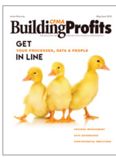

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BY RICH SHAVELL

The Various Buckets of Depreciation: Current Rules & Changes

Tax depreciation rules can be complex. However, developing a better understanding of them can help contractors yield significant tax savings.

This article provides an overview of current depreciation rules for after December 31, 2017, as well as recent changes that both increase options to accelerate deductions and phase out other possible opportunities.

Repair Regulations

The first step in this process is to minimize capital assets by expensing all items now permissible under the recent repair regulations.

In 2013, the IRS released final regulations for tangible property costs (equipment, property, and other fixed assets) commonly known as the "repair regs." Generally, the IRS requires most tangible property costs be capitalized and depreciated over several years rather than deducting the full amount in the current year.

The repair regs provide the opportunity to immediately deduct certain items that would have previously been capitalized, like small tools and supplies, up to $2,500. Companies with an applicable financial statement for the year (i.e., an audited statement or a statement required to be submitted to a federal or state agency) can deduct up to $5,000.

However, contractors that either do not have an annual financial statement or receive an annual reviewed or compiled statement would be at the lower threshold of $2,500 unless they submit the statement to an agency (e.g., for prequalification with a state's Department of Transportation). Contractors must establish appropriate expensing policies in accordance with these regulatory changes.

(For more information, refer to "Repairs or Improvements? New IRS Rules on Tangible Property" in the May/June 2012 issue of *CFMA Building Profits*.)

Rather than capitalizing assets that can be expensed, contractors can capably "leave room" for more assets to fit into the other buckets of depreciation as discussed in the following sections.

Characteristics of General Class Lives

Before we explore these buckets of depreciation, it's important to understand the general characteristics of class lives under the Modified Accelerated Cost Recovery System (MACRS) that best accelerate tax deductions.

The IRC provides property classes that define assets' "lives" or the period for depreciating them. For example, five-year property includes automobiles, agricultural assets, vans and light trucks, computer equipment, office machinery, appliances, and certain energy property. Seven-year property includes office furniture such as desks, couches, file cabinets, chairs, and safes. Fifteen-year property includes certain improvements made directly to or added to land such as shrubbery, fences, roads, and sidewalks. Finally, 27-year and 39-year property cover residential and commercial buildings, respectively.

Where appropriate and possible to document, assets should be depreciated at the lowest depreciation class life. In some cases, a cost segregation study may be useful in determining and documenting the amounts that can be taken as "catch-up" deprecation in the current year with the timely filing of Form 3115 – Application for Change in Accounting Method.

(For more information, refer to "Understanding Cost Segregation Studies & Potential Tax Benefits" in the March/April 2016 issue of *CFMA Building Profits*.)

However, one should consider general depreciation over class lives under MACRS only after the benefits of the other buckets are realized. The rest of this article will cover the following buckets:

- Section 179 expensing election;
- Bonus depreciation;
- Qualified improvement property (QIP); and
- Other specialized depreciation categories.

The Buckets of Depreciation: Post-2017 Quick Reference chart on the last page also provides a general overview of each bucket of depreciation.

Section 179 Expensing

Under IRC §179, businesses can expense the full purchase price of qualifying equipment and/or software purchased or financed during the tax year. However, there are certain limitations in both amount and circumstances.

Effective January 1, 2018, the deduction limit is increased to $1 million and applies to both new and used assets. However, if the taxpayer spends more than $2.5 million in annual equipment purchases, then the Section 179 deduction is reduced on a dollar-for-dollar basis. Therefore, the Section 179 expensing provision is phased out once annual aggregate purchases total $3.5 million.

In addition, Section 179 expensing cannot add to or increase a net operating loss (NOL). In this case, the election can still be made, but the expensed amounts will be carried over to the following tax year. Sometimes it's better to not make the election and instead depreciate the asset, especially if NOLs are expected in the near future or alternative buckets for depreciating the assets exist, such as bonus depreciation.

Let's say a company spends $50,000 on used construction equipment. Rather than general depreciation over a five-year period, the full amount of $50,000 can be written off immediately under Section 179 vs. only $10,000 depreciation for the current year (a first-year 20% statutory rate for a five-year asset applies). Notwithstanding bonus depreciation, this increased tax deduction lowers taxes now rather than in future years.

Bonus Depreciation Rates Phased Out

Previously, bonus depreciation was generally taken after the Section 179 spending cap was reached. Now with bonus depreciation set at 100% (effective for assets placed into service after September 27, 2017) being extended to include both new and most used equipment in the first year it is placed in service, this will be the primary bucket for writing off assets when acquired.

Previously, this bucket only applied to new and not used assets while also periodically either not in the law or at varying rates from 30% to 100%.

Bonus depreciation is useful for larger businesses that spend more than the Section 179 phase-out threshold of $2.5 million on new capital equipment. Also, companies with an NOL are still qualified to deduct the statutory bonus portion of the cost of new and used equipment.

Bonus depreciation is scheduled to phase out as follows:

- 100% for September 27, 2017 through December 31, 2022;
- 80% for 2023;
- 60% for 2024;
- 40% for 2025; and
- 20% for 2026, after which point it expires.

It is important to note that there are now special bonus depreciation rules for QIP, a class of nonresidential real property eligible for bonus depreciation.

Building Improvements to Qualified Real Property

In December 2017, the *Tax Cuts and Jobs Act* (TCJA) implemented beneficial changes to the way qualified improvements made to the interior of real property are treated for tax purposes.

As a result, the three previous categories of real property improvement were removed and condensed into the QIP category.

Qualified Improvement Property

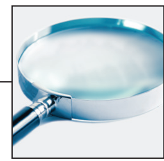
These assets are defined as any improvement to an interior portion of a building that is real property if the improvement is placed in service after the date the building was first placed in service after December 31, 2017.

Qualified improvement property (QIP) applies to 2018 and future years but excludes expenditures that are attributable to the enlargement of a building, any elevator or escalator, or the internal structural framework of the building.

Significantly, assets qualifying for bonus depreciation are intended to have a 15-year depreciable life.

Here is an example: A calendar year subcontractor buys a building and then spends $5 million to turn it into new office space. Of that amount, $1 million is attributable to upgrading the elevators and revising the building's internal structural framework, is ineligible for QIP and therefore, also ineligible for bonus depreciation.

However, the balance of the QIP qualifies. As a result, the company is entitled to bonus depreciation deduction of



$4 million for 2018 ($4 million QIP x 100%). The remaining balance of $1 million is then depreciated over a 15-year period.

Of note, tax writers have not yet explicitly designated QIP for the 15-year class life, which means these assets technically fall under a default recovery period of 39 years. This has caused QIP to be technically ineligible for bonus depreciation as of the start of 2018.

Congress is aware of the issue and is expected to rectify this in upcoming technical corrections. CFMs should also confirm this technical correction before 2019, when 2018 tax returns are prepared.

Other Buckets

There are other buckets of depreciation to consider that are beyond the scope of this article. For example, residential rental property is depreciated over 27.5 years vs. 39 years for nonresidential real property.

In addition, 15-year depreciation is now permanent and available to the new condensed class of QIP, which replaces the previous three classes of leasehold improvements: qualified leasehold improvement, qualified retail improvement, and qualified restaurant improvement.

Depreciation of Listed Property

Once an asset can be easily classified as either personal or business property under Section 280F, the IRS limits the amount of depreciation that can be deducted for that asset.

Passenger automobiles fall under this classification, and fixed depreciation thresholds can be taken each year throughout the life of this vehicle. If the vehicle is used for personal purposes, either the depreciation is limited and/or an imputed amount may be added to the respective driver's income.

As of January 1, 2018, the new annual limits that have been put into place for passenger vehicles are as follows:

- $10,000 for the first year – with bonus depreciation: $18,000;
- $16,000 for the second year;
- $9,600 for the third year; and
- $5,760 for each remaining year in the recovery period.

Bonus depreciation remains at $8,000, which brings depreciation for the first year a vehicle is placed into service to $18,000. For assets placed into service after 2018, these depreciation limits are indexed for inflation.

Summary

Understanding how tax depreciation is broken down into various buckets is a fundamental knowledge set for the CFM. Effective dates and phase outs continue to change while new buckets for depreciation come into law.

If your company is having a profitable year and needs additional assets (e.g., dump trucks, vans, desks, computers), then maximizing all expensing provisions is the first step. Consult with your tax advisor to ensure you are maximizing the use of the basic acceleration techniques such as Section 179 expensing and bonus depreciation, along with understanding what qualifies under the new QIP category. ■

Endnotes

1. Reg. §1.263(a)-3.
2. Reg. §1.263(a)-1(f)(1).
3. Ibid.
4. *Tax Cuts and Jobs Act* §1310(a)(1).
5. §179(d)(2).
6. §179(d)(3)(A).
7. §168(k)(2)(A)(ii) as amended by *Tax Cuts and Jobs Act.*
8. §168(k)(6) as amended by *Tax Cuts and Jobs Act.*
9. *Tax Cuts and Jobs Act* §13204(b)(1).
10. IRC §168(e)(6)(A) & (B).
11. See Committee Report §5039 and *Tax Cuts and Jobs Act* §13204.
12. Reg. §1.61-21.
13. §280F(a)(1)(A) as amended by *Tax Cuts and Jobs Act.*
14. §280F(a)(7) as amended by *Tax Cuts and Jobs Act.*

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DON'T MISS
THE BUCKETS OF DEPRECIATION: POST-2017 QUICK REFERENCE CHART
ON THE NEXT PAGE

Buckets of Depreciation: **Post-2017 Quick Reference**[1]

Type	General Description	Unique Characteristics
"Repair Regs"	Allows for election to expense certain items costing up to $2,500. $5,000 threshold applies to companies with an applicable financial statement for that year.	Lower-priced purchased items (i.e., tools and equipment) can be expensed rather than capitalized and depreciated or utilized in other "buckets."
Qualified Improvement Property (QIP)	Eligible real property non-structural improvements to interior areas and placed in service after the date the building is first placed into service after December 31, 2017.	Eligible for bonus depreciation and remainder, if any, has a 15-year depreciable life.[2]
Bonus Depreciation	2018 limit is 100% and is scheduled to phase out through 2026 unless current law is extended. 2018 through 2022: 100% 2023: 80% 2024: 60% 2025: 40% 2026: 20%	Effective September 27, 2017, and now applies to both new and used equipment.
Section 179 Expensing	Maximum deduction of $1 million made permanent. Businesses exceeding a total of $2.5 million of purchases in qualifying equipment face phase-out dollar-for-dollar (eliminating deduction above $3.5 million in qualified purchases). Several limitations may cause carryover of unused Section 179 deductions.	Can be new or used equipment. No current year deduction if the business has a tax loss.
General Class Lives Characteristics	Includes asset classes of five-year property such as automobiles and work vehicles, agricultural assets, office machinery such as computers or copiers, etc. Asset class of seven-year property includes office furniture (e.g., desks, sofa, chairs, file cabinets).	Generally, 200% declining balance method for class lives less than 15 years. Generally, 150% declining balance for class lives 15 years or greater.
Nonresidential Real Property	Qualifies under IRC Section 1250, such as building, store, or warehouse that is neither residential rental property nor property with a class life less than 27.5 years.	Depreciated straight-line over a life of 39 years.
Residential Rental Property	Rental units, such as apartments and condos.	Depreciated straight-line over a life of 27.5 years.

1. Always consult your tax advisor. This is a general overview of post-2017 depreciation for which not all limitations and qualifications are reflected.
2. This is intent of Congress under recent law change but technical corrections to tax code is necessary and expected.