TAX ALERT

11/14/2022

TCJA Bonus Depreciation Set to Phase Out After 2022

The Tax Cuts and Jobs Act (TCJA) significantly boosted the potential value of bonus depreciation for taxpayers — but only for a limited duration. The amount of first-year depreciation available as a so-called bonus will begin to drop from 100% after 2022, and businesses should plan accordingly.

Bonus Depreciation Rules & Phase Outs Explained

Bonus depreciation has been available in varying amounts for some time. Immediately prior to the passage of the TCJA, for example, taxpayers generally could claim a depreciation deduction for 50% of the purchase price of qualified property in the first year — as opposed to deducting smaller amounts over the useful life of the property under the modified accelerated cost recovery system (MACRS).

The TCJA expanded the deduction to 100% in the year qualified property is placed in service through 2022, with the amount dropping each subsequent year by 20%, until bonus depreciation sunsets in 2027 unless Congress acts to extend it. Special bonus depreciation rules apply to property with longer recovery periods.

Businesses can take advantage of the deduction by purchasing, among other things, property with a useful life of 20 years or less. That includes computer systems, software, certain vehicles, machinery, equipment, and office furniture.

Both new and used property can qualify. Used property generally qualifies if it doesn't meet the following restrictions:

- Used by the taxpayer or a predecessor before acquiring it
- Acquired from a related party
- Acquired as part of a tax-free transaction

Qualified improvement property (generally, interior improvements to non-residential property, excluding elevators, escalators, interior structural framework, and building expansion) also qualify for bonus depreciation. A drafting error in the TCJA indicated otherwise, but the CARES Act, enacted in 2020, retroactively made such property eligible for bonus depreciation. Taxpayers that placed qualified improvement property in service in 2018, 2019, or 2020 may, generally, now claim any related deductions not claimed then — subject to certain restrictions.

Buildings themselves aren’t eligible for bonus depreciation, with their useful life of 27.5 (residential) or 39 (commercial) years — but cost segregation studies can help businesses identify components that might be. These studies identify parts of real property that are tangible personal property. Such property has shorter depreciation recovery periods and therefore qualifies for bonus depreciation in the year placed in service.

The placed-in-service requirement is particularly critical for those wishing to claim 100% bonus depreciation before the maximum deduction amount falls to 80% in 2023. With the continuing shipping delays and shortages in labor, materials, and supplies, taxpayers should place their orders promptly to increase the odds of being able to deploy qualifying property in their businesses before year-end.

Note, too, that bonus depreciation is automatically applied by the IRS unless a taxpayer opts out. Elections apply to all qualified property in the same class of property that is placed in service in the same tax year (for example, all five-year MACRS property).

Bonus Depreciation vs. Section 179 Expensing

Taxpayers sometimes confuse bonus depreciation with Section 179 expensing. The two tax breaks are similar, but distinct.

Like bonus depreciation, Section 179 allows a taxpayer to deduct 100% of the purchase price of new and used eligible assets. Eligible assets include software, computer and office equipment, certain vehicles and machinery, as well as qualified improvement property.

But Section 179 is subject to some limits that don't apply to bonus depreciation. For example, the maximum allowable deduction for 2022 is $1.08 million.

In addition, the deduction is intended to benefit small-sized and medium-sized businesses, so it begins phasing out on a dollar-for-dollar basis when qualifying property purchases exceed $2.7 million. In other words, the deduction isn't available if the cost of Section 179 property placed in service this year is $3.78 million or more.

The Section 179 deduction also is limited by the amount of a business's taxable income; applying the deduction can't create a loss for the business. Any cost not deductible in the first year can be carried over to the next year for an unlimited number of years. Such carried-over costs must be deducted according to age — for example, costs carried over from 2019 must be deducted before those carried over from 2020.

Alternatively, the business can claim the excess as bonus depreciation in the first year. For example, say you purchase machinery that costs $20,000 but, exclusive of that amount, have only $15,000 in income for the year it's placed in service. Presuming you're otherwise eligible, you can deduct $15,000 under Section 179 and the remaining $5,000 as bonus depreciation.

Also, in contrast to bonus depreciation, the Section 179 deduction isn't automatic. You must claim it on a property-by-property basis.

Bonus Depreciation Caveats to Consider

At first glance, bonus depreciation can seem like a no-brainer. However, it's not necessarily advisable in every situation.

For example, taxpayers who claim the qualified business income (QBI) deduction for pass-through businesses could find that bonus depreciation backfires. The amount of your QBI deduction is limited by your taxable income, and bonus depreciation will reduce this income. Like bonus depreciation, the QBI deduction is scheduled to expire in 2026, so you might want to maximize it before then.

The QBI deduction isn't the only tax break that depends on taxable income. Increasing your depreciation deduction also could affect the value of expiring net operating losses and charitable contribution and credit carryforwards.

And deduction acceleration strategies always should take into account tax bracket expectations going forward. The value of any deduction is higher when you're subject to higher tax rates. Newer businesses that currently have relatively low incomes might prefer to spread out depreciation, for example. With bonus depreciation, though, you'll also need to account for the coming declines in the maximum deduction amounts.

California Nonconformity

California does not conform to bonus depreciation. California does not allow either the 50% or 100% bonus depreciation. The different rules create tax basis differences between federal and California.

Buy Now, Decide Later – 2022 Bonus Depreciation Timing Considerations

If you plan on purchasing bonus depreciation qualifying property, it may be wise to do so and place it in service before year end to maximize your options. Your Seiler tax advisor can help you chart the most advantageous course of action based on your specific circumstances and the upcoming changes in tax law.