HOW YEAR-END PURCHASES OF BUSINESS EQUIPMENT CAN SAVE TAXES

Unless Congress acts between now and the end of the year, bonus first-year depreciation generally isn't available for purchases of qualifying assets in 2015. But as this *Hot Topic* explains, year-end purchases of depreciable property still can achieve significant tax savings even if bonus depreciation isn't revived. One key for savings is the half-year convention which generally applies in the computation of cost recovery deductions for the year the property (other than real property) is first placed into service.

Is bonus depreciation gone for good?

Bonus depreciation - the ability to claim boosted first-year depreciation deductions for qualifying assets - has been a staple of business year-end planning since it was introduced by the Job Creation and Worker Assistance Act of 2002. However, bonus depreciation is a temporary provision in the Code, and, although it has been extended many times, sometimes retroactively, currently it is in expired status. Unless Congress retroactively reinstates and extends it, bonus depreciation applies only to qualified property acquired and placed in service after December 31, 2011, and before January 1, 2015 (before January 1, 2016 for certain specialized property).

Recommendation: As year end approaches, keep a close eye on legislative developments. If Congress does in fact retroactively reinstate and extend bonus depreciation, as it has done many times before, it will amount to windfall savings for 2015 for taxpayers that have already bought qualifying new assets (generally, those with a MACRS recovery period of 20 years or less) and place them in service this year. A retroactive reinstatement also could mean substantial savings for “last minute” purchases of eligible assets. That's because the bonus first-year depreciation deduction applies without any proration based on the length of time that an asset is in service during the tax year.

First year savings under the half-year convention.

Because of the half-year convention which generally applies in the computation of cost recovery deductions for property (other than real property) first placed in service during the current tax year, year-end purchases of depreciable property can achieve significant tax savings even if bonus depreciation is not extended. That's because the half-year convention treats a business asset placed in service at any time during the tax year as having been placed in service in the middle of that year.

For instance, if a calendar-year business buys and places in service this year items of 5-year MACRS property costing a total of $600,000 and it uses the 200% declining balance method, the 2015 MACRS deduction for this 5-year property would be $120,000 ((1/5th of $600,000 × 2 (200% declining balance) × .50 (reflecting the half-year convention), even if the items are bought and placed in service in the final days of 2015.

Caution: Accelerating a purchase into 2015 isn't always be a good idea. For example, it may not produce good results for a taxpayer who has an about-to-expire net operating loss. On the other hand, a taxpayer for whom accelerating the purchase will produce a net operating loss for 2015 which can be carried back to 2013, and who had income taxed at the highest rate in that year, has a good reason to make the purchase in 2015.

Beware of the midquarter convention.

The strategy of buying depreciable assets near the end of the year only works if the midquarter convention is avoided. The midquarter convention generally applies to all non-real-estate property placed in service during the year if the aggregate bases of such property placed in service in the last quarter exceed 40% of the aggregate bases of all such property placed in service during the year.

Under the midquarter convention, the first-year depreciation allowance for nonrealty property placed in service during the year depends on the number of quarters an asset was in service during the year. Assets placed in service at any time during a quarter are treated as placed in service at the midpoint of the quarter. If the midquarter convention applies, assets placed in service in the first quarter get 10.5 months of depreciation; in the second quarter, 7.5 months of depreciation; in the third quarter, 4.5 months of depreciation and in the final quarter, 1.5 months of depreciation.

Recommendation: If most of a taxpayer's earlier equipment purchases for the year were placed in service during the third quarter, a business that wants maximum first-year depreciation deductions should try to avoid placing more than 40% of its depreciable personal property in service during the final quarter.

Illustration: In 2015, XYZ, a calendar-year corporation, bought and placed in service a $50,000 piece of equipment in the first quarter, another $50,000 piece of equipment in the second quarter, and a $300,000 piece of equipment in the third quarter. Now it is thinking of buying and placing in service an additional five units of $56,000 equipment - for a total of $280,000 - in the final quarter. If all the equipment is 5-year MACRS property, the results would be as follows:

If XYZ proceeds with its plans, the midquarter convention would apply (the $280,000 of final quarter purchases is 41.18% of the total $680,000 of assets placed in service during the year). As a result, XYZ would wind up with a first-year depreciation deduction of $89,000 (per the midquarter depreciation tables, 35% ($17,500) for 1st quarter purchases, 25% ($12,500) for 2nd quarter purchases, 15% ($45,000) for 3rd quarter purchases and 5% ($14,000) for 4th quarter purchases).

If XYZ buys and places in service only four units of $56,000 equipment in the final quarter - for a total of $224,000 - it would not be caught by the midquarter convention and could claim a $124,800 first-year depreciation deduction (20% of the total $624,000 cost). The midquarter convention wouldn't apply because the final quarter purchases of $224,000 won't exceed 40% of the total $624,000 of assets placed in service during the year.

Careful use of expensing can avoid the midquarter convention. When determining if the midquarter convention applies, the taxpayer excludes that portion of the basis of property which is expensed under Code Sec. 179. As a result, by expensing the right property, a taxpayer may be able to avoid having to use the midquarter convention.

Illustration: In September, 2015, a calendar-year business bought and placed in service a $25,000 piece of machinery. In December, it buys and places in service another $25,000 piece of machinery. If the December $25,000 acquisition is expensed, the business avoids the midquarter convention, since the final quarter purchase is disregarded for purposes of the 40% test. By contrast, if the first $25,000 purchase is expensed, the midquarter convention would apply to the final quarter purchase since the expensed third-quarter purchase would be disregarded.

Observation: Using the expensing election to avoid the midquarter convention is an option only for companies which don't make large capital purchases during the year. Under current rules, for qualified property placed in service in tax years beginning after 2014, the maximum expensing amount is $25,000. And if more than $200,000 of expensing-eligible property is placed in service during the year, the maximum expensing amount is reduced dollar-for-dollar by the excess. Thus, unless Congress changes the rules, no amount can be expensed if $225,000 or more of eligible property is placed in service during the year.

Other ways of avoiding the midquarter convention.

Even if it appears that the midquarter convention will apply, a closer look may show it can be avoided. The following assets are excepted (along with expensed assets) for purposes of computing whether the midquarter convention applies, and in applying this special convention:

- Nonresidential real property, residential rental property and any railroad grading or tunnel bore.

- Property placed in service and disposed of during the same tax year, unless it is reacquired and again placed in service during that tax year.

- Property excluded from MACRS under Code Sec. 168(f). This consists of property depreciated via a unit-of-production or similar method; films, videotapes and sound recordings; public utility property, if a normalization method of accounting is not used; and property subject to the anti-churning rules.

- The basis of a business car also is excluded if the taxpayer properly elects for the placed-in-service year to claim deductions using the standard mileage allowance method.

- That portion of basis attributable to the personal-use portion of mixed-use assets (e.g., a self-employed's car used for both business and personal use) is disregarded.

- For purposes of computing the 40% test, the amount expensed under the capitalization regulations' "de minimis safe harbor election" also should not apply.

Using the midquarter convention to the taxpayer's advantage.

Although the midquarter convention results in lower-first-year depreciation deductions for assets placed in service during the second half of the year, it produces larger first-year writeoffs than the half-year convention would for assets placed in service during the first half of the year. So arranging to fall within the midquarter convention rule can sometimes work to the taxpayer's advantage.

Illustration: In January of this year, a calendar-year business bought $200,000 of 5-year assets. If it doesn't purchase and place into service additional equipment before year-end, its depreciation deduction for the January assets will be $40,000 (20% of $200,000). Suppose, however, it is planning to add another $140,000 of 7-year assets soon. If it buys that additional equipment and places it in service in the final quarter of the year, the midquarter convention applies ($140,000 final quarter purchase is more than 40% of total $340,000 of purchases during the year). As a result, first-year depreciation for the final quarter purchases would be $4,998 (3.57% as per the tables for final-quarter purchases of 7-year property), but the first-year allowance for the $200,000 of January assets would jump to $70,000 (35%). So the business would wind up with $30,000 more in first-year depreciation for the January assets ($70,000 less $40,000).

Caution: Carefully work through the computations to make sure there will be savings. There may not be a savings if the assets placed in service early in the year have longer recovery periods than those placed in service during the last half of the year. That's because the midquarter convention's first-year deductions for longer-lived assets may not be large enough to offset the loss of the mid-year convention's larger writeoffs for shorter-lived assets.