2015

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Recommended Citation
Hoff, Gary (2015) "New fifty percent special depreciation allowance," Ag Decision Maker Newsletter: Vol. 8 : Iss. 6 , Article 2.
Available at: http://lib.dr.iastate.edu/agdm/vol8/iss6/2

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New fifty percent special depreciation allowance

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Income Tax School

When Congress enacted the Job Creation and Worker Assistance Act of 2002 (JCWAA), they made one of the largest changes to the depreciation rules since 1986. This change allowed taxpayers who purchased qualified, first-use assets to deduct 30 percent of their cost in the first year. As a part of the Jobs and Growth Tax Reconciliation Act of 2003 (JGTRRA), Congress made an even larger change to the depreciation rules. JGTRRA allows taxpayers to claim a first year deduction of 50 percent of the cost of qualified assets. The basic rules governing the 30 percent/50 percent deduction are discussed in this article using primarily agricultural examples.

To qualify for the 30 percent special depreciation allowance (SDA), the asset must be purchased after September 10, 2001 and before September 11, 2004. It must also be placed into service before January 1, 2005. The “placed in service” period is extended until January 1, 2006 for certain property with a longer production period. No written binding contract for the purchase of the property could have been in effect before September 11, 2001. In 2003, JGTRRA extended the deadline for purchases to January 1, 2005.

In addition JGTRRA also increased the 30 percent SDA to 50 percent for qualifying purchases after May 5, 2003 and before January 1, 2005. The 50 percent rate does not apply if there was a written binding contract in place before May 6, 2003.

Qualifying property
To qualify, property must be new property of one of the following types:

- **Property depreciated using modified accelerated cost recovery system (MACRS)** with a recovery period of 20 years or less. Generally, every type of property except real property has a recovery period of 20 years or less. In addition, the MACRS method is used to depreciate most property.
  - **Water utility property**, which is either of the following:
    - Property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to this provision, would be 20-year property
    - Any municipal sewer
  - **Computer software that is not an IRC §197 intangible**, which is software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.
  - **Qualified leasehold improvement property**.
    The property must also meet the following tests:
    - Acquisition date test.
    - Placed in service date test.
    - Original use test.
    - The property must not be excepted property.

**Property Depreciated Under MACRS – 20 Years or Less**
MACRS property includes properties which have 3-, 5-, 7-, 10-, 15-, and 20-year recovery periods. The following is not an all-inclusive list of the property falling into each class.

- **3 Year** – breeding hogs, over-the-road tractor (semi) and some horses
- **5 Year** – automobiles, general purpose trucks, and computers and typewriters, copiers, etc.
• **7 Year** – personal property within nonresidential real estate (carpeting, movable partitions, etc.), office furniture and fixtures, breeding and dairy cattle, farm equipment, and much more.
• **10 Year** – single purpose agricultural and horticultural structures.
• **15 Year** – drainage tile
• **20 Year** – farm buildings

**Qualified leasehold improvement property**
There are specific rules for certain qualified leasehold improvement property. The following three conditions must be met in order for the property to be considered qualified leasehold improvement property:

1. The improvement is made under a lease, 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 sublessee) of that portion.
3. The improvement is placed in service more than three years after the date the building was first placed in service.

**Original use test**
According to the Joint Committee’s explanation, the term “original use” means the first use of the property. This is whether or not “use” corresponds to use of property by the taxpayer. When evaluating whether property qualifies as “original use,” the same factors are used to determine whether property qualifies as “new IRC §38 property” for purposes of the investment tax credit. Additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) will satisfy the “original use” requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer will not satisfy the “original use” requirement.

**Example 1.** Linda replaces the engine in her tractor with a new engine. If the new engine was purchased after May 6, 2003, it will qualify for the SDA. If Linda replaced the engine with a used engine, it would not qualify.

Unlike the IRC §179 immediate expensing rule, the special 30 percent/50 percent special depreciation allowance does not prohibit the purchase of otherwise qualifying property from a “disqualified person.”

**How much can be deducted?**
The special depreciation allowance for qualified property is an additional 30 percent/50 percent of the property’s depreciable basis. In a fashion similar to IRC §179, the entire amount of the SDA is taken into account regardless of the date in the tax year in which the property is first placed into service (i.e., there is no pro-ration required). Unlike the IRC §179 expense election, the 30 percent/50 percent SDA has no annual expense limits or limits on total annual asset investments. In addition, IRC §179 contains a “taxable income” limit, which is not included in the 30 percent/50 percent special depreciation allowance rules. In effect, the 30 percent/50 percent provides a tax planning opportunity by creating a net operating loss to offset either prior year’s or subsequent year’s taxes. In short, there are no limits on the amount of either the 30 percent or 50 percent SDA. The depreciable basis is the property’s cost or other basis multiplied by the percentage of business/investment use and then reduced by the following items:

• Any IRC §179 deduction taken for the property.
• Any deduction for removal of barriers to the disabled and the elderly for the property.
• Any investment credit, disabled access credit, or enhanced oil recovery credit for the property.

**Example 2.** On November 1, 2003, Chris Davis purchased and placed in service qualified property that cost $100,000. He did not elect to claim an IRC §179 deduction. He can deduct either 30 percent of the cost ($30,000) or 50 percent of the cost ($50,000) as a special depre-
Election out. You may elect, for any class of property, not to treat as qualified property all property in such class placed in service during the tax year. If you make the election, the property may be subject to an alternative minimum tax (AMT) adjustment for depreciation. To make the election, attach a statement to your timely filed return indicating that you are electing not to claim the additional allowance and the class of property for which you are making the election.  

Note. If a taxpayer timely filed his return without making the election (not to claim the special depreciation allowance), he can still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Write “File pursuant to section 301.9100-2” on the amended return.

Once made, the election may not be revoked without consent from the IRS.

Trades
If the purchase of an asset, qualifying for SDA, is a part of a like-kind exchange, the remaining basis of the traded property also qualifies for the 30 percent/50 percent SDA.

Example 4. John purchases a new qualifying tractor for $25,000 boot plus his old tractor. If the old tractor has a remaining basis of $15,000, both the $25,000 and the $15,000 qualify for the SDA. Therefore John can claim a $20,000 current year deduction plus the regular depreciation on the remaining basis.

Caution. Not all states allow full use of the SDA for purposes of calculating state income tax. Taxpayers should check their applicable state law, before deciding whether to claim the SDA on their federal tax return.