A Washington National Tax Services (WNTS) Publication

# WNTS Insight

## IRS addresses key issues in new bonus depreciation guidance

**March 30, 2011**

The IRS March 29 released important guidance, Revenue Procedure 2011-26 (the guidance), that clarifies several issues related to 50- and 100-percent bonus depreciation. Bonus depreciation was extended in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act), enacted December 17, 2010.

The Act extended 50-percent bonus depreciation through December 31, 2012 (December 31, 2013, for longer production period property (LPPP) and certain aircraft). 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 enacted new section 168(k)(5), which allows 100-percent bonus depreciation 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).

There are numerous issues surrounding the extended and new bonus depreciation provisions. Some of the issues addressed and clarified in the guidance are discussed below. (For prior discussion, see WNTS Insight, "Key issues under temporary 100-percent expensing and extended 50-percent bonus depreciation provisions of 2010 Act," January 24, 2011.)

**Self-constructed property acquisition rule**

Self-constructed property includes property that a taxpayer manufactures, constructs, or produces by itself for its own use. In addition, 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.

For bonus depreciation purposes, self-constructed property is acquired when manufacture, construction, or production of the property begins. This date may be determined by identifying when physical work of a significant nature begins under a facts-and-circumstances analysis or under a 10-percent safe harbor.

Prior to the release of the guidance, it was unclear whether the manufacture, construction, or production of self-constructed property

must begin after December 31, 2007, or after September 8, 2010, to qualify for 100-percent bonus depreciation. Rev. Proc. 2011-26 clarifies that September 8, 2010, is the appropriate date. Thus, if the manufacture, construction, or production of self-constructed property begins after September 8, 2010, then the property will meet the 100-percent bonus depreciation acquisition requirement. (See discussion below for the new rules applicable to components.)

### Acquired property acquisition rule

The guidance provides that property acquired after September 8, 2010, and before January 1, 2012 (January 1, 2013 in the case of LPPP and certain aircraft) satisfies the 100-percent bonus depreciation acquisition requirement. Solely for purposes of section 168(k)(5), the guidance provides that a taxpayer acquires qualified property when the taxpayer pays or incurs the cost of the property.

***Observation:*** This rule is not intended to change the rule under current law for determining when a taxpayer has acquired property for purposes of section 168(k).

### Written binding contract date

For both acquired property and self-constructed property, the guidance provides that if a taxpayer enters into a written binding contract after September 8, 2010, and before January 1, 2012, to acquire (including to manufacture, construct, or produce) qualified LPPP or certain aircraft, the property will be treated as having met the acquisition rule.

***Observation:*** This rule is not intended to narrow the scope of the statute, which permits 100-percent bonus depreciation for property acquired after September 8, 2010, pursuant to a written binding contract entered into after December 31, 2007. Rather, this rule is intended to treat LPPP and certain aircraft as meeting the acquisition rule as long as the written binding contract is entered into by January 1, 2012, even if amounts due under the contract may be paid or incurred after such date, or even if manufacture, construction, or production may commence after such date.

## Components

The guidance adopts a taxpayer-favorable approach for components of self-constructed property solely for purposes of determining whether the components are eligible for 100-percent bonus depreciation. This approach, which departs from prior bonus depreciation rules, allows a taxpayer that began the construction, manufacture, or production of a larger self-constructed asset prior to September 9, 2010, to choose whether to claim the 100-percent bonus depreciation deduction for self-constructed or acquired components of the larger property acquired after September 8, 2010.

The guidance also provides rules to aid in the identification of a component of a larger asset for 100-percent bonus depreciation purposes. Under the guidance, the term "component" is intended to refer to any part used in the manufacture, construction, or production of the larger self-constructed property. A component may be the same as or different than the appropriate unit of property for depreciation purposes or other purposes of the Internal Revenue Code. ***Observation:*** This is a fairly broad definition that could include most work or property added to self-constructed property after September 8, 2010.

A taxpayer may claim a 100-percent bonus depreciation deduction for such components that also meet the remaining 100-percent bonus depreciation requirements.

***Observation:*** The self-constructed property component rule provided in the guidance is a taxpayer-favorable rule in three ways. First, components of a larger property that fails the 100-percent bonus depreciation acquisition requirement may be eligible for 100-percent bonus depreciation. Second, a component is defined in a broad manner, which may reduce potential controversy related to determining the appropriate component of a larger unit of property. Third, defining a component to be "any part" potentially increases the portion of an asset eligible for 100-percent bonus depreciation.

## Longer production period property

The guidance provides that there is no basis limitation rule for LPPP placed in service in 2012 for purposes of applying the 100-percent bonus depreciation rules. This position is consistent with the statutory language of section 168(k) as it applies to 100-percent bonus depreciation. However, according to the Joint Committee on Taxation staff (the JCT), it is contrary to Congressional intent and a technical correction may be needed. See footnote 1597 to the *General Explanation of Tax Legislation Enacted in the 111th Congress* (JCS-2-11). Thus, under the guidance, absent enactment of such a technical correction, any basis established for LPPP during 2012 would meet the requirements to be eligible for 100-percent bonus depreciation.

**Qualified leasehold improvement property overlap**

Qualified leasehold improvement property (as defined in section 168(k)(3)) is eligible for either 50-percent or 100-percent bonus depreciation (assuming all other requirements of bonus depreciation are met). However, qualified restaurant property (as defined in section 168(e)(7)) and qualified retail improvement property (as defined in section 168(e)(8)) are statutorily not eligible for bonus depreciation.

The guidance clarifies that property that meets the definition of qualified leasehold improvement property and the definition of either qualified restaurant property or qualified retail improvement property is eligible for either 50-percent or 100-percent bonus depreciation. Thus, if the property does not meet the definition of qualified leasehold improvement property (as defined in section 168(k)(3)), such property will not be eligible for any bonus depreciation.

**Choosing between 100-percent and 50-percent bonus depreciation**

In general, bonus depreciation is mandatory for eligible property. A taxpayer that wishes to forgo bonus depreciation must make an affirmative election to do so. This election is made each year for each class of MACRS property (e.g., five-year property, seven-year property, etc.) by each legal entity that owns eligible property (e.g., each member of a consolidated group).

The guidance provides that a taxpayer may make an election to claim 50-percent bonus depreciation for 100-percent bonus depreciation property in the tax year that includes September 9, 2010. This rule is a partial departure from the JCT explanation of the Act, which indicated the intention that taxpayers be allowed to choose between 100-percent bonus depreciation and 50-percent bonus depreciation for all 100-percent bonus depreciation property. Despite the partial departure from the JCT explanation, this is a favorable rule for taxpayers that face administrative difficulties determining whether property qualifies for 50-percent bonus depreciation or 100-percent bonus depreciation.

A taxpayer therefore has three choices with respect to bonus depreciation for a tax year that includes September 9, 2010. As noted above, a taxpayer may choose either 100-percent or 50-percent bonus depreciation on an entity-by-entity and class-by-class basis. In addition, a taxpayer may choose to forgo bonus depreciation altogether. Thus, for 100-percent bonus depreciation property placed in service in the year that includes September 9, 2010, a taxpayer may choose whether to claim 100-percent bonus depreciation, claim 50-percent bonus depreciation deduction, or forgo bonus depreciation.

***Observation:*** The election to choose to forgo 100-percent bonus depreciation and claim 50-percent bonus depreciation for qualified property is available only for the tax year that includes September 9, 2010. Thus, 100-percent bonus depreciation is mandatory for property that meets the 100-percent bonus depreciation requirements placed in service in a year that does not include September 9, 2010. For 100-percent bonus depreciation property placed in service in a year that does not include September 9, 2010, a taxpayer may claim 100-percent bonus depreciation or forgo bonus depreciation. If a taxpayer elects to forgo bonus depreciation for such year, the election also would apply to any 50-percent bonus depreciation property in the same class held by the same entity.

**Coordination with tax credits and section 1603 grants**

The guidance provides that, except for the rehabilitation credit under section 47, the 100-percent bonus depreciation deduction is determined after the reduction of the property's basis by (1) the amount of any

credits claimed for the property that require an adjustment to basis, or (2) any payments received for specified energy property under section 1603 of the American Recovery and Reinvestment Tax Act of 2009.

For example, a taxpayer receiving a section 1603 grant and taking bonus depreciation on an asset first should decrease its basis in the asset by the amount of the section 1603 grant received. After the basis has been reduced, bonus depreciation can be computed on any remaining basis.

**Vehicles subject to section 280F limitations**

The guidance provides taxpayers a safe harbor to account for depreciation allowances for vehicles that otherwise would qualify for 100-percent bonus depreciation but are subject to the section 280F limitations. The safe harbor is intended to mitigate the taxpayer-unfavorable result that occurs in the tax years subsequent to the placed-in-service year of the vehicle and prior to the first tax year succeeding the end of the recovery period of the vehicle.

This guidance is a departure from the JCT explanation of the Act, which indicated the intention that the 100-percent bonus depreciation rules not apply to vehicles subject to the section 280F limitations. Under the section 280F limitation rules, depreciation during the asset's recovery period is limited to the lesser of the section 280F limit or the non-section 280F regular depreciation amount. After the end of the asset's recovery period, any remaining basis is recovered at the rate specified by section 280F. Under 100-percent bonus depreciation, a taxpayer would take depreciation in the year in which the assets are placed in service, subject to the section 280F limitation rules, and then not take any additional depreciation until the year following the year in which the asset's recovery period ends.

Under the safe-harbor method of accounting, a taxpayer is deemed to have claimed 50-percent bonus depreciation for purposes of determining any remaining adjusted basis eligible for depreciation deductions for the tax years subsequent to the placed-in-service year and prior to the first tax year succeeding the end of the recovery period. By applying 50-percent bonus depreciation to these vehicles, the guidance provides

favorable result as it allows the taxpayer to take some depreciation from the year the asset is placed in service through the last year of the asset's recovery period and then to take the annual depreciation deduction permitted by section 280F until the basis of the asset is fully recovered. A taxpayer adopts the safe-harbor method of accounting by applying such method on its federal income tax return for the first tax year subsequent to the placed-in-service year.

**Mid-quarter convention**

The guidance clarifies that the depreciable basis of qualified property that is eligible for any additional first-year depreciation deduction is taken into account in determining whether the mid-quarter convention applies to the property placed in service during the tax year.

**Extension of bonus depreciation into 2010 by the Small Business Jobs Act of 2010**

The Small Business Jobs Act of 2010 retroactively extended bonus depreciation into calendar year 2010 when enacted on September 27, 2010. The retroactive extension of bonus depreciation in the fall of 2010 may have had a significant impact on fiscal-year taxpayers with a tax year that began in 2009 and ended in 2010 as well as taxpayers with a tax year of less than 12 months that began and ended in 2010. Some of these taxpayers may have elected out of bonus depreciation or simply not claimed bonus depreciation for qualified property. If a taxpayer did not make an affirmative election to forgo bonus depreciation, the guidance allows a taxpayer to (1) file either an amended return or a change in accounting method application to catch up on missed bonus depreciation for qualified property or (2) make a deemed election to forgo bonus depreciation. A taxpayer that made a valid election to forgo bonus depreciation may revoke the election and claim bonus depreciation, provided the taxpayer complies with the requirements of the revenue procedure.

*For more information on this WNTS Insight, please contact Annette Smith at (202) 414-1048 or annette.smith@us.pwc.com, George Manousos at (202) 414-4317 or george.manousos@us.pwc.com, James Liechty at (202) 414-1694 or james.f.liechty@us.pwc.com, Rick Farley at*

*(646) 471-4084 or richard.c.farley@us.pwc.com, or Sara Logan at (202) 414-1417 or sara.l.logan@us.pwc.com.*

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