

## **Section 168(k) Bonus Depreciation<sup>1</sup>**

The Job Creation and Worker Assistance Act of 2002 created a special depreciation allowance for property placed in service after September 10, 2001. The special depreciation allowance is equal to 30%<sup>2</sup> of the adjusted basis of all qualifying property.

### **A. Types of Qualifying Property**

Section 168(k) special depreciation can be claimed for any property that is

1. **MACRS eligible property with a recovery period of 20 years or less;**

3 year, 5 year, 7 year, 10 year, 15 year and 20 year property, except any property that is *required* to use the Alternative Depreciation System under Section 168(g) such as listed property where the business use percentage does not exceed 50% (See Section 280F(b)(1), property used predominantly outside the United States, tax-exempt use property, and tax-exempt bond financed property.

**Note:** A taxpayer who elects (but is not required) to use Section 168(g) ADS depreciation is permitted to claim a special depreciation allowance.

2. **Water utility property;**
3. **Non-Section 197 computer software; and**

Special depreciation may be claimed with respect to computer software if:

- a. It is computer software as defined in Section 197(e)(3). Section 197(e)(3) defines computer software as any

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<sup>1</sup> Excerpt prepared by Christopher M. Harvey, Esq. for presentation at the 34<sup>th</sup> Annual Tax Forum at Villanova University on January 10, 2003.

<sup>2</sup> The Jobs and Growth Tax Relief Reconciliation Act of 2003 replaces 30% with 50%. §201.

program designed to cause a computer to perform a desired function, but does not include any database or similar item unless the database or item is incidental to the operation of the computer software.

- b. The computer software is off the shelf software or not acquired as part of the purchase of a trade or business.

4. **Qualified leasehold improvements.**

A qualified leasehold improvement is any improvement to the interior of the building which is nonresidential real property if

- a. The improvement is made under or pursuant to a lease by the lessee (or sublessee) or lessor;
- b. The portion of the building is to be occupied exclusively by the lessee (or sublessee); and
- c. The improvement is placed in service more than 3 years after the date the building was first placed in service.

However, qualified leasehold improvements do not include elevators, escalators, structural components that benefit common areas, building enlargement, or a building's internal structural framework.

Certain expenditures that only benefit the tenant's space would qualify as qualified leasehold improvements, such as ceilings and doors, heating and cooling equipment, lighting fixtures that are permanently installed not temporary or removable, and electrical and plumbing systems.

**B. Original Use**

The original use of the property must commence with the taxpayer after September 10, 2001. Original use means the first use of the property. In order to met the original use test, the property

1. **Must be new property.** There is no question that original never used purchases would satisfy this requirement. However, taxpayers could encounter some other more interesting fact patterns.

**Example:** Would a dealer car used for test driving satisfy this requirement?

**Example:** What about a taxpayer who purchased a front end loader from a company who purchased it 2 days earlier but had never accepted delivery (i.e. never placed it in service)?

2. **Qualify as new Section 38 property for purposes of the investment tax credit.**
3. **Capital expenditures incurred by the taxpayer to recondition or rebuild acquired property would satisfy the original use requirement.** However, cost of acquired reconditioned equipment would not satisfy the original use requirement.

**Example:** Taxpayer purchases a used forklift for \$8,000. Taxpayer spends \$4,000 reconditioning the forklift. The \$8,000 purchase price does not qualify, but the \$4,000 spent reconditioning does qualify.

**Example:** Taxpayer purchases a \$12,000 reconditioned forklift. None of the \$12,000 will qualify.

4. **Like Kind Exchange Property Can Qualify.** To the extent that the taxpayer adds boot to the transaction, the additional boot becomes a separate asset under MACRS available for the special depreciation.

**Example:** Taxpayer exchanges a used forklift (FMV: \$10,000, AB: \$5,000) and \$20,000 for a new forklift worth \$30,000. For MACRS property placed in service after 1/3/00, the old basis on exchanged assets are depreciated as though the exchange never took place, while any new basis is treated as a separate asset. Accordingly, the taxpayer will continue to depreciate

the old forklift over its remaining basis of \$5,000. The new basis of \$20,000 will be treated as a separate MACRS asset, qualifying for the special depreciation since the asset is a new purchase.

### **C. Acquired Between**

In order to qualify for Section 168(k) special depreciation, the qualified property must be

1. Acquired after September 10, 2001 and before September 11, 2004<sup>3</sup>; but only if no binding contract to purchase was in place before September 11, 2001; or
2. Acquired by the taxpayer under a written binding purchase contract after September 10, 2001 and before September 11, 2004.

If the qualified property is self-constructed, the taxpayer must begin manufacturing or constructing the asset after September 10, 2001 and before September 11, 2004.

### **D. Placed in Service**

All qualifying special depreciation property must be placed in service by January 1, 2005. However, if the property has a recovery period of at least 10 years or is transportation property (tangible personal property) used in the trade or business of transporting people and property.

### **E. Ordering Rules**

In determining the first year depreciation, the adjusted basis of the asset is reduced by

1. Section 179 limited expensing
2. Section 168(k) special depreciation; then
3. Section 168 MACRS depreciation.

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<sup>3</sup> The Jobs and Growth Tax Relief Reconciliation Act of 2003 extends the acquisition date from September 11, 2004 to January 1, 2005. §201.

To the extent that the Section 280F limitations on luxury automobiles apply, it would apply to cap the sum of the above.

*Example:* Taxpayer acquires \$80,000 5 year MACRS asset on June 15, 2002. Taxpayer elects to expense \$24,000 under Section 179 and elects to claim the special depreciation.

Cost of the Asset	\$80,000
Section 179 Limited Expensing	<u>(24,000)</u>
Basis for 168(k) Special Depreciation	56,000
30% Special Depreciation	<u>(16,800)</u>
Basis for Section 168 MACRS	<u>39,200</u>
First Year MACRS (20%)	<u>(7,840)</u>
Total Depreciation in First Year	<u><u>\$48,640</u></u>

## **F. How to Claim the Deduction**

**Where to Claim.** The special depreciation allowance of Section 168(k) is generally claimed on Line 14 of Form 4562. However, listed property is claimed on Line 25 of Form 4562 and employee vehicle depreciation is claimed on Form 2106.

**Automatic Election.** Section 168(k) special depreciation is automatic unless the taxpayer elects out. The election to opt out of the special depreciation is made on a class by class basis and must be made by the due date (including extensions) of the tax return for the year in which the qualified property was placed in service. The Instructions to Form 4562 state:

**Election out.** You may elect, for any class of property, not to treat as qualified property all property in such class placed in service during the tax year. If you make the election, the property may be subject to an AMT adjustment for depreciation. To make the election, attach a

statement to your timely filed return indicating that you are electing not to claim the additional allowance and the class of property for which you are making the election. For more details, see Rev. Proc. 2002-33.

**Planning Point.** Generally, A taxpayer will want to claim the special depreciation. However, some taxpayers might come out ahead by electing out of the special depreciation. Taxpayers with expiring NOL loss carryforwards or who are in a low marginal tax bracket currently but expect to be in a higher marginal tax bracket in the future should consider an election out of the special depreciation.

***Missed Filing the Automatic Election?*** If a taxpayer timely filed without filing the appropriate election opting out of the special depreciation, the taxpayer has 6 months after the due date of the return to file an amended return and make the appropriate election. (If this date is missed, the taxpayer can elect out by seeking a letter ruling under Treas. Reg. Section 301.9100-3). Alternatively, the taxpayer can file an amended return by the due date (including extensions) of the next succeeding tax year to claim the special depreciation.

**Caution:** If the taxpayer fails to take the special depreciation allowance or elect out of the special depreciation, the taxpayer must still reduce basis by the special depreciation.

For returns filed before June 1, 2002, Revenue Procedure 2002-33, taxpayers who did not claim the special depreciation and who did not elect out of the special depreciation have 3 options.

1. ***Claim the benefit on an amended return.*** The taxpayer can file an amended return by the due date (including extensions) of the tax return for the next succeeding year.

2. ***Claim the benefit on the next return.*** Taxpayer can claim the special depreciation allowance on the tax return for the next succeeding tax year by filing Form 3115 Application for Change in Accounting Method.
3. ***Do nothing and forgo the special depreciation.*** A taxpayer who filed a tax return for years 2000 or 2001 before June 1, 2002 and did not claim the special depreciation allowance is deemed to have elected out of claiming special depreciation if the taxpayer claimed regular depreciation on the return.

***Revoking an Election to Not Claim Special Depreciation.*** A taxpayer can only revoke an election to not claim special depreciation with the prior written consent of the Commissioner. See Revenue Procedure 2002-1 for the procedure on requesting the commissioner's permission.

#### **G. Effect on the Alternative Minimum Tax**

The special depreciation allowance is not an adjustment for the alternative minimum tax. While the normal MACRS depreciation deductions are an adjustment for AMT purposes, the special depreciation is not. Taxpayers who are in or near to becoming subject to AMT will likely desire to claim the special depreciation allowance.

#### **H. Effect on Luxury Automobiles.**

***Luxury Automobiles.*** Section 280F(d)(5)(A) defines listed property to include any passenger automobile that is 4-wheeled and rated at 6,000 pounds unloaded gross vehicle weight or less. Since all listed property is not qualifying property for the 30% special depreciation, an additional \$4,600<sup>4</sup> is added to the first year Section 280F(a)(1) depreciation limitation. The \$4,600 limitation is not indexed for inflation. For 2002, the first year depreciation limitation is capped at \$3,060 (for both Section 179 and regular MACRS), resulting in a total of \$7,660 with the special depreciation.

***Exception for Trucks, Vans and Sport Utility Vehicles.*** Sections 280F(d)(5)(A)-(B) provide that trucks and vans are not listed property if the

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<sup>4</sup> The Jobs and Growth Tax Relief Reconciliation Act of 2003 increases the \$4,600 to \$7,650. §201.

gross vehicle weight (including passengers and cargo) is more than 6,000 pounds. Private Letter Ruling 9520034 provides that sport utility vehicles are included within the term “truck or van” in Section 280F(d)(5)(B).

**Planning Point.** If a truck, van or sport utility vehicle has a gross vehicle weight rating of more than 6,000 pounds, the taxpayer is entitled to Section 179 limited expensing, Section 168(k) special depreciation and Section 168 MACRS depreciation on the balance not limited by Section 280F. This can be a wonderful tax benefit to a taxpayer. A taxpayer purchasing a \$50,000 sport utility vehicle that is more than 6,000 pounds (e.g. Lincoln Navigator) would be entitled to \$24,000 of Section 179 limited expensing, 30% of the balance of \$36,000 or \$10,800 as Section 168(k) special depreciation, and regular MACRS depreciation on the balance of \$25,200. First year depreciation of 20% would be \$5,040. Total first year depreciation on a \$50,000 SUV would be \$39,840 (nearly 80% of the SUV’s purchase price).

### **I. Effect on Section 1245 Recapture.**

Any special depreciation claimed by a taxpayer (or not claimed but where the taxpayer failed to properly elect out of special depreciation) reduces the adjusted basis of the asset and exposes the taxpayer to a gain on disposition. Any gain on disposition is recharacterized as ordinary income to the extent of any depreciation allowed or allowable.

**Trap for the Unwary.** Here is where that missed election out of special depreciation comes home to haunt the taxpayer. A taxpayer who fails to properly elect out of the special depreciation will be deemed to have taken the special depreciation. Accordingly, the depreciation is now in that category of allowable depreciation. If the taxpayer disposes of the asset, that taxpayer would be in the unfortunate situation of not only

missing a depreciation deduction (the special depreciation), but also having to recognize gain as ordinary income on the disposition. Ouch!

## **THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003**

Section 179 Election to Expense Certain Depreciable Business Assets.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 increases the dollar limitation for taxable years 2003 through 2005 from \$25,000 to \$100,000. In addition the phaseout for the dollar amount of Section 179 property placed into service for those years is increased from \$200,000 to \$400,000. This amount will be indexed for inflation and will only increase in increments of \$1,000.