

WNTS Insight



Key issues under temporary 100-percent expensing and extended 50-percent bonus depreciation provisions of 2010 Act

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act) extends 50-percent bonus depreciation through December 31, 2012 (December 31, 2013, for long-production-period property (LPPP) and certain aircraft), and temporarily increases the available deduction to 100 percent. Prior to this modification, bonus depreciation had been set to expire on December 31, 2010 (December 31, 2011, for LPPP and certain aircraft).

The Act also temporarily allows 100-percent expensing for qualifying property acquired and placed in service after September 8, 2010, and before January 1, 2012, (January 1, 2013, for LPPP and certain aircraft). Under this provision, qualified property acquired and placed in service after September 8, 2010, pursuant to a written binding contract entered into after December 31, 2007, meets the 100-percent expensing requirements. Property that meets these requirements is not eligible for the 50-percent bonus depreciation deduction. However, property that does not meet the 100-percent expensing requirements still may be eligible for 50-percent bonus depreciation.

This WNTS Insight addresses key technical issues arising under the Act's statutory language, some of which may require IRS guidance for certainty of interpretation.

100-percent expensing

The 100-percent expensing provision in the Act takes effect by substituting "100" for "50" in the applicable 100-percent period. The Act does not change the definition of eligible property under the existing bonus depreciation rules in section 168(k). The following four requirements (discussed in more detail below) must be met for property to be eligible for 100-percent expensing:

- The property must be of a specified type (the "description-of-property requirement"),
- The original use of the property must commence with the taxpayer after December 31, 2007,

- The property must be acquired by the taxpayer after September 8, 2010, and
- The property must be placed in service before January 1, 2012 (January 1, 2013, for LPPP and certain aircraft).

Observation: Property that does not meet these four requirements still may be eligible for 50-percent bonus depreciation if (1) the property is of a specified type, (2) the original use of the property commences after December 31, 2007, (3) the property is acquired after December 31, 2007, and (4) the property is placed in service before January 1, 2013 (January 1, 2014, for LPPP and certain aircraft).

Property of a specified type

The Act does not change the description-of-property requirement for 100-percent expensing. Thus, for purposes of this requirement property previously eligible for 50-percent bonus depreciation continues to be eligible for 100-percent expensing. This property includes (1) MACRS property that has a recovery period of 20 years or less, (2) computer software under section 167(f)(1), (3) water utility property under section 168(e)(5), and (4) qualified leasehold improvement property.

Observations: The Act extends through December 31, 2011, the 15-year straight-line cost recovery period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property. Both qualified retail improvement and qualified restaurant property, despite having a MACRS recovery period of less than 20 years, are not qualified property for purposes of 100-percent expensing or 50-percent bonus depreciation.

Because qualified leasehold improvements are specifically listed as property that meets the bonus depreciation description-of-property requirement, such property is eligible property for bonus depreciation purposes regardless of whether the MACRS recovery period for the property is 15 or 39 years. Accordingly, if the 15-year recovery period for

qualified leasehold improvements is not extended beyond 2011, 39-year recovery period qualified leasehold improvements will continue to be eligible property for bonus depreciation.

Property for which the alternative depreciation system is mandatory, such as foreign-use property, does not meet the description-of-property requirement and therefore is not eligible for 100-percent expensing or 50-percent bonus depreciation.

Original use requirement

To qualify for 100-percent expensing, the original use of the property must commence with the taxpayer after December 31, 2007. Original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer.

Observation: Similarly, the original use requirement for 50-percent bonus depreciation remains December 31, 2007. Property that is first used by a taxpayer after this date continues to meet the 50-percent bonus depreciation original use requirement.

Note: In the following two circumstances, the taxpayer is considered to be the original user of the property:

- New property that a business has acquired and holds in inventory until the taxpayer subsequently acquires the property from that business for use primarily in the taxpayer's trade or business
- The taxpayer acquires new property and holds the property in inventory, and then subsequently withdraws the property from inventory and uses the property in the taxpayer's trade or business.

Additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfy the original

use requirement and may be eligible for 100-percent expensing. However, the cost of the reconditioned or rebuilt property acquired by the taxpayer does not satisfy the original use requirement. Whether property is reconditioned or rebuilt property is a question of fact. Property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property.

Observation: An addition of new property to used property made after September 8, 2010, will meet the 100-percent expensing original use requirement. An example of such an addition is the installation of a new engine to a piece of equipment previously used in a taxpayer's trade or business.

Acquisition-date requirement

The Act provides specific acquisition-date requirements for 100-percent expensing. To qualify for 100-percent expensing, the property must be:

- Acquired by the taxpayer after September 8, 2010, and before January 1, 2012 (the property does not qualify if a written binding contract for its acquisition was in effect before January 1, 2008), or
- Acquired by the taxpayer after September 8, 2010, and before January 1, 2012, pursuant to a written binding contract that was entered into after December 31, 2007, and before January 1, 2012.

Observation: The Act does not modify the 50-percent bonus depreciation written binding contract testing date for purposes of determining whether property meets the 100-percent expensing acquisition date requirement. Accordingly, a taxpayer that entered into a written binding contract after December 31, 2007, and that acquires the property after September 8, 2010, satisfies the 100-percent expensing acquisition requirement. For example, a taxpayer that entered into a

written binding contract on July 1, 2010, and acquires the property on September 10, 2010, meets the 100-percent expensing acquisition-date requirement.

If a taxpayer manufactures, constructs, or produces bonus depreciation-eligible property for its own use (self-constructed property), then the property is deemed to be acquired on the date construction begins. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into before the manufacture, construction, or production of the property begins is considered self-constructed property of the taxpayer.

Manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins generally depends upon the facts and circumstances.

However, under a safe harbor provision (the "10-percent rule"), physical work of a significant nature will not be considered to begin before the taxpayer incurs (or pays in the case of a cash-method taxpayer) more than 10 percent of the total cost of the property (excluding land and preliminary activity costs). Taxpayers may use this safe harbor rule in lieu of making a factual determination as to when manufacture, construction, or production begins.

Observation: It is unclear whether the relevant date after which manufacture, construction, or production must begin for self-constructed property to qualify for 100-percent expensing is December 31, 2007, or September 8, 2010. The 100-percent expensing provision provides that the property must be acquired after September 8, 2010. Nonetheless, for self-constructed property the requirement that construction must commence after December 31, 2007, was left unchanged. Informal discussions with some government officials indicate that they believe the relevant date is December 31, 2007, consistent with the written binding contract date. However, since informal guidance cannot be relied upon, absent published guidance this remains unclear. The IRS is expected to publish guidance in the next couple of months to clarify this issue, among others.

Note: The Act does not provide guidance on application of the acquisition-date requirement for components of property. If the rules in the current bonus depreciation regulations are deemed applicable to 100-percent expensing property, then all constituent parts of a larger property acquired after December 31, 2007, and prior to September 9, 2010, would meet the 50-percent bonus depreciation acquisition-date requirement. Further, if a component of a larger property is acquired after December 31, 2007, and prior to September 9, 2010, and the remainder of the larger property is acquired and placed in service after September 8, 2010, then the component should meet the 50-percent bonus depreciation requirement and the remainder of the property should meet the 100-percent expensing acquisition requirement.

Observation: Numerous issues arise as to the identification of a component of a unit of property and a larger unit of property, with little guidance to date from the IRS. These issues may have a significant impact on whether a taxpayer meets the 100-percent expensing or 50-percent bonus depreciation acquisition-date requirement.

Placed-in-service requirement

The Act modifies the placed-in-service requirement for 100-percent expensing property. To be eligible for 100-percent expensing, the property must be placed in service by the taxpayer before January 1, 2012, or, in the case of LPPP and certain aircraft, before January 1, 2013.

Observation: For 50-percent bonus depreciation, the Act modifies the placed-in-service date from January 1, 2011, to January 1, 2013 (January 1, 2014, for LPPP and certain aircraft).

LPPP is property that (1) has a recovery period of at least 10 years or is transportation property, (2) is subject to section 263A, and (3) has an estimated production period exceeding one year and a cost exceeding \$1 million. Transportation property is personal property used in the trade or business of transporting persons or property.

Under the 50-percent bonus depreciation rules, qualifying basis for LPPP is limited to the adjusted basis related to production as of December 31, 2010. However, under the Act, the qualifying basis of

100-percent expensing LPPP placed in service in 2012 is not limited. Thus, all of the basis of 100-percent expensing LPPP placed in service in 2012 qualifies for 100-percent expensing.

Observation: For LPPP placed in service in 2013, only the adjusted basis of the assets related to production as of December 31, 2012, will qualify for the 50-percent bonus depreciation deduction. For property constructed by a third party, this basis is limited to the lesser of the amount paid as of December 31, 2012, or the percentage of work performed as of that date. Accordingly, a taxpayer may wish to make additional payments on or before December 31, 2012, to the extent the amount paid is less than the percentage of work performed as of that date.

Aircraft that meet certain requirements also have an extended placed-in-service date of December 31, 2012, for 100-percent expensing. The special basis rules (discussed above) applicable to LPPP do not apply to such aircraft, so the full basis of qualifying aircraft placed in service in 2012 is eligible for 100-percent expensing.

To qualify for the extended date and full basis rules, the aircraft must:

- Not be transportation property (other than for agricultural or fire-fighting purposes), which is defined as personal property used in the trade or business of transporting persons or property,
- Be purchased and at the time of the contract for purchase the taxpayer must have made a non-refundable deposit of the lesser of 10 percent of the cost, or \$100,000,
- Have an estimated production period exceeding four months, and
- Have a cost exceeding \$200,000.

Observation: For 50-percent bonus depreciation, the placed-in-service date for certain aircraft described above is extended to December 31, 2013. As with 100-percent expensing property, the full basis of qualifying aircraft placed in service under the extended placed-in-service date is eligible for 50-percent bonus depreciation.

Election out

Both the 50-percent bonus depreciation provision and the 100-percent expensing provision (collectively "bonus depreciation") are mandatory. However, a taxpayer may make an election out of bonus depreciation for any particular tax year. This election is made for each MACRS class (for example, five-year property, seven-year property, etc.) and by each legal entity (for example, each member of a consolidated group). An election to forgo bonus depreciation applies to all bonus depreciation-eligible property of the entity for the class of property to which the election applies for the year for which the election is made.

Observations

A taxpayer may not elect to forgo 100-percent expensing and at the same time claim 50-percent bonus depreciation for property that meets the 100-percent expensing requirements. This rule is a departure from the 50-percent and 30-percent bonus depreciation rules in 2003 and 2004, under which a taxpayer could choose whether to claim 50-percent bonus depreciation, 30-percent bonus depreciation, or no bonus depreciation.

A taxpayer that elects to forgo bonus depreciation does so for all qualified property in that property class for that tax year. Thus, for example, a taxpayer that places both 100-percent expensing property and 50-percent bonus depreciation property in service in 2011 and elects to forgo bonus depreciation for a particular class of property for such year may not claim any bonus depreciation (50-percent or 100-percent) on qualified property for that property class placed in service in 2011.

Other considerations

Long-term contracts

The Small Business Jobs Act of 2010 included a provision applicable to long-term contracts that previously had not been included in the bonus depreciation rules. For any bonus depreciation deductions claimed in 2010 (and 2011 for LPPP) for property with a recovery period of seven

years or less, bonus depreciation is "decoupled" from the allocation of contract costs under the section 460 percentage-of-completion method.

Prior to the Small Business Jobs Act of 2010, claiming bonus depreciation on property used in section 460 long-term contracts accelerated contract revenue, thereby reducing cash flow benefits of the additional depreciation deduction. With the decoupling of bonus depreciation from allocable contract costs under the percentage-of-completion method for property placed in service in 2010 (and 2011 for PPP), taxpayers with contracts subject to section 460 may accelerate depreciation deductions without accelerating income. However, the decoupling of section 460 and bonus depreciation was not extended into 2011 and beyond by the 2010 Tax Relief Act.

Other effects

The retroactive enactment of 100-percent expensing may have an unexpected impact on a taxpayer's estimated tax payments and mid-quarter convention computation, as well as on other areas such as the section 199 deduction. Taxpayers should evaluate carefully whether they can avoid any unexpected ancillary impacts that may arise due to enactment of 100-percent expensing.

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