ALTB 04-02 New 50% Special Depreciation Allowance

Abstract
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% of their cost in the first year. As a part of the Jobs and Growth Tax Relief 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% of the cost of qualified assets. The basic rules governing the 30%/50% deduction are discussed in this article using primarily agricultural examples.

To qualify for the 30% 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% (SDA) to 50% for qualifying purchases after May 5, 2003 and before January 1, 2005. The 50% 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 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%/50% special depreciation allowance does not prohibit the purchase of otherwise qualifying property from a “disqualified person.”

**Related Article** Clicking on the following link will take you to an article regarding the IRC §179 expensing deduction:
http://www.farmdoc.uiuc.edu/legal/taxation/articles/ALTB_04-01/ALTB_04-01.pdf An additional article on combing the 30%/50% special depreciation allowance with the IRC §179 expensing allowance is available from
http://www.farmdoc.uiuc.edu/legal/taxation/articles/ALTB_04-03/ALTB_04-03.pdf

**How Much Can Be Deducted?**

The special depreciation allowance for qualified property is an additional 30%/50% 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%/50% 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%/50% special depreciation allowance rules. In effect, the 30%/50% 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% or 50% 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% of the cost ($30,000) or 50% of the cost ($50,000) as a special depreciation allowance for 2003. He uses the remaining $70,000 (30%) or $50,000 (50%) to compute his regular MACRS depreciation deduction for 2003 and later years.

**Example 3** Assume the same facts as **Example 2**, except Chris chooses to deduct $40,000 as an IRC §179 deduction. He uses the remaining $60,000 of cost to compute his
special depreciation allowance of $18,000 (30% × $60,000), or $30,000 (50% × $60,000), Chris uses the remaining $42,000 (30%) or $30,000 (50%) of cost to compute his regular depreciation deduction for 2003 and later years.

**ELECTING OUT OF THE SPECIAL DEPRECIATION ALLOWANCE**

The 30%/50% SDA is a required deduction unless the taxpayer elects not to claim the deduction. If the taxpayer does not need the large deduction that the SDA might allow, he must be careful to make a proper election on his tax return. The election must be an affirmative statement attached to or written on the return. The election must also include the classes of property on which the taxpayer wishes not to claim the SDA.

In order to manage his tax liability, a taxpayer may wish to claim the SDA on 7-year property, but not claim it on other classes of property purchased. If the taxpayer claims the SDA, he must claim it for all eligible purchases within the class for that year.

The IRS issued Rev. Proc. 2002-33 on April 29, 2002, to provide guidance about how to elect out of the special depreciation allowance, and much of this document was devoted to taxpayers who had already filed their 2000 (fiscal returns) or 2001 calendar returns prior to June 1, 2002. For taxpayers who had not filed their returns before June 1, 2002, the rules were much less complex, since specific instructions were available for the “election out” procedure. The instructions to Form 4562 (for the 2002 year) state:

"**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 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."

For more details, see Rev. Proc. 2002-33—

**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%/50% 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.