WHITE PAPER

Changes to Cost Recovery Rules by H.R. 1

DON WARRANT, CPA
DIRECTOR

Table of contents

Taxpayers generally must capitalize the cost of tangible property used in a trade or business or held for the production of income and recover such costs through annual deductions for depreciation or amortization. The recovery period is based on the type of property or activity in which the property is primarily used. In addition, taxpayers can elect to expense the cost of qualified property in the year of acquisition and are required to deduct bonus depreciation for eligible property placed in service during the tax year. Alternatively, taxpayers may elect to not claim bonus depreciation for any class of property.

H.R. 1, commonly referred to as "The Tax Cuts and Jobs Act" (the "Act") changes the cost recovery rules under prior law. Some changes are effective for property **acquired after Sept. 27, 2017** and other changes are effective for property **placed in service in taxable years beginning after Dec. 31, 2017.** Taxpayers must continue to apply the tangible property regulations to determine whether an amount is required to be capitalized or may be expensed at the time of acquisition. These regulations also provide an annual election to capital repairs in conformity with book treatment.

A CRITICAL TAKEAWAY

Taxpayers generally must capitalize the cost of tangible property used in a trade or business or held for the production of income and recover such costs through annual deductions for depreciation or amortization. The recovery period is based on the type of property or activity in which the property is primarily used. In addition, taxpayers can elect to expense the cost of qualified property in the year of acquisition and are required to deduct bonus depreciation for eligible property placed in service during the tax year. Alternatively, taxpayers may elect to not claim bonus depreciation for any class of property.

Section 179 expense election

Under prior law, taxpayers could elect to expense up to $500,000 of the acquisition cost of qualified property placed in service during the tax year rather than recover such costs through annual depreciation deductions. Qualified property is generally limited to tangible, depreciable, personal property, computer software, and upon election each year, "qualified real property" acquired by purchase from an unrelated person for use in the active conduct of a trade or business. The $500,000 amount phased-out between $2 million and $2.5 million of the cost of qualified property. These amounts were adjusted annually for inflation to $510,000 and $2,030,000 respectively for the 2017 tax year.

The amount eligible to be expensed each year is also limited by the taxable income from the active conduct of a trade or business. If taxable income is exceeded, the excess is carried forward to future years subject to these limitations. States may impose their own limitations on the amount that may be expensed under this election by decoupling from the federal election.

In the case of a like-kind exchange or involuntary conversion, the carry-over basis may not be expensed under this election. Only the additional consideration paid for the acquisition of qualified replacement property can be expensed under this election.

Effective for property **placed in service in taxable years beginning after Dec. 31, 2017**, the Act increases the maximum amount a taxpayer can elect to expense to $1 million of acquisition cost which begins to phase-out at $2.5 million. These amounts will be adjusted annually for inflation.

In addition, the Act expands the types of property eligible for the section 179 expense election. The following property placed in service after Dec. 31, 2017 is included:

1) Qualified improvement property;
2) The following capital improvements to non-residential buildings:
Roofs, HVAC, fire protection and alarm systems, and security systems; and
3) Tangible personal property used predominantly in furnishing lodging.

The Act eliminated "qualified real property" as a type of property eligible for the election. However, qualified improvement property expands the types of property eligible for the election because it includes the following property: capital improvements to non-residential buildings that are not made pursuant to a written lease agreement, capital improvements to the common areas of non-residential buildings, and capital improvements to non-residential buildings placed in service within the first three years of placing the building in service.

3 QUESTIONS ABOUT SEC 179 EXPENSE TO ASK YOUR TAX ADVISOR

1. What affect does expensing have on the QBI deduction that applies to non-corporate taxpayers beginning with the 2018 tax year?
2. What affect does expensing have on federal or state tax credits?
3. When will the recapture period lapse?

Bonus depreciation

Under prior law, the rules for claiming bonus depreciation required taxpayers to deduct 50 percent of the acquisition cost of eligible new property placed in service during the tax year unless the taxpayer elected not to deduct bonus depreciation for any class of property. The 50 percent deduction phased out over a two-year period beginning with the 2018 tax year (and extended by one-year for certain long-production-period property and aircraft).

3 QUESTIONS ABOUT BONUS DEPRECIATION TO ASK YOUR TAX ADVISOR

1. Will my federal tax deduction be limited by my tax basis or the passive activity loss rules?
2. Will I owe more state tax by claiming bonus depreciation?
3. What impact does bonus depreciation have on renovations of existing buildings vs. new building construction?

Effective for property **acquired after Sept. 27, 2017**, the Act requires taxpayers to deduct 100 percent of the cost of eligible new and used property unless the taxpayer elects not to claim bonus depreciation for any class of property. The 100 percent deduction phases out at a rate of 20 percent per year beginning with the 2023 tax year (and extended by one-year for certain long-production-period property and aircraft).

The Act removed the requirement that the original use of the property had to begin with the taxpayer. However, to prevent taxpayers from taking advantage of the new law, the taxpayer may not have used the property at any time before its acquisition and the property must be acquired from an unrelated person. Related persons include members of an affiliated group of corporations and business owners.

Alternatively, taxpayers can elect to deduct 50 percent instead of 100 percent of the acquisition cost of eligible property for **their first taxable year ending after Sept. 27, 2017**. The election is made by attaching a statement to a timely filed original return (including extensions), or to an amended return filed within 6 months of the due date of the original return (excluding extensions).

Taxpayers who acquired eligible property under a written binding contract entered into **before Sept. 28, 2017**, or who performed physical work of a significant nature on property that is manufactured or constructed for their own use, including property constructed by others on their behalf, before Sept. 28, 2017, are required to apply the bonus depreciation rules under prior law.

The Act excludes any property used in a trade or business with floor plan financing indebtedness when average annual gross receipts exceed $25 million. The gross receipts of related trades or businesses and affiliated group members are combined to determine whether gross receipts exceed $25 million.

In addition, any business that is required to use the Alternative Depreciation System (ADS) under the new law may not claim bonus depreciation. For example, a real property trade or business electing out of the business interest deduction limitation when average annual gross receipts exceed $25 million is required to use ADS to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property. In addition, a farming business electing out of the business interest deduction limitation when average annual gross receipts exceed $25 million is required to use ADS to depreciate any property with a recovery period of 10 years or more.

In the case of a like-kind exchange or involuntary conversion, the carryover basis in used replacement property is not eligible for bonus depreciation whereas the full tax basis in new replacement property is eligible for bonus depreciation. The Act limits like-kind exchanges to exchanges of real property only for exchanges occurring after Jan. 1, 2018. As a result, any gain from an exchange of tangible personal property is included in federal taxable income. States may choose to decouple from this provision.

Recovery periods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. The "type of property" of an asset is used to determine the "class life" of the asset, which in turn determines the applicable recovery period.

3 QUESTIONS ABOUT RECOVERY PERIODS TO ASK YOUR TAX ADVISOR

Can I reduce or eliminate my current year taxable income by:

1. Reclassifying capitalized costs from 27.5 or 39-year recovery periods to 5-year, 7-year, and 15-year recovery periods, going back to 1986?
2. Changing the recovery periods of other tangible property that should have been assigned to a shorter recovery period?
3. Changing from depreciating to deducting the remaining tax basis in property abandoned in prior years?

CHANGES TO RECOVERY PERIODS

Effective for property placed in service in **taxable years beginning after Dec. 31, 2017**, the Act made the following changes to recovery periods (in years):

	Prior Law		New Law	
	MACRS	ADS	MACRS	ADS
Residential rental buildings	27.5	40	27.5	30
Qualified improvement property*	39	40	15	20
New Farm machinery**	7	10	5	10

* *This change is effective when technical corrections are made.*

** *Excludes any grain bin, cotton ginning asset, fence, or other land improvements used in a farming business. Used farm machinery continues the 7-year life. In addition, the requirement to use 150 percent declining balance method for 3, 5, 7 and 10-year property used in a farming business is repealed by the Act.*

In addition, effective for **taxable years beginning after Dec. 31, 2017**, the Act repealed qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property which were previously recovered over a 15-year period using the straight-line method of depreciation.

3 QUESTIONS ABOUT AUTOMOBILES TO ASK YOUR TAX ADVISOR

1. Should I trade-in or sell outright?
2. Should I replace with a heavy truck or SUV to avoid the depreciation limitations that apply to passenger automobiles?
3. Will I owe more state tax if I expense or deduct the full cost of a heavy truck or SUV?

Passenger automobiles

IRC section 280F limits the annual depreciation for passenger automobiles including the section 179 expense. A "passenger automobile" is any 4-wheeled vehicle that is manufactured primarily for use on public streets, roads, and highways, and which is rated at 6,000 pounds or less unloaded gross vehicle weight. A truck, van or sport utility vehicle (SUV) is not subject to these limitations when the gross vehicle weight rating exceeds 6,000 pounds. A truck is any vehicle that has a primary load-carrying device or container attached, or is equipped with an open cargo area or covered box not readily accessible from the passenger compartment.

The Act increased the annual 280F depreciation limits that apply to passenger automobiles for **taxable years beginning after December 31, 2017**. These limits will be adjusted annually for inflation. There were no changes to the $8,000 bonus depreciation that applies to qualified passenger automobiles, or the $25,000 section 179 limit that applies to qualified heavy SUVs.

	Prior Law	New Law
Year 1	$3,160	$10,000
Year 2	$5,100	$16,000
Year 3	$3,050	$9,600
Future years	$1,875	$5,760
	Bonus	**Section 179**
Passenger auto	$8,000 additional	280F Limitation
Heavy Truck / Van	Full Cost	Full Cost
Heavy SUV	Full Cost	$25,000 Limit

In addition, states may decouple from these limitations. For example, New York State decoupled from bonus depreciation and the $25,000 section 179 expense for a heavy SUV unless it is used by an eligible farmer.

Conclusion

The changes to the federal cost recovery rules impact taxpayer decisions regarding whether to depreciate or expense property, whether to capitalize repairs in conformity with book treatment or expense, and whether to claim bonus depreciation or to elect not to claim bonus depreciation for any class of property.

Since the cost recovery rules interact with other provisions of the Act, and taking into account statutory phase-outs and limitations that may apply, cost recovery decisions should be considered in connection with and not exclusive of, other Act provisions to create an overall tax minimization strategy.

Contact Us

Cost recovery can be a complex issue, and the tax experts at Freed Maxick are prepared to assess your situation, make recommendations, and help you execute appropriate actions to minimize your taxes.

To discuss your situation and opportunities,
contact Don Warrant, CPA at 716.847.2651 or **CLICK HERE**.