ADDITIONAL FIRST YEAR DEPRECIATION – ANYONE LOOKING FOR A TAX DEDUCTION?

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Introduction

Earlier this year Congress passed the "Job Creation and Worker Assistance Act of 2002" (JCWAA)[1]. This Act was signed into law on March 9, 2002, and was designed to help move the sagging economy toward a period of economic recovery. It contains $123 billion in tax breaks through 2004.[2] Some provisions of JCWAA were enacted retroactively and thus present potential compliance requirements for returns already filed during the 2002 filing season.

The focus of this article is on one such provision, the special depreciation allowance found in Section 101 of P.L. 107-147 which covers "certain property acquired after September 10, 2001, and before September 11, 2004."[3] This provision added §168(k) to the Internal Revenue Code, which allows this additional depreciation, it states in part: "The depreciation deduction provided by §167(a) for the taxable year in which such property [qualified property] is placed in service shall include an allowance equal to 30 percent of the adjusted basis of the qualified property …"[4]

For qualified property, there exists an immediate tax write off of 30 percent of the properties adjusted basis. As noted above this provision covers qualified properties placed in service after September 10 2001. Given the timing of JCWAA's passage some returns covering the period after September 10, 2001, would have already been filed, and others would have been filed before the effects of the Act would have been generally known.

Given the potential tax savings of this provision, if a return was filed without claiming this benefit, it is likely that some steps should be taken to secure the deduction for the taxpayer. These steps, as discussed later, would include filing amended returns or requesting a change in accounting method. Even if circumstances exist which would indicate that the additional deduction should not be sought by a particular taxpayer, it would be necessary to insure that the client has properly elected not to claim the additional depreciation deduction

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[1] P.L. 107-147(2002).

[2] Commerce Clearing House New Law Explanations – Executive Editor's Comments.

[3] P.L. 107-147, Supra note 1, at § 101.

[4] I.R.C. §168(k)(1)(A).

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It is necessary to insure that the client has properly elected out of the provisions of §168(k), unlike the provision of §179 (Election to expense certain depreciable business assets)[5] where a taxpayer "may elect" to expense certain costs of long lived assets, additional first year depreciation is not an election. §168(k) indicates that the deduction for depreciation "shall" include this additional depreciation if the property qualifies.[6] This being the case, it would appear that under the depreciation allowed or allowable provisions of §1016, which basically requires a reduction in the basis of property for depreciation deductions claimed, with the reduction not being less than the depreciation deduction which would have been allowed under the tax law[7], the additional first year depreciation would create a reduction in basis whether tax benefit was taken for it or not. Also, the provision of §165(k) require that the additional depreciation must be used to reduce basis before computing the allowable depreciation deduction for the current or future years. "[T]he adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year."[8]

Even if the taxpayer does not wish to take advantage of this new provision, doing nothing is not an option.[9] The rules relating to this provision need to be considered and appropriate action taken as it relates to qualified property placed in service in 2001 and any qualified property placed in service through September 10, 2004.

Overview of the Additional Depreciation Allowance

There are several special provisions which should be considered when making a determination as to whether or not property placed in service during the appropriate time period is covered by these law changes.

In general an additional depreciation deduction equal to 30 percent of the adjusted basis of qualified property is allowed for the year the property was first placed in service.

This deduction is calculated on the adjusted basis of the property after deducting the elected amount of §179. The §179 deduction and the 30 percent additional depreciation

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[5] I.R.C. §179.

[6] I.R.C. §168(k)(1)(A).

[7] I.R.C. §1016(a)(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount-- (A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and (B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws, but not less than the amount allowable under this subtitle or prior income tax laws. . . .

[8] I.R.C. §168(k)(1)(B).

[9] With the possible exception of returns filed before June 1, 2002 as according to RP 2002-33 if the return was filed without claiming the additional depreciation then in general the taxpayer is deemed to have elected out of the additional depreciation provisions.

amounts are used to reduce basis in the property and then regular MACRS will be figured on the remaining bases.

As an example: A calendar year taxpayer purchased and placed into service in July 2002 qualified property in the amount of $120,000. The property is 5 year recovery property. The client elects to use the full §179 deduction of $24,000 (client has sufficient net income from business to be able to deduct this amount). Before computing the additional first year depreciation the client must reduce the basis by the §179 amount which would leave a basis of $96,000. The additional depreciation will be 30 percent of that amount or $28,800. The bases which will then be used to figure the MACRS deduction will be $67,200. The first year deduction based on MACRS 5 year recovery property will be $13,440. Thus the current (2002) deduction for this property would be $66,240 ($24,000 §179 deduction + $28,800 §168(k) additional depreciation + $13,440 §168(a) MACRS).

It is apparent that this will be a significant deduction for many taxpayers who will make the decision to invest in qualified property during the specified period.

Qualified property for this purpose is generally property which was first put into service after September 10, 2001 and before September 11 2004.[10] There are two exceptions here which should be noted. First, if there was a binding contract related to the property executed before September 10, 2001 the property will not qualify.[11] This legislation was designed to encourage taxpayers to invest and help the economy recover after the events of 9/11. Second, if there is a binding contract executed after September 10, 2001 and before September 11, 2004, the property could still qualify if placed in service before January 1, 2005.[12]

The original use of the property must commence with the taxpayer after September 10, 2001.[13] IRS Publication 3991 states: "The original use of the property must have begun with you [the taxpayer] after September 10, 2001. 'Original use' means the first use to which the property is put, whether or not by you [the taxpayer]."[14]

To be qualified property under §168 it must be property to which §168 applies and must generally, have a recovery period of 20 years or less. The term qualified property also includes certain computer software, water utility property, and qualified leasehold improvement property.[15]

Property required to be depreciated using the alternative depreciation system of §168(g) are excluded from the definition of qualified property. This would not include property for which a voluntary election was made to have the alternative depreciation

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[10] See I.R.C. §168(k)(2)(A)(iii)(I); [The property is] acquired by the taxpayer after September 10, 2001, and before September 11, 2004, but only if no written binding contract for the acquisition was in effect before September 11, 2001, . . .

[11] Id.

[12] See I.R.C. §168(k)(2)(A)(iii)(II) and §168(k)(2)(A)(iv); May also need to consider §168(k)(2)(B) which deals with "property having longer production periods" which could extent the placed in service date to before January 1, 2006.

[13] See I.R.C. §168(k)(2)(A)(ii).

[14] I.R.S. Publication (3991 revised May 2002); pg 14.

[15] I.R.C. §168(k)(2)(A)(i)(I) (IV).

system apply, but would include listed property with limited business use which is required to be depreciated using the alternative deprecation system.[16]

Electing Not to Claim the Additional Depreciation

If the particulars of the situation indicate that it would not be in the taxpayer's best interest to claim this additional depreciation, it will be necessary to elect out of this provision. Simply not claiming the deduction would appear to be inadequate to make this election. The statute allows for electing out of the additional depreciation provisions, but does not provide a procedure. The Internal Revenue Service in Revenue Procedure 2002-33 attempts to clarify this point and provides:

> An election not to deduct the additional first year depreciation for any class of property that is qualified property … placed in service during the taxable year must be made by the due date (including extensions) of the federal tax return for the taxable year in which the qualified property … is placed in service by the taxpayer. The election must be made in the manner prescribed on Form 4562, Depreciation and Amortization, and its instructions.[17]

The instructions for form 4562 indicate that to elect out a statement should be attached to the return indicating the class of property for which the election not to claim the additional depreciation deduction is being made.[18] Thus a timely affirmative statement on the part of the taxpayer is required.

What about returns filed covering 2001 which included depreciation on what would now be qualified property that did not claim the additional depreciation? The answer to this depends on whether the return was filed before June 1, 2002, or after May 31, 2002.

If the return was filed before June 1, 2002, the taxpayer could have elected out by having filed a statement with the return indicating the intention of doing so.[19] Also, according to Rev. Proc. 2002-33 if no statement was attached the taxpayer is deemed to have elected out [if the taxpayer:]" (a) on the return did not claim the additional first year depreciation for that class of property but did claim depreciation; and (b) does not file an amended federal tax return … or a form 3115 within the time prescribed … to claim the additional first year depreciation …[20]

What if the return was filed on or after June 1, 2002? Then an affirmative election made on a timely filed return (including extensions) would be required.[21]

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[16] See I.R.C. §168(k)(2)(C); see also §168(g) alternative depreciation system, and §280F(b) limitation where business use of listed property not greater than 50 percent.
[17] Rev. Proc. 2002-33 section 3.03.
[18] I.R.S. Instructions for Form 4562 (revised March 2002); pg 4.
[19] Form 4562, Supra note 20, at 4.
[20] Rev. Proc. 2002-33 section 4.02(2).
[21] Rev. Proc. 2002-33 section 3.01: Which states in part: [P]ursuant to §168(k)(2)(C)(iii) and 1400L(b)(2)(C)(iv), a taxpayer may make an election not to deduct the additional first year depreciation for any class of property placed in service during the taxable year.

There can be some relief from the requirement to make the election on a timely filed return by using the provisions of Reg. §301.9100-2(b). If certain requirements are met, one of which is that the taxpayer has timely filed the return for the year in which the election should have been made, this regulation provides for an automatic six month extension from the due date of the return (excluding extensions) for making regulatory or statutory elections.[22] In this case, the return would be the one covering the year the property was placed in service. If the automatic extension is not available, the taxpayer can file a request for an extension giving the cause of the failure to timely make the election and requesting relief.[23]

Claiming the Additional Depreciation on a previously filed Return

There are basically two ways to claim the additional depreciation on a return filed covering 2001. These methods are available so long as an affirmative statement electing out has not been filed.

The first method, and likely the most time efficient method, is to file an amended return claiming the additional depreciation.[24] This must be done on or before the due date of the tax return for the next taxable year. This is the due date excluding extensions so for example, calendar year individual taxpayers must file the amended return by April 15, 2003. The amended return should be marked at the top "Filed Pursuant to Rev Proc 2002-33".[25]

The other alternative is to file a form 3115 Application for Change in Accounting Method, with the taxpayer's tax return for the next taxable year.[26] The filing of this request for change of accounting method is to follow the procedures given in Rev. Proc. 2002-9.[27]

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[22] See Treasury Reg. §301.9100-2(b) for requirements which must be met to qualify for the automatic 6-month extension.

[23] See Treasury Reg. §301.9100-3; §301.9100-3(a) "Requests for extensions of time for regulatory elections that do not meet the requirements of section 301.9100-2 must be made under the rules of this section. Requests for relief subject to this section will be granted when the taxpayer provides the evidence (including affidavits described in paragraph (e) of this section) to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government."

[24] Rev. Proc. 2002-33, section 4.01(1).

[25] Id.

[26] Rev Proc 2002-33 section 4.01(2) "filing a Form 3115, Application for Change in Accounting Method, with the taxpayer's federal tax return for the next succeeding taxable year. This Form 3115 is to be filed in accordance with the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-3 I.R.B. 327, as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, and as modified and clarified by Announcement 2002-17, 2002-8 I.R.B. 561, (or any successor) with the following modifications:
(a) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply, and
(b) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002-9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc. 2002-33." This statement should be legibly printed or typed on the appropriate line on any Form 3115 filed under this revenue procedure."

[27] Id.

Effect on Automobile Depreciation

JCWAA increased the first year limit allowed for depreciation on automobiles.[28] The increase only applies to automobiles that would qualify for the additional depreciation by virtue of being qualified property under §168(k).[29] This increase is for the first year of service only and is determined by adding $4,600 to the currently allowed first year cap.[30] For 2001 and 2002 the first year cap is $3,060, thus the cap for a passenger automobile which is also qualified property would be $7,660.[31]

To qualify for the additional depreciation, the automobile must be purchased during the appropriate time periods, it must be new, and it must meet the predominate business use test of §280F(b)[32]. If it does not, then the first year depreciation cap is $3,060 for 2001 and 2002.[33] The cap is multiplied by the percentage of business use and thus is adjusted down for the personal use of the automobile.[34]

For example: A taxpayer purchases a new automobile costing $45,000. The taxpayer uses the vehicle consistently 70% for the active conduct of business and 30% for personal transportation. The automobile is new and was purchased in February of 2002. The maximum depreciation amount which can be claimed on the vehicle for 2002 would be $5,362 [$7,660 maximum amount given 100% business use, reduced by $2,298 ($7,660 x 30% personal use).]

Another point to consider is that an election not to claim the additional depreciation affects all property in a particular class purchased during the year. If a taxpayer elects not to claim the additional depreciation on a qualified automobile, the taxpayer will be electing out for all five year class property placed in service during the year.

Consider State Requirements

It would be necessary to check state statutes as some states have chosen not to allow this additional depreciation deduction in all cases. For example, Oklahoma passed legislation requiring that 80% of the federal bonus depreciation be added back to federal taxable income in calculating Oklahoma taxable income. The 80% of bonus depreciation required to be added back will be allowed as a reduction of Oklahoma taxable income at the rate of 25% a year over the subsequent four years. This applies to Oklahoma

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[28] See I.R.C. §280F(d)(5) for full definition of a passenger automobile.
[29] The automobile would have to qualify under the general rules of §168(k).
[30] I.R.C. §168(k)(2)(E)(i).
[31] See Rev. Proc. 2001-19 and 2002-14.
[32] I.R.C. §280F(b) states in part: If any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under section 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under section 168(g) (relating to alternative depreciation system).
[33] See I.R.C. §168(k)(2)(C) "Exceptions-- (i) Alternative depreciation property-- The term "qualified property" shall not include any property to which the alternative depreciation system under subsection (g) applies, determined (I) without regard to paragraph (7) of subsection (g) (relating to election to have system apply), and (II) after application of section 280F(b) (relating to listed property with limited business use)."
[34] I.R.C. §280F(a)(2).

Corporate income tax and Fiduciary income tax; it does not however apply to individual income tax.[35]

Conclusion

The acceleration of the deduction for depreciation generally results in substantial tax savings for taxpayers who are in the market to purchase fixed assets. New section 168(k) was enacted retroactively and may affect returns which have already been filed. New section 168(k) requires a valid election not to be covered by the provision if not being covered would be to the benefit of the taxpayer.

As the procedural situations relating to the timing of the signing and the retroactive nature of the additional depreciation provision of the JCWAA are worked out; it would appear that significant tax planning opportunities could arise between now and September 10, 2004.

[35]Okla. Stat. Title 68 §2358.6.