Bonus depreciation rules, recovery periods for real property and expanded section 179 expensing

March 19, 2018

The Tax Cuts and Jobs Act (TCJA or the Act) made many changes to the depreciation and expensing rules for business assets. This tax alert will focus on three major provisions of the final legislation:

- Bonus depreciation
- Applicable recovery periods for real property
- Expansion of section 179 expensing

We will first provide a summary of the new provisions by individual topic, followed by a discussion of various considerations and tax planning opportunities.

Bonus depreciation

Businesses may take 100 percent bonus depreciation on qualified property both acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. Property ***acquired prior to*** Sept. 28, 2017, but ***placed in service after*** Sept. 27, 2017, would remain eligible for bonus depreciation **under pre-Act law (i.e., 50 percent bonus)**. The acquisition date for property acquired pursuant to a written binding contract is the date of such contract. Full bonus depreciation is phased down by 20 percent each year for property placed in service after Dec. 31, 2022, and before Jan. 1, 2027.

Under the new law, the bonus depreciation rates are as follows:

Placed-in-service year	**Bonus depreciation percentage**	
	Qualified property in general/specified plants	**Longer production period property and certain aircraft**
Portion of basis of qualified property acquired before Sept. 28, 2017, but placed in service after Sept. 27, 2017		
Sept. 28, 2017 − Dec. 31, 2017	50 percent	50 percent
2018	40 percent	50 percent
2019	30 percent	40 percent
2020	None	30 percent
2010 and thereafter	None	None
Portion of basis of qualified property acquired and placed in service after Sept. 27, 2017		
Sept. 28, 2017 − Dec. 31, 2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent
2028 and thereafter	None	None

A transition rule provides that for a taxpayer's first taxable year ending after Sept. 27, 2017, the taxpayer may elect to apply a 50 percent allowance instead of the 100 percent allowance. Taxpayers can still elect not to claim bonus depreciation for any class of property placed in service during the tax year. The election out of bonus depreciation is an annual election.

Due to the repeal of the corporate alternative minimum tax, the legislation also repeals the election to claim minimum tax credits in lieu of bonus depreciation for tax years beginning after 2017.

Qualified property

Under the new law, qualified property is defined as tangible personal property with a recovery period of 20 years or less. The new law eliminates the requirement that the original use of the qualified property begin with the taxpayer, as long as the taxpayer had not previously used the acquired property and the property was not acquired from a related party. ***The inclusion of used property is a significant, and favorable, change from previous bonus depreciation rules.***

The legislation ***attempted*** to simplify the bonus depreciation rules for qualified improvement property (QIP); although, due to a drafting error, the final statutory language does not reflect the congressional intent. The Act removed QIP from the definition of qualified property for bonus depreciation purposes, but the intent was to make QIP bonus-eligible by virtue of a 15-year recovery period. In the end, the 15-year recovery period for QIP (as well as the 20-year alternative depreciation system (ADS) recovery period) was omitted from the final legislation. The House Ways and Means Committee is expected to address this error in a technical corrections bill; however, it is uncertain if a technical corrections bill can pass Congress.

The bonus percentage for QIP placed in service in the last quarter of 2017 depends on the acquisition date of the property. QIP acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2018, is eligible for the 100 percent bonus depreciation allowance. However, if the QIP was acquired *prior to* Sept. 28, 2017, with a written binding contract to purchase the property entered into prior to Sept. 27, 2017, but placed in service *after* Sept. 27, 2017, the QIP would remain eligible for bonus depreciation under pre-Act law with a 50 percent bonus depreciation allowance.

QIP recovery period/bonus summary

Acquired/placed-in-service dates	Recovery period	Bonus?
Acquired and placed in service on or before Sept. 27, 2017	39	Yes/50%
Acquired on or before Sept. 27, 2017; placed in service after Sept. 27, 2017, and on or before Dec. 31, 2017	39	Yes/50%
Acquired and placed in service after Sept. 27, 2017, and on or before Dec. 31, 2017	39	Yes/100%
Acquired and placed in service after Dec. 31, 2017, and on or before Dec. 31, 2022	15 (but see discussion above about a technical correction)	Yes/100% (but see discussion above)

Lastly, qualified property does not include: 1) property used in providing certain utility services if the rates for furnishing those services are subject to ratemaking by a governmental entity or instrumentality, or by a public utility commission; 2) any property used in a trade or business

that has floor plan financing indebtedness; and 3) property used in a real property trade or business that makes an irrevocable election out of the interest expense deduction limitation under section 163(j). Under the interest expensing provisions, these entities would have to depreciate residential real property, nonresidential real property and QIP under the ADS and, therefore, such property would not be eligible for bonus depreciation.

Applicable recovery periods for real property

The new law retains the current Modified Accelerated Cost Recovery System (MACRS) recovery periods of 39 and 27.5 years for nonresidential and residential rental property, respectively. However, the ADS recovery period for residential rental property is reduced to 30 years from 40 years effective for property placed in service on or after Jan. 1, 2018.

The Act also eliminates the separate definitions of qualified leasehold improvement, qualified restaurant and qualified retail improvement property, and provides simplification with a general 15-year recovery period for QIP (and 20-year ADS recovery period) [see discussion above about technical correction]. QIP is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service, excluding: enlargements, elevators/escalators and internal structural framework. The improvements do not need to be made pursuant to a lease.

For example, QIP placed in service after Dec. 31, 2017, generally is depreciable over 15 years using the straight-line method and half-year convention without regard to (1) whether the improvements are property subject to a lease, (2) placed in service more than three years after the date the building was first placed in service, or (3) made to a restaurant building. The Act clarifies that restaurant building property placed in service after Dec. 31, 2017, (that does not meet the definition of QIP) is depreciable over 39 years as nonresidential real property using the straight-line method and the midmonth convention.

Electing real property trades or businesses

As noted above, a real property trade or business that elects out of the interest expense deduction limitation must use ADS to depreciate nonresidential real property (40 years), residential rental property (30 years) and QIP (20 years). The modifications to the ADS recovery period for residential rental property (40 years to 30 years) as well as the 20-year ADS recovery period for QIP (versus 40-year under pre-Act law) may provide an opportunity for certain taxpayers in real property trades or businesses to shorten their recovery periods while at the same time electing out of the interest limitation. An election out would require taxpayers to treat a change in the recovery period and method as a change in use (if affecting property already placed in service for the year the election is made).

The recovery period provisions apply to property placed in service after Dec. 31, 2017.

Expansion of section 179 expensing

The Act increases the maximum amount a taxpayer may expense under section 179 to $1 million and increases the investment limit (also referred to as the total amount of equipment purchased or phase-out threshold) amount to $2.5 million. The $1 million limitation is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the

taxable year exceeds $2.5 million. Both amounts are indexed for inflation for taxable years beginning after 2018.

The Act expands the definition of section 179 property to include certain depreciable tangible personal property used predominately to furnish lodging or in connection with furnishing lodging (i.e., beds or furniture used in hotels and apartment buildings). The definition of qualified real property for section 179 purposes was also expanded to include any of the following improvements made to nonresidential real property: roofs, heating, ventilation and air-conditioning property, fire protection and alarm systems and security systems as long as the improvements are placed in service after the date the building was first placed in service.

The provision applies to property placed in service in taxable years beginning after Dec. 31, 2017.

Planning considerations

The new expensing and cost recovery rules may significantly change the analysis for cost recovery, similar to when the de minimis election and other elections and accounting methods were added under the repair regulations. Determining the appropriate tax treatment for tangible property expenditures may require a "decision tree" analysis beginning with identification of items that qualify for a current deduction under existing rules (i.e., repairs or incidental materials and supplies), then identifying other exceptions and applying as appropriate. For example, a taxpayer may first apply conformity to financial statement expensing, where possible, using the de minimis rules. Then, apply bonus depreciation and section 179 for items ineligible under the de minimis rules, considering respective eligibility and phase-out thresholds to maximize the tax benefit.

Bonus versus section 179. Consideration and comparison of bonus depreciation and section 179 is critical in planning for depreciation deductions. Both result in substantial present value tax savings for businesses that already had plans to purchase or construct qualified property. Unlike section 179 expensing, however, taxpayers do not need net income to take bonus depreciation deductions. Additional tax planning in relation to the new net operating loss (NOL) limitations – as well as the new limitation on losses of noncorporate taxpayers – will be necessary in these situations. Further, bonus depreciation is not limited to smaller businesses or capped at a certain dollar level as under section 179, where larger businesses that spend more than the investment limitation on equipment will not receive the deduction. Lastly, the years in which full expensing is available may offset the impact where the section 179 deduction may not be allowed due to either the expensing or investment limitations.

Qualified real property under section 179. The increase in both the section 179 expense and investment limitations as well as the expansion of the definition of qualified real property would also provide immediate expensing to taxpayers that invest in certain qualified real property (especially for property that is not eligible for bonus depreciation). The expanded definition of real property under section 179 may also be able to offset situations in which certain building replacement property would have otherwise been capitalized under the repair regulations (if on a repairs method). For example, if under the repairs analysis, it is determined that one of two HVAC units requires capitalization under the restoration rules, the unit may be qualified real property and deducted as a section 179 expense, assuming within the expensing and investment limitations.

State decoupling. We expect many states to decouple from 100 percent bonus depreciation as well as the increased percent 179 amounts.

Used property. Including used property in the definition of qualified property for bonus depreciation has a potentially significant impact on M&A restructuring as bonus depreciation now applies to qualified property acquired in a taxable acquisition. In asset acquisitions, either actual or deemed under section 338, capitalized costs added to the adjusted basis of the acquired property may be able to be fully expensed if allocable to qualified property. Structuring taxable transactions as asset purchases rather than stock acquisitions may result in an immediate deduction of a portion of the purchase price in the acquisition year or generate NOLs that have favorable tax planning consequences in connection with the new NOL rules.

Placed-in-service date. Because of the significant impact of 100 percent bonus depreciation, more scrutiny is anticipated around the determination of the placed-in-service date of an asset. Before the Act, taxpayers generally wanted an earlier placed-in-service date in order to accelerate depreciation deductions. Under the new law, taxpayers may try to support a later placed-in-service date to claim the 100 percent versus 50 percent bonus depreciation allowance.

For depreciation purposes, property is considered placed in service when the asset is ready and available for use in its intended function. Taxpayers often acquire depreciable assets such as machinery and equipment before they begin their intended income-producing activity. In these situations, generally depreciation deductions may not be claimed for the machinery and equipment before the taxpayer's business starts and the depreciating asset is used in that activity.

This guideline is particularly important for property acquired prior to Sept. 28, 2017, but placed in service after Sept. 27, 2017, that would remain subject to 50 percent bonus depreciation under pre-Act law. A taxpayer may have acquired equipment prior to Sept. 28, 2017, but did not place the asset into service until after Sept. 27, 2017, when a facility was opened and the equipment was used in that income-producing activity. On the surface, since the asset is placed in service after Sept. 27, 2017, full expensing appears to apply. However, because the asset was acquired prior to this date, it is only eligible for 50 percent bonus. Both acquisition and placed-in-service dates will require a detailed review of the facts and circumstances to make sure the appropriate bonus depreciation allowance is claimed.

Elections. Elections that reduce annual depreciation deductions (election out of bonus depreciation, annual election to use ADS, etc.) will also become more critical in tax years beginning on or after Jan. 1, 2022, when depreciation deductions will reduce "adjusted taxable income" for purposes of the interest deduction limitation. It will become increasingly important to model out the impact of various depreciation elections for planning purposes.

Cost segregation studies. Consideration of a cost segregation study is now more important than ever. A cost segregation study is an in-depth analysis of the costs associated with the construction, acquisition or renovation of owned or leased buildings for proper tax classification and identification of assets that may be eligible for shorter tax recovery periods resulting in accelerated depreciation deductions. The reclassification of assets from longer to shorter tax recovery periods may also make these assets eligible for bonus depreciation resulting in even more substantial present value tax savings, especially with full expensing for qualified property placed in service after Sept. 27, 2017. Tangible personal property identified in the cost segregation of acquired property placed in service after Sept. 27, 2017, will now be qualified

property for bonus depreciation purposes since the definition of qualified property was expanded to include used property.

Cost segregation is especially critical to real property trade or businesses that may not claim bonus depreciation on QIP because of the election out of the interest deduction limitation. These entities may desire the tax benefit from the reclassification of personal property to shorter tax recovery periods resulting in accelerated depreciation deductions. The modification to the recovery period under ADS (to 30 years from 40 for property placed in service after Dec. 31, 2017) for residential rental property, as well as the 20-year ADS recovery period for QIP, also provides these real estate taxpayers with the ability to recover real property over shorter recovery periods.

Permanent tax reductions resulting from accelerated depreciation deductions may also exist because of the tax rate reduction in 2018. Taxpayers that constructed, renovated or acquired a building placed in service in 2017 may want to consider a cost segregation study to maximize tax deductions. Alternatively, if the building was placed in service prior to 2017 and no cost segregation study was done at the time, a retroactive cost segregation study can be done in 2017 and the section 481(a) catch-up adjustment can all be claimed on the 2017 tax return by filing a change in accounting method. Both may generate a one-time permanent tax savings by accelerating deductions in 2017 at 2017's higher tax rates.

We recommend modeling out the potential tax implications of performing a cost segregation study in 2017 versus 2018 with the new lower tax rates as well as careful analysis of the placed-in-service date and the impact on the bonus depreciation allowance.

For related insights and in-depth analysis, see our tax reform resource center.

For more information on this topic, or to learn how Baker Tilly tax specialists can help, contact our team.
