

# Bonus Depreciation and the Business Automobile Exception

The IRS issued Rev. Proc. 2011-26 to provide relief from the unintended result of zero depreciation being claimed in years 2 through 6 when electing 100% bonus depreciation for business automobiles placed in service in 2011.

Section 401(b) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312, December 17, 2010) (hereafter, Tax Relief Act of 2010) added IRC §168(k)(5), which provides business owners the opportunity to take 100% (instead of 50%) bonus depreciation for qualified property. On the surface, this provision is intended to boost the economy by providing business owners an incentive to replace existing assets that may be nearing the end of their usefulness with newer and presumably better technology assets. An unintended result of this legislation arises with business automobiles that are classified as listed property, which makes them subject to special depreciation limits during the recovery period (IRC §280F). That is, a taxpayer can claim up to \$11,060 on an automobile placed in service in 2011 but can't then claim any of the unused depreciation until after the recovery period ends (i.e., 2017). Relief from this unintended result is provided by Revenue Procedure 2011-26

(IRB 2011-16, March 29, 2011).

## Limitations on Passenger Automobiles Depreciation

In general, the costs of business assets with a life greater than one year are required to be capitalized and then depreciated over the applicable recovery period. Any automobile or light general purpose truck is classified as listed property and can be depreciated by means of straight-line or modified accelerated cost recovery system (MACRS) depreciation over five years and the use of the half-year convention. IRC §280F(a), however, limits the amount of depreciation that may be claimed for any taxable year. The maximum depreciation deduction for automobiles placed in service in 2010 and 2011 (Rev. Proc. 2010-18, IRB 2010-9, February 16, 2010, and Rev. Proc. 2011-21, IRB 2011-12, March 1, 2011) is \$3,060, \$4,900, and \$2,950 for the first three years, respectively, and \$1,775 for each succeeding taxable year in the recovery period. For trucks and vans, the depreciation limit for the first three years is \$3,160, \$5,100, and \$3,050 (\$3,260, \$5,200, and \$3,150), respectively, and \$1,875 (\$1,875) for each succeeding taxable year in the recovery

period. Let's take a look at an example to illustrate.

**Example 1:** Josie purchases and places an automobile into service for her business on August 3, 2011. The automobile cost is \$30,000 and is used 100% for business. This means the cost of the automobile is qualified listed property, so Josie can elect to use the optional depreciation percentages for five-year property. If Josie elects out of 100% bonus depreciation on this asset, she would claim the following depreciation expenses: \$3,060 in 2011, which is the lesser of \$3,060 and \$6,000 (20% of \$30,000); \$4,900 in 2012, which is the lesser of \$4,900 and \$9,600 (32% of \$30,000); \$2,950 in 2013, which is the lesser of \$2,950 and \$5,760 (19.2% of \$30,000); and then \$1,775 in 2015 and every year thereafter until the asset is totally expensed or liquidated.

## Bonus Depreciation

To stimulate the economy, legislation was enacted that allowed taxpayers to elect 50% bonus depreciation on qualified business assets placed in service after December 31, 2007, and prior to January 1, 2013. As a further stimulus, the Tax Relief Act of 2010 increased the bonus depreciation

election to 100% for qualified business assets placed in service after September 8, 2010, and prior to January 1, 2012. Thus business owners are able to expense the entire cost of the qualified business assets in the year the asset is placed in service.

A qualified business automobile placed in service in 2011 and used more than 50% of the time for business purposes is eligible to elect the 100% bonus depreciation election on the business portion of the property. Any depreciation deduction amount in excess of the first-year limitation, however, is treated as unrecovered basis pursuant to IRC §280F(d)(5). Furthermore, under IRC §280F(a)(1)(B)(ii), this unrecovered basis isn't deductible until the first taxable year succeeding the recovery period. A business automobile placed in service in 2011 therefore allows the taxpayer to claim up to \$11,060 of depreciation expense in 2011 by electing 100% bonus depreciation. The difference between the automobile's cost and the \$11,060 is treated as the unrecovered basis that can't be claimed until 2017—and even then the depreciation expense is limited to \$1,775 per year until the automobile is totally depreciated or disposed. This result appears to be inconsistent with the intention of Congress, yet Congress took no corrective action.

### Unrecovered Basis

The IRS issued Rev. Proc. 2011-26 (IRB 2011-16, March 29, 2011) to provide a safe harbor method of accounting that would allow business owners the opportunity to depreciate some of the business

automobile during the recovery period. Specifically, a business owner will be allowed to elect 100% bonus depreciation for the automobile placed in service in 2010 or 2011 and be able to claim the maximum depreciation expense of \$11,060 as provided by IRC §280F(a)(A)(i) in the first year. The unrecovered basis then will be calculated for the first year as the difference between the cost of the asset and the sum of 50% bonus depreciation and first-year MACRS depreciation. Finally, the depreciation expense in the subsequent recovery period years will be calculated as if the taxpayer had elected 50% (instead of 100%) bonus depreciation. The procedure seems complicated, so let's revisit Josie and see how she would apply the new process.

**Example 1 Revisited:** The \$30,000 automobile is placed into service for Josie's business on August 3, 2011, and is used 100% for business. Josie elects 100% bonus depreciation. As a result, she would claim \$11,060 in 2011 as depreciation expense, which is the lesser of \$11,060 and \$30,000. The safe-harbor-deemed depreciation for 2011 is \$18,000, which is the 50% bonus depreciation of \$15,000 ( $\$30,000 \times 50\%$ ) plus the MACRS depreciation of \$3,000 ( $(\$30,000 - \$15,000) \times 20\%$ ). The unrecovered depreciation for 2011 that is delayed until 2017 is \$6,940, which is the safe-harbor-deemed depreciation of \$18,000 less the actual depreciation taken of \$11,060. It should be noted that the delayed unrecovered depreciation amount also is subject to the IRC §280F(a)(1)(B)(ii) limitation rules.

Josie would claim \$4,800 in 2012, which is the lesser of \$4,900 and \$4,800 (32% of \$15,000); \$2,880 in 2013, which is the lesser of \$2,950 and \$2,880 (19.2% of \$15,000); and then \$1,728 in 2014, 2015, and 2016, which is the lesser of \$1,775 and \$1,728 (11.52% of \$15,000). Beginning in 2017 and every year thereafter until the asset is totally expensed or liquidated, Josie would claim \$1,775 in depreciation expense.

### No Unrecovered Basis

Rev. Proc. 2011-26 provides a different safe-harbor rule when there's no unrecovered basis on the qualified business property. In this situation, the taxpayer is unable to use the optional depreciation percentages (e.g., 32% and 19.2%) for computing the depreciation expense in the years subsequent to the year that the automobile is placed in service. Rather, the taxpayer must use the 200% declining balance method and the half-year convention. This situation occurs when an automobile costs less than \$18,433, is used exclusively for business, and the taxpayer elects 100% bonus depreciation. Let's consider a different example.

**Example 2:** Myron places an automobile into service in his business on April 12, 2011. The automobile cost \$16,000, is used 100% for business, and 100% bonus depreciation is elected. Myron would claim \$11,060 in 2011 as depreciation expense, which is the lesser of \$11,060 and \$16,000. The unrecovered depreciation basis for 2011 is zero because the safe-harbor-deemed depreciation of

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\$9,600 ((50% of 16,000) plus (20% of \$8,000)) is less than the actual depreciation of \$11,060. For 2012, Myron would claim depreciation expense of \$1,976, which is the lesser of 40% of the adjusted depreciation basis of \$4,940 (\$16,000 less \$11,060) and the IRC §280F(a)(1)(A)(i) limit of \$4,900.

### Use with Care

Bonus depreciation has attractive cash flow benefits, especially to small business owners. Without the IRS's issuance of Rev. Proc. 2011-26, taxpayers would have been restricted to claiming a limited amount of depreciation expense in the first year alone as a result of the interaction of the bonus depreciation and IRC §280F limitation rules. Fortunately, the IRS intervened by providing the safe-harbor rules that allow taxpayers to claim a limited amount of the 100% bonus depreciation and still be able to claim some depreciation expense during the recovery period.

But a business owner needs to be cautious when viewing this tax benefit. The purchase of new equipment is a current and potentially future drain on the company's cash flow. Unless there's an increase in revenue, the drain could result in the business owner facing another financial choice. Tax benefits are nice, but they aren't the only element to consider when making capital investment decisions. **SF**

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