New Section 179 and Bonus Depreciation Deduction Rules or Equipment Purchases

The Tax Cuts and Jobs Act, signed into law on December 22, 2017, has brought significant changes for how businesses depreciate assets. Businesses that are in need of new equipment or make improvements to their properties may benefit from the latest tax reform provisions for Section 179 and bonus depreciation. When deciding whether to take Section 179 deductions or bonus depreciation, one must consider the other changes in the tax law, such as the excess loss limitation rules, to be sure that they can benefit from these deductions.

Section 179

Businesses must have taxable income in order to benefit from a Section 179 deduction. The allowable Section 179 deduction has increased from $510,000 in 2017 to $1 million for tax years beginning after December 31, 2017. The maximum asset spending phase out has also increased from $2 million to $2.5 million for tax years after 2017. The updated law also now allows for the deduction of qualified improvement property and certain qualified real property.

Advantages of the 179 deduction include a reduction of taxable income and therefore tax liability, which can be especially beneficial to businesses that have cash flow issues. Business owners will also have some flexibility in choosing which assets they would like to take a Section 179 deduction on and which assets they would like to take bonus depreciation on. The phase out amount may prevent some businesses from taking Section 179, and trusts are not eligible for Section 179.

Bonus Depreciation

Unlike the 179 deduction, both businesses running at a loss and trusts can take bonus depreciation. Bonus depreciation provides a deduction on eligible assets purchased in the year they are placed into service. The new provisions have increased the bonus depreciation deduction from 50% to 100% for qualified assets purchased after September 27, 2017. This will remain in effect until January 1, 2023 when the amount of bonus depreciation will decrease by 20% per year until the end of 2026. Qualified improvement property has been added in the new provisions as eligible purchases as well. In addition, the new law allows bonus depreciation on assets that are acquired from a previous user, such as in the case of a cost segregation study.

Like the Section 179 deduction, bonus depreciation will benefit businesses with cash flow issues by reducing the taxable income and therefore the tax liability in the year of the deduction. Another advantage is that there is no limit to asset spending in a given year, or to the amount that can be taken. Additionally, businesses do not have the option to select specific items for the deduction. So in a given year, taking bonus depreciation on one asset requires the company to take bonus depreciation on all assets that fall into that asset class. Many states do not allow bonus depreciation, such as New York, so the deduction will need to be added back to the income on the state tax return. This will result in income for Federal purposes being higher than that for State purposes in the year of the deduction and the reverse in subsequent years.

Financing Options

Considering different financing options will help in arranging a plan that best benefits the company financially. When taking out a traditional bank loan to purchase assets, it is important to factor in the loan origination fees and interest expense. Previously, there were no limits to the interest expense deduction, but tax reform has limited this deduction for businesses whose average annual gross receipts exceed $25 million over the 3 preceding years. The $25 million of gross receipts is calculated by taking into account the gross receipts of all related entities.

Limits also now exist on claiming business losses. In a given year, an individual taxpayer cannot take business losses (net losses from all flow through entities and self-employment activities), that exceed $250k/$500k (single and married filing separate/married filing jointly) and must carry forward any additional losses to future years, which will then be subject to the net operating loss limitations.

Another option for acquiring assets is through equipment leasing, which typically has lower monthly payments than traditional bank financing. Leases may be a favorable option for property only being used short-term or for equipment that becomes obsolete quickly. This option also typically does not require a significant down payment. There are two types of leases: operating and capital. Operating leases allow the business to pay a lease fee that is deductible from income. Additionally, assets are not included on the balance sheet nor are they depreciated by the lessee. With an operating lease, the business does not assume the risk of ownership, and the property is returned at the end of the lease period. Capital leases differ from operating leases, and the business assumes some risk with a capital lease. Assets would be placed on the balance sheet and depreciated, and companies would then be able to benefit from the changes to Section 179 and bonus depreciation. At the end of the capital lease's term, the business typically retains the property or has a bargain purchase option.

With the new provisions to the tax law, businesses need to determine whether asset expensing will be financially beneficial. To discuss the advantages and disadvantages further, contact your Anchin relationship partner or Laura Mirro, a member of Anchin Private Client, at 212.840.3456.

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