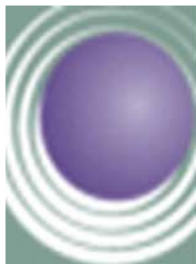

ITEP Policy Brief
Institute on Taxation and Economic Policy

A Primer on Accelerated Depreciation, "Bonus Depreciation" and Tax Options for States

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In 2002 and again in 2003, Congress passed new corporate tax breaks allowing companies to write off up to half of the cost of their investments in new machinery and buildings immediately. This so-called "bonus depreciation" loophole attracted a hail of criticism when these breaks were being debated. But these new depreciation breaks are only the latest addition to the array of "accelerated depreciation" tax breaks that have been in existence since 1970. This policy brief looks at how accelerated depreciation and the new "bonus depreciation" works, and evaluates its impact on economic growth and on the health of the corporate income tax.

What is Depreciation?

Most people think of depreciation as the gradual decline in the value of a piece of property over time due to the wear and tear of everyday use. For example, a new car depreciates rapidly, losing most (if not all) of its value over time. In corporate tax law, however, depreciation has a slightly different meaning: when businesses buy property that has an expected useful life of more than one year, they are allowed to write off the cost of the property as a business expense gradually, over the life of the property. The amount the business writes off each year is called the depreciation expense. Businesses frequently buy property and equipment to help them make their products, and are allowed to deduct these purchases from their taxable income as a cost of doing business—but the rules for these deductions vary according to the type of property purchased:

- Businesses purchases for immediate, short-term use can be immediately deducted, or "expensed," from taxable income in the year in which they're purchased. In other words, these items depreciate immediately. In general, business purchases that last less than one year fall into this category.
- Business purchases of items that typically last longer than one year are called *capital assets*. These items lose their value gradually over the useful life of the asset—but in many cases there is no easily agreed-upon way to describe the rate at which the asset's value depreciates. For this reason, federal (and state) corporate tax laws allow businsesses to choose from two different approaches to depreciating capital assets: *straight-line* depreciation and *accelerated* depreciation.

Under straight-line depreciation, a business depreciates the value of a capital asset by the same amount every year for the life of the asset. Under accelerated depreciation, the business is allowed to deduct a greater percentage of the asset's value in the early years of ownership. The chart at right shows how these two methods differ for an asset with a seven-year working life. Compared to the "straight line" baseline, accelerated depreciation lets firms pay less in the early years, and more in the later years.

For any particular year, the amount a company can write off for any particular investment is calculated by taking the "basis" of the property (that is, its XYZ) and multiplying it by a percentage

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taken from an IRS table. The IRS has established a standard set of percentages for machinery with lifetimes ranging from 3 to XX years. The **chart at right** shows how these percentages decline over time.

A dollar tomorrow is worth more than a dollar today. For this reason, allowing companies to shorten the period during which an asset's cost can be recovered gives them a more valuable tax break than providing the same writeoff over a longer period. In dollar terms, the amount written off is the same either way. But it's worth more to taxpayers if they can deduct it more quickly.

Proponents of accelerated depreciation argue that it is not a true tax break: acceleraeted depreciation does not change the total amount of deduction– it merely changes the timing of this deduction.

Accelerated depreciation is exactly what it sounds like: a way of letting companies write off the cost of their investments in machinery and buildings faster than they actually wear out.

This equipment can last from a few months to many years, and contributes to the business' profitability the entire time it's in use.

Because these fixed assets have a long-term use, they are depreciated differently for tax purposes.

The main goal of accelerated depreciation is to encourage companies to invest in capital.

How "Bonus Depreciation" Work

The 2002 tax bill, the Job Creation and Worker Assistance Act of 2002, gave an extra first-year deduction for property acquired after September 10, 2001 and before September of 2004. The first-year deduction, known as "bonus depreciation," was 30% of the adjusted basis for all qualifying properties. In other words, in addition to the amount that could be deducted under normal MACRS rules, companies taking bonus depreciation could immediately write off 30 percent of the cost of a capital investment in the very first year.

The 2003 tax bill, the Jobs and Growth Tax Relief Reconciliation Act of 2003, increased the first-year depreciation to 50 percent for capital investments purchased after May 5, 2003. The deadline for the 50% (and the 30%, not that it matters, right?) was extended a bit from September to December 31 of 2004.

The "bonus" depreciation provisions are in addition to the existing accelerated depreciation rules. So for any company using bonus depreciation, the remaining cost after the bonus depreciation is subject to the same MACRS rules that existed before 2002.

[Parenthetically, the 2003 Act also increased the size of capital investment that can be immediately expensed from $25,000 to $100,000.] This is the "Section 179 election." The Section 179 election is only available for companies with annual capital expenditures under $400,000.

Section 179 also only applies to tangible personal property that you bought. So real property doesn't apply, and personal property that you got by some means other than buying it (like a gift) doesn't apply.

[Something about how much bonus depreciation costs, from JCT?]

So what conditions do you have to satisfy for bonus depreciation?

1) You have to be buying "qualified equipment." This is tangible property with an expected lifetime of 20 years or less. Computer software is an example of a qualified investment. Some real property may qualify too.

2) The qualifying stuff must be "new" in a meaningful sense. It has to have been built for the taxpayer claiming the deduction. New property satisfies it clearly. If existing property is spruced up, only the sprucing qualifies. And if you buy something that's just plain used, you don't qualify.
3) Time deadlines. See above. I don't understand why the 30% thing continues until December. Isn't 50% always better?
4) The new property must be placed in service by December 31, 2004. There's an exception: some property that takes an extra long time to build gets an extra year, until 12/31/2005. In particular, property that takes more than two years to build– or that takes over 1 year and costs over $1 million—gets the extra year.

Like any tax break targeted to corporations, accelerated depreciation primarily benefits the very well off (who own the lion's share of corporate stock and other capital.)

Bonus depreciation erodes the AMT. Regular MACRS depreciation is limited by the AMT. So capital-intensive companies like printing companies can find that they pay a bunch of AMT beause their depreication applies to the regular tax but not the AMT. But bonus depreication applies to both the regular tax and the AMT, so is much more likely to lead to zero-tax corporations.

You don't have to take bonus depreication. If you buy two things, you can take it on one and not on the other. And you can take the 30 instead of the 50 if you want to.
Who won't want to take bonus depreciation? People who expect to pay a higher marginal tax rate in future years and want to save their depreication for the high-tax year. Also, people who have NOL carryforwards that are about to expire.

Definitions:
Depreciation is an accounting term for how businesses allocate the cost of a capital asset over the period of its useful life. Depreciation reflects the reality of the things we buy: due to wear and tear and the eventual obsolescence of most goods, these things are worth less over time.
Depreciation is used for all items that are expected to last for more than a year.

Depreciation is an accounting term for the "wear and tear" that any business asset experiences during its useful lifetime. In principle, the amount of depreciation is the amount of value an asset loses every year. For a business, the amount of depreication in any year equals the value of equipment that must be replaced.

Some business types think this is unfair: You shell out $40,000 for a piece of equipment, and you have $40,000 of expenses right now, but you can only write off $8,000 that year. (20% first year?)

Since 1986, the depreciation scheme in use at the federal level is MACRS, the Modified Accelerated Cost Recovery System. MACRS divides all fixed assets up depending on their expected working life: 3, 5, 7, 10, 15 and 20 years.

Congress has passed one particular thing designed to ease the pain of this gradual writeoff: Section 179.

A realistic depreciation scheme helps give a better picture of the actual financial health of a company at any particular time. Artificially accelerating depreciation makes it harder for investors and the public to judge the real profitability of a firm.

Under "straight-line" depreciation, the rate of depreciation is constant for the entire working life of the asset.
You basically get to choose between straight-line and accelerated.

Who is likely to choose what?
New start-ups are likely to choose straight line. In the short run, this means less deductions, higher profits and therefore higher taxes, but there is (one guy argues) a premium on being able to accurately forecast your true long-term profitability when you're a startup.
Established companies, on the other hand, are liklely to prefer accelerated depreciation, so they can increase their apparent expenses (and decrease their reported profit and taxes) in the short run.

"Decoupling" as an Option for States

Most state corporate income taxes are based on federal definitions of taxable income. As a result, when federal lawmakers enact a new federal tax break, states must either conform to the federal change, restrricting their own tax base and allowing a state tax cut for corporations, or must "decouple" from the federal change by defining their tax base in a way that does not include the new federal tax break.
Decoupling means that a corporation must calculate its depreciation two ways: for federal purposes, it can apply the "bonus depreciation" rules, but for state purposes it must apply the regular accelerated depreciation rules.

The recent wave of decoupling is not a new development. In 1981, when the federal government expanded accelerated depreciation, almost half of the states with cporate income taxes chose to decouple from this new tax break. [And then in 1986...?]