchase. These changes constitute a major tax break for almost all businesses.

First, a decision must be made—using existing rules—whether an expenditure is an expense or an asset requiring capitalization. If it's an expense, the treatment doesn't change from prior years. If the item is subject to depreciation, however, the new rules can have an impact on how the asset is expensed for federal income tax purposes.

If the asset qualifies for the revised §179 additional first-year expensing and the proper election is made, these revised rules will be applied. Then the new 50% bonus depreciation provision of §168(k) will be applied to the asset (if it qualifies for this treatment). The definitions of qualified property under these sections are similar though not identical. Finally, after the additional first-year expensing and bonus depreciation amounts are taken, the remaining basis of the asset, if any, is depreciated using MACRS depreciation or other allowable depreciation methods.

Section 179 Expensing

Section 179 expensing is available only (1) for qualified property, (2) for amounts not in excess of the annual statutory amounts allowable in the Code, and (3) if §179 treatment is elected by the taxpayer. Since there are limits on the aggregate amount of §179 expensing that can be taken in any one year, careful planning dictates that this election should be made with care.

Qualified property is redefined as §1245 assets (tangible personal property and a few other specified items subject to depreciation recapture) purchased for use in a trade or business where the property is either (1) tangible property normally subject to §168 MACRS depreciation, or (2) off-the-shelf computer software that is readily made available for purchase by the general public, including businesses, and is subject to depreciation under Code §167. The second item was added by the JGTRRA and applies to software placed in service in a tax year that begins after December 31, 2002, and before January 1, 2006. For 2003, the aggregate amount of §179 expensing allowable for qualified asset purchases is raised from $25,000 to $100,000. The amounts expensed reduce the taxpayer's basis in the assets selected for §179 expensing. For 2004 and 2005, the amount is indexed and thus will be adjusted for inflation. In 2006, the §179 amount is scheduled to return to the pre-JGTRRA level ($25,000).

Also, as before, the amount allowable is subject to phaseout rules when the amount of qualified property purchased in the year exceeds certain statutory amounts. For 2003, the limit is raised from $200,000 to $400,000. When qualified property purchases exceed this threshold, the taxpayer loses $1 of §179 expense for each $1 of qualified property purchases in excess of the threshold. Thus, §179 expensing is phased out when qualified property purchases exceed $500,000. This limitation amount also is indexed for inflation for 2004 and 2005, and it is scheduled to return to the pre-JGTRRA level of $200,000 in 2006.

Example 1: A business acquires $440,000 of qualified property in 2003 and elects §179 expensing. Assume that the qualified property is five-year MACRS recovery property. Under the altered §179 provision, the taxpayer will be allowed to expense currently $60,000 ($100,000 - ($440,000-$400,000)) of the $440,000 of qualified property. The remaining basis may then be subjected to the new 50% bonus depreciation (discussed below). Any remaining basis after that can be depreciated using regular depreciation methods.

In electing §179 expensing, the taxpayer still selects the qualified properties that will be expensed. Because of the limits on §179 expensing and because different assets are subject to different depreciation methods and statutory lives, this election—and the selection of assets—should be made to ensure maximum benefit is derived from the combination of §179, bonus depreciation, and regular depreciation for the current and future years.

Bonus Depreciation

Although the §179 changes will help mostly small businesses, the revised bonus—or additional first-year—depreciation provisions of §168(k) will have an impact on almost all businesses. Prior to the JGTRRA, a taxpayer could expense 30% of the basis of qualified property (after any §179 expensing amount reduces the basis of the property) in the first year it was placed in service. Generally, qualified property is (1) MACRS property with a recovery period of 20 years or less, (2) water utility property, (3) computer software subject to depreciation under §167, or (4) qualified leasehold improvement property. Original use of the property must have begun with the taxpayer after September 10, 2001. The taxpayer must have acquired the property after September 10, 2001, and before January 1, 2005, and the property must be placed in service before January 1, 2005.

The JGTRRA adds another first-year depreciation deduction: 50% of the adjusted basis of qualified property. For purposes of the 50% deduction, qualified property generally is defined the same as for the 30% deduction. The dates, however, are different: the 50% provision applies to property that is placed in service after May 5, 2003, and before January 1, 2005. No binding contract to acquire the property may have been in effect before May 6, 2003. The House Committee Report for the JGTRRA clarifies that the adjusted basis of qualified property acquired by a taxpayer in a §1031 like-kind exchange or in a §1033 involuntary conversion is eligible for the additional first-year depreciation deduction. If the taxpayer elects 30% first-year additional depreciation for a class of property, then the 50% provision doesn't apply. If the taxpayer does not elect 30% first-year additional depreciation, then the 50% provision applies unless the taxpayer elects out of it. If that occurs, then depreciation deductions will stem solely from the regular MACRS provisions. A taxpayer's use of 50% first-year additional depreciation can provide a substantial first-year deduction for qualified property.

Example 2: Now let's assume that the business in Example 1 acquires $400,000 of qualified property in 2003, elects §179 expensing, and uses 50% additional first-year depreciation. Under the new §179 limits, the taxpayer expenses $100,000 of the property's cost, so the basis of the property is reduced to $300,000 for purposes of the 50% additional first-year depreciation deduction. Of that basis, $150,000 is expensed under the 50% provision. Assuming that the half-year convention applies and that the taxpayer will use regular MACRS to depreciate the property (i.e., use 200% declining balance depreciation), 20% of the remaining basis of $150,000 is depreciated. So $280,000 (70%) of the property's total cost is deducted in the first year!

The JGTRRA also changed the first-year allowable depreciation amount for a passenger automobile where the 50% additional first-year depreciation deduction is taken. In lieu of the $4,600 increase in the first-year allowable deduction permitted for automobiles that are subject to the 30% provision, the JGTRRA provides that the increase is $7,650 for passenger automobiles where the 50% provision is used. Neither amount is indexed for inflation. ■

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