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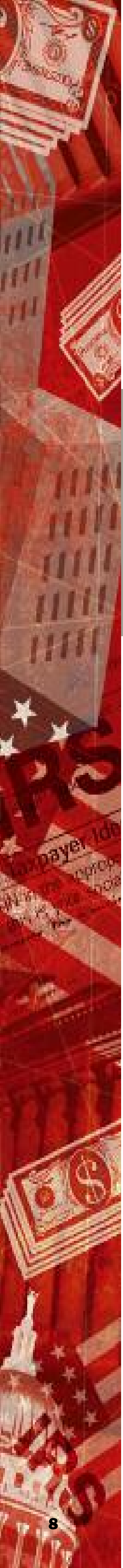

Expensing vs. Capitalizing Business Property in Light of ATRA

Companies facing changing tax rates should examine the full impact of IRC §179 expensing and bonus depreciation when conducting their tax planning. In some situations, they don't provide a better alternative to regular depreciation.

President Obama signed the American Taxpayer Relief Act of 2012 (ATRA) into law on January 2, 2013. This set of tax laws was the outcome of an intense debate among lawmakers, lobbyists, and the Office of the President regarding numerous expiring provisions. Although much attention focused on the tax provisions affecting individual taxpayers, such as tax rates and the alternative minimum tax (AMT), ATRA also provided some tax relief to the business community, such as increasing the maximums for Internal Revenue Code (IRC) §179 expensing and extending bonus depreciation for another year.

Expensing and Depreciation

Introduced in 1982, IRC §179 was intended to benefit businesses with minimal annual investment in capital assets by enabling them to fully expense tangible property in the year it was purchased. While IRC §179 has no actual small business requirement, the limitations for the eligible expense amount and the phase-out based on total annual investment effectively serves smaller companies. Additionally, only profitable businesses benefit from IRC §179 because the expense is limited to a company's modified income before taking the deduction. With the exception of real estate, most types of business equipment and property acquired through purchase qualify for immediate expensing. Further, these assets must be used at least 50% in a taxpayer's business. Expensing under IRC §179 is available to corporations and sole proprietors, and it flows through to partners and shareholders of partnerships and S corporations, respectively.

By 2000, the amount of the immediate expense had increased to $20,000, with a dollar-for-dollar investment limitation of $200,000. A provision was introduced to adjust the yearly allowable expense under IRC §179 for inflation, and, in the past 10 years, the total amount eligible for IRC §179 expensing and the investment limitation have been increased several times. In 2011, they were up to $500,000 and $2 million, respectively. The law that expired in December 2012 had reduced the dollar limit to $139,000 and the investment threshold to $500,000 for 2012. The amounts were set to go back to $25,000 and $200,000 in 2013, but ATRA increased the maximums for 2012 retroactively and for the 2013 tax year to $500,000 and $2 million.

In addition to IRC §179 expensing, businesses can also take advantage of additional first-year depreciation, known as bonus depreciation. Introduced in 2004 at 30% of an asset's cost, bonus depreciation expired in 2007 and was reintroduced in 2008 at 50%. For a 15-month period between September 2010 and December 2011, the bonus depreciation amount was at 100% of an asset's cost. Bonus depreciation was set to expire completely by the end of 2012, but ATRA extended it for one year at the 50% level. Table 1 provides an overview of §179 expensing and bonus depreciation available for 2008 through 2013.

Choosing the Right Option

Many businesses have taken advantage of §179 expensing and bonus depreciation opportunities in order to reduce their taxable income, but it's important to note that these provisions provide only temporary tax relief.

Table 1. IRC §179 and Bonus Depreciation for the Years 2008 through 2013

	§179 (annual election/irrevocable)	Bonus Depreciation (§168(k)) (annual election)
Assets (type)	Tangible property (three-, five-, seven-year MACRS) and computer software Purchased (but can be used)	Tangible property (three-, five-, seven-year MACRS) and computer software Purchased (must be new)
Thresholds	(1) Dollar limit (2) Phase-out if too many purchases (3) Must have income Limit for passenger vehicles	No thresholds based on income or dollar limits/purchase limits
Carryovers	If the §179 expense is limited by *income*, amount not deductible can be carried forward *indefinitely*. (NO carryforward for limitation by dollar limit/phase-out!)	N/A
Recent changes	Dollar limit/phase-out 2008: $250,000/$800,000 2009: $250,000/$800,000 2010: $500,000/$2,000,000 2011: $500,000/$2,000,000 2012: $500,000/$2,000,000 2013: $500,000/$2,000,000 2014+: $25,000/$200,000 (*tentative*)	2008: 50% Bonus 2009: 50% Bonus 2010: 50%/100% Bonus (after 9/8/2010) 2011: 50%/100% Bonus 2012: 50% Bonus 2013: 50% Bonus 2014: none (*tentative*)

If an asset is expensed in the current year, taxpayers won't be able to depreciate it in future years, leading to higher taxable income later. Because of the declining value of money (net present value considerations), it's generally better to get a tax benefit now than later. Thus it makes sense for businesses to expense as much as possible for tax purposes in the year when the capital expenditure occurs. This logic may not apply, however, in situations when tax rates change, which currently is the case for business owners (sole proprietors, S corporation shareholders, partners, and members of LLCs) who have taxable income in excess of $400,000 (single taxpayers) or $450,000 (married filing jointly). The question in that situation is whether the jump from a 35% tax rate to a 39.6% rate justifies using regular depreciation in lieu of either §179 expensing or bonus depreciation. For regular C corporations, the tax rates haven't changed with ATRA, but there have been arguments that the relatively high corporate tax rate in the United States hurts businesses. A lower corporate tax rate would indirectly affect individual investors also (due to higher post-tax earnings) and would have the opposite effect with regard to the expensing vs. capitalizing decision (in other words, expensing would be superior to depreciating over time).

Due to the low inflation and almost 0% interest rates on many savings instruments, we believe that a very low discount rate is justified for some taxpayers. We therefore calculated the net present value (NPV) of the tax benefit of expensing vs. depreciating for various situations using rates of 1%, 3%, and 5% for properties placed in service in 2012 and 2011. For all calculations, we assumed an original investment of $1 million.

Table 2 shows the calculations for property placed in service in 2012. The taxpayer can use §179 expensing and/or 50% bonus depreciation (assuming the property qualifies). Our comparisons involved using both expensing and bonus depreciation vs. using neither for seven-year and five-year property. Because of the tax rate change in 2013, taxpayers might be better off using regular depreciation (Modified Accelerated Cost Recovery System, or MACRS) for properties placed in service in 2012 as opposed to §179 expensing or bonus depreciation. The benefit of using regular depreciation vs. expensing depends on the life of the property and the discount rate.

Table 3 looks at the calculations for property placed in service in 2011. Due to tax rate changes, one

Table 2. Using §179 and Bonus Depreciation vs. MACRS for Property Placed in Service in 2012

	Five-year MACRS Property			Seven-year MACRS Property		
	With §179 & Bonus	Regular MACRS	Tax Shield Difference	With §179 & Bonus	Regular MACRS	Tax Shield Difference
Year 2012 (top tax rate is 35%)	$800,000	$200,000	$(210,000)	$785,725	$142,900	$(224,989)
Year 2013 (top tax rate is 39.6%)	$ 80,000	$320,000	$ 95,040	$ 61,225	$244,900	$ 72,735
Year 2014 (top tax rate is 39.6%)	$ 48,000	$192,000	$ 57,024	$ 43,725	$174,900	$ 51,945
Year 2015 (top tax rate is 39.6%)	$ 28,800	$115,200	$ 34,214	$ 31,225	$124,900	$ 37,095
Year 2016 (top tax rate is 39.6%)	$ 28,800	$115,200	$ 34,214	$ 22,325	$ 89,300	$ 26,522
Year 2017 (top tax rate is 39.6%)	$ 14,400	$ 57,600	$ 17,107	$ 22,300	$ 89,200	$ 26,492
Year 2018 (top tax rate is 39.6%)				$ 22,325	$ 89,300	$ 26,522
Year 2019 (top tax rate is 39.6%)				$ 11,150	$ 44,600	$ 13,246
Total difference			$ 27,600			$ 29,570
Net present value using 1% discount rate			$ 20,537			$ 21,986
Net present value using 3% discount rate			$ 12,489			$ 7,938
Net present value using 5% discount rate			$ 3,345			$ (3,429)

Notes:

- Original investment is $1 million
- Property qualifies for §179 expensing and for bonus depreciation
- Maximum §179 expense for 2012 is $500,000
- The taxpayer is in a sufficient net income situation
- Any state tax effects and potential AMT effects are ignored

might wonder if taxpayers would have been better off using regular depreciation rather than taking advantage of the 100% bonus depreciation that was available in 2011. (Some might even consider amending their prior year's return.) The calculations illustrate the hypothetical benefit for tax-

Table 3. Comparison of Depreciation Tax Shield Using 100% Bonus Depreciation vs. Regular MACRS for Property Placed in Service in 2011

	Five-year MACRS Property			Seven-year MACRS Property		
	With §179 & Bonus	Regular MACRS	Tax Shield Difference	With §179 & Bonus	Regular MACRS	Tax Shield Difference
Year 2011 (top tax rate is 35%)	$1,000,000	$200,000	$(280,000)	$1,000,000	$142,900	$(299,985)
Year 2012 (top tax rate is 35%)		$320,000	$ 112,000		$244,900	$ 85,715
Year 2013 (top rate is 39.6%)		$192,000	$ 76,032		$174,900	$ 69,260
Year 2014 (top rate is 39.6%)		$115,200	$ 45,619		$124,900	$ 49,460
Year 2015 (top rate is 39.6%)		$115,200	$ 45,619		$ 89,300	$ 35,363
Year 2016 (top rate is 39.6%)		$ 57,600	$ 22,810		$ 89,200	$ 35,323
Year 2017 (top rate is 39.6%)					$ 89,300	$ 35,363
Year 2018 (top rate is 39.6%)					$ 44,600	$ 17,662
Total difference			$ 22,080			$ 28,161
Net present value using 1% discount rate		$ 18,197			$ 21,343	
Net present value using 3% discount rate		$ 10,832			$ 8,636	
Net present value using 5% discount rate		$ 3,962			$ (2,950)	

Notes:

- Original investment is $1 million
- Property qualifies for 100% bonus depreciation
- The taxpayer is in a net income situation
- Years 2011 and 2012 are not discounted
- Any state tax effects and potential AMT effects are ignored

payers who didn't use the 100% bonus depreciation in 2011 but depreciated the property using MACRS. Because the tax rates didn't change until 2013, the tax shield difference doesn't come into play until later. For three-year property, which isn't shown in the table, using 100% bonus is the better option. Using depreciation instead of expensing would have been better in the case of five-year or seven-year property, but the benefit may not be large enough to warrant filing an amended return (especially in cases where the business is a flow-through entity and at least two returns would need to be amended). If the return is amended for any other reasons, tax professionals may want to consider changing the depreciation method used if the business owners are high-income taxpayers who will benefit from taking the depreciation in 2013 rather than 2011. **SF**

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