LAST CHANGE TO USE BONUS FIRST-YEAR DEPRECIATION IN YEAR-END TAX PLANNING

Bonus-first-year depreciation, which was designed to act as an economic stimulus in the wake of the September 11th terrorists attacks, will end on December, 31, 2004, for most taxpayers (unless Congress acts to extend it, which appears to be unlikely). As a result, taxpayers have an additional incentive to accelerate purchases of new depreciable assets into 2004 if their goal is to maximize deductions this year. This <u>Hot Topic</u> takes a detailed look at the closing window of opportunity to claim bonus-first year depreciation, and how to make the most of it in year-end tax planning.

■ Background

Taxpayers are entitled to a bonus first-year depreciation allowance equal to 50% of the unadjusted depreciable basis of property which meets the following requirements:

- The property falls within one of four eligible classes of property. The most widely applicable classes are: MACRS recovery property with a recovery period of 20 years or less; many types of computer software; and qualified leasehold improvement property. In general, qualified leasehold improvement property is any improvement to an interior portion of a building which is nonresidential real property, if: (1) the improvement is made under or pursuant to a lease, as defined, either by the lessee, sublessee or lessor of the building portion; (2) the portion of the building is to be occupied exclusively by the lessee (or any sublessee) of the portion, and (3) the improvement is placed in service more than 3 years after the date the building was first placed in service by any person.

- The original use of qualified property begins with the taxpayer after May 5, 2003. "Original use" is the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer.

- The property is acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition was in effect before May 6, 2003.

- The property is placed in service by the taxpayer before January 1, 2005. (Certain specialized classes of long-lived property may be placed in service before 2006.)

- A taxpayer may elect to claim bonus first-year depreciation at a 30% rate (instead of 50%) or elect not to claim bonus first-year depreciation at all.

  Observation: Bonus first-year depreciation is especially valuable to businesses which will make maximum use of Code Sec. 179, expensing, or won't use it at all because of large purchases of expensing-eligible assets. For tax years beginning in 2004, the maximum expensing allowance of $102,000 is phased out dollar-for-dollar by the amount of expensing eligible assets placed in service in excess of $410,000, and is unavailable when investment in expensing-eligible assets attains

$512,000.

■ Year-end tax planning

The bonus depreciation deduction is not prorated for the time the qualifying property is in service during the year. As a result, accelerated first-year deductions are available even if qualifying assets are in service for only a few days in 2004.

< Illustration 1: ABC Corp. is a calendar-year taxpayer that buys and places in service on December 20, 2004, an item of new 5-year MACRS property costing $50,000. It does not expense any portion of the asset or elect out of the special depreciation allowance. It depreciates the asset using the 200% declining balance method. The half-year convention applies for 2004 rather than the mid-quarter convention. ABC may claim a MACRS depreciation deduction of $30,000 for the property for 2004 ($25,000 bonus depreciation + $5,000 regular depreciation ($50,000 - $25,000 * .20)), even though the property is in service for only a few days in 2004. If, instead, ABC waited until 2005 to buy the property and place it in service, its first year depreciation deduction would be only $10,000 ($50,000 * .20).

■ Effect of expensing

If Code Sec. 179, expensing, is claimed for part of the cost of an asset, the amount expensed is subtracted before the additional 50% first-year depreciation allowance is computed. The taxpayer then computes regular first-year depreciation (and depreciation for future years) with reference to the adjusted basis remaining after expensing and after the additional 50% first-year allowance.

Observation: Year-end tax savings may be less compelling, but still worthwhile, if a substantial portion of the cost of the asset is expensed under Code Sec. 179.

< Illustration 2: Widget, Inc. has a fiscal year ending in May. On December 23, 2004, it buys and places in service $100,000 of new five-year MACRS property. Widget elects to expense $50,000 of the cost of the property under Code Sec. 179, reserving the balance of its expensing allowance ($52,000) for other property. The half-year MACRS depreciation convention applies for the placed-in-service year.

Widget's first-year writeoff for the property is $80,000, calculated as follows:
... $50,000 expensing +
... $25,000 bonus depreciation allowance (($100,000 - 50,000) * .50) +
... $5,000 regular depreciation allowance ($100,000 ! $50,000 ! $25,000 * .20 regular first-year allowance).

< Illustration 3: The facts are the same as in Illustration (2), except Widget buys and places the property in service on February 3, 2005, and expenses $50,000 of the cost of the property. Here, its first year writeoff is $60,000 ($50,000 expensing + $10,000 regular first-year depreciation ($100,000 ! $50,000 * .20).

■ Doubling up on bonus depreciation

When otherwise eligible MACRS property or computer software is acquired via a Code Sec. 1031 like-kind exchange or as a result of a Code Sec. 1033 involuntary conversion, both the carryover basis and the excess basis, if any, of the acquired property are eligible for bonus depreciation. The regulations make it clear it is possible for an initial expenditure on a qualifying asset to result in two bonus depreciation allowances.

< Illustration 4: On December 10, 2003, FF, a calendar-year corporation, bought and placed in service a new $10,000 supercomputer. FF was depreciating the supercomputer using the 200% declining balance method and the half-year convention over the 5-year MACRS recovery period. On December 10, 2004, FF acquired a new supercomputer by exchanging the old supercomputer and $4,000 cash in a like-kind exchange. The following results apply (unless FF elects not to apply the temporary regulations for depreciating property acquired in a Code Sec. 1031 or Code Sec. 1033 exchange):

For 2003, FF may claim a 50% bonus first year depreciation deduction of $5,000 for the original supercomputer (unadjusted basis of $10,000 * .50), and a regular MACRS depreciation deduction of $1,000 ($10,000 ! $5,000 bonus depreciation = $5,000 adjusted depreciable basis * .20 regular first year depreciation allowance).

For 2004, FF may claim a regular MACRS depreciation deduction of $800 for the original supercomputer ($5,000 remaining adjusted depreciable basis * .32 regular second-year depreciation rate * ½ year).

For 2004, the 50% bonus first year depreciation deduction for the new supercomputer is $3,600, calculated as follows:

1. The remaining carryover basis of the traded-in supercomputer at the time of its replacement is $3,200 (original supercomputer's unadjusted depreciable basis of $10,000 ! bonus first year depreciation deduction of $5,000 ! 2003 regular MACRS depreciation deduction of $1,000 ! 2004 regular MACRS depreciation deduction of $800 = $3,200). The bonus first-year depreciation allowance for the remaining carryover basis is $1,600 ($3,200 * .50).

2. The remaining excess basis of the new supercomputer at the time of replacement is $4,000 (the cash paid to acquire the new supercomputer). The bonus first-year depreciation deduction for the remaining excess basis is $2,000 ($4,000 * .50).

   Observation: Thus, in Illustration (4), FF's investment in the original $10,000 supercomputer generated a 50% bonus depreciation deduction of $5,000 in 2003, and another 50% bonus depreciation deduction of $1,600 in 2004.

- **Last year for extra-generous luxury auto depreciation limits**

When bonus first-year depreciation deductions end at the close of 2004, so will the extra-generous first-year dollar limit on autos, light trucks and vans subject to the"luxury auto" rules. Under the Code, the first-year depreciation deduction for one of these vehicles, if it is otherwise qualifying property eligible for bonus depreciation, is $7,650 more than the first-year depreciation which would otherwise apply. However, the boosted dollar amount applies only if the vehicle is bought and placed in service before 2005. As a result, taxpayers thinking of buying a new auto, light truck or van for trade or business use should buy the vehicle and place it in service this year if they want to maximize first-year deductions.

- Illustration 5: A real estate appraisal company is thinking of adding another $28,000 minivan to its fleet of vehicles used by appraisers to visit properties. If it buys the minivan and places it in service before the end of 2004, the first-year depreciation deduction will be $10,910 for 2004. If it waits until 2005 (assuming first-year allowances remain the same as they were for this year), the first-year depreciation deduction for the minivan will be only $3,260.

Caution: The dollar limits must be reduced proportionately if business/investment use of a vehicle is less than 100%. For example, if the taxpayer in illustration (5) were a self-employed person who buys a new minivan in 2004 and uses it 60% for business and 40% for personal driving, the first year dollar limit is $6,546 if the minivan is eligible for bonus first-year depreciation ($10,910 * .60), and $1,956 if he buys it in 2005 ($3,260 * .60).