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# The Various Buckets of Depreciation: A Review of Current Rules & Changes

Tax depreciation rules can be complex, but developing a better understanding of them can yield significant tax savings for contractors.

This article provides an overview of current depreciation rules as well as recent changes that both increase options to accelerate depreciation deductions and phase out some favorable opportunities.

## Repair Regulations

The first step in this process is to minimize capital assets by expensing all items now permissible under the recent repair regulations.

In 2013, the IRS released final regulations for tangible property costs (equipment, property, and other fixed assets), commonly known as the “repair regs.”<sup>1</sup> Generally, the IRS requires most tangible property costs be capitalized and depreciated over several years rather than deducting the full amount in the current year.

The repair regs provide the opportunity to immediately deduct certain items that would have previously been capitalized, like small tools and supplies, up to \$2,500.<sup>2</sup> Companies with an applicable financial statement (AFS) for the year – that is, an audited statement or a statement required to be submitted to a federal or state agency – can deduct up to \$5,000.<sup>3</sup>

However, contractors that either do not have an annual financial statement or receive an annual reviewed or compiled statement would be at the lower threshold of \$2,500 unless they submit the statement to an agency, such as for prequalification with a state Department of Transportation. Contractors must establish appropriate capitalization and expensing policies in accordance with these regulatory changes. (Refer to “Repairs or Improvements? New IRS Rules on Tangible Property” by Jonathan D. Olson and John W. Dorn in the May/June 2012 issue.)

Rather than capitalizing assets that can be expensed, contractors can capably “leave room” for more assets to fit into the other buckets of depreciation, as we will shortly see.

## General Class Lives Characteristics

Before we explore these buckets of depreciation, it’s important to understand the general characteristics of class lives under the Modified Accelerated Cost Recovery System (MACRS) that best accelerate tax deductions.

The IRC provides property classes that define assets’ “lives” – the period for depreciating them. For example, five-year property includes such items as automobiles, vans and light trucks, computer equipment, office machinery, appliances, and certain energy property. Seven-year property includes office furniture, such as desks, couches, file cabinets, chairs, and safes. Fifteen-year property includes certain improvements made directly to land or added to it, such as shrubbery, fences, roads, and sidewalks. Finally, 27.5-year and 39-year property cover residential and commercial buildings, respectively.

Where appropriate and able to be documented, assets should be depreciated at the shortest depreciation class life. In some cases (generally in the case of depreciation on a building), a cost segregation study may be useful in determining and documenting the amounts that can be taken as “catch-up” depreciation in the current year with the timely filing of Form 3115 – Application for Change in Accounting Method.

(Refer to my article “Understanding Cost Segregation Studies & Potential Tax Benefits” in the March/April 2016 issue.)

However, general depreciation over class lives under MACRS should be considered only *after* the benefits of the other buckets are realized. The rest of this article will cover:

- Section 179 expensing election;
- Bonus depreciation;
- Qualified leasehold improvement property (QLP);
- Qualified improvement property (QIP); and
- Other specialized depreciation categories.

And, the reference chart on the last page provides a general overview of each bucket of depreciation.

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## Section 179 Expensing

Under IRC §179, businesses can expense the full purchase price of qualifying equipment and/or software purchased or financed during the tax year. There are certain limitations in both amount and circumstances.

As part of the *Protecting Americans from Tax Hikes (PATH) Act*, the now-permanent deduction limit is \$500,000 and, unlike bonus depreciation, applies to both new and used assets;<sup>4</sup> that is, used equipment purchased by the contractor can be expensed under Section 179, whereas bonus depreciation only applies to new (first use) assets.<sup>5</sup>

However, if the taxpayer spends more than \$2 million in annual equipment purchases, the Section 179 deduction is then reduced on a dollar-for-dollar basis.<sup>6</sup> Therefore, the Section 179 expensing provision is phased out once annual aggregate purchases total \$2.5 million.<sup>7</sup>

In addition, Section 179 expensing cannot add to or increase a net operating loss (NOL).<sup>8</sup> In this case, the election can still be made, but the expensed amounts will be carried over to the following tax year. Sometimes, it's better to not make the election and instead depreciate the asset, especially if NOLs are expected in the near future or alternative buckets for depreciating the assets exist, such as bonus depreciation.

Let's say a company spends \$50,000 on used construction equipment. Rather than general depreciation over a five-year period, the full amount of \$50,000 can be written off immediately under Section 179 vs. only \$10,000 for the current year (year-one 20% statutory rate for a five-year asset). This increased tax deduction lowers taxes now rather than in future years.

## Bonus Depreciation Rates Phased Out

Bonus depreciation is usually taken after the Section 179 spending cap is reached and is available for new (first use) equipment only. For 2016, bonus depreciation applies to 50% of the purchase cost of new equipment, which is unchanged from 2015.<sup>9</sup>

Bonus depreciation is useful for larger businesses spending more than the Section 179 cap of \$2 million on new capital equipment. Also, companies with an NOL are still qualified to deduct the statutory bonus portion of the cost of new equipment and carry the increased loss forward.

Bonus depreciation is scheduled to phase out as follows:<sup>10</sup>

- 50% for 2015, 2016, and 2017;
- 40% for 2018; and
- 30% for 2019, after which point it is scheduled to expire.

However, there are new special bonus depreciation rules for QIP – a class of nonresidential real property now eligible for bonus depreciation purposes.

## Building Improvements to Qualified Real Property

In December 2015, the PATH Act implemented beneficial changes to the way qualified improvements in commercial buildings are treated for tax purposes.

As a result, two new opportunities for accelerating depreciation fall under the broader scope of qualified real property. Qualified real property requires that property<sup>11</sup> is depreciable, purchased for use in the active conduct or trade of business, and can't be certain ineligible property (e.g., used for lodging outside the U.S. or used by governmental units, foreign persons or entities, and certain tax-exempt organizations).<sup>12</sup> Let's consider two subsets of qualified real property.

### Qualified Improvement Property

These assets are defined as any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date that the building was first placed in service.<sup>13</sup> QIP applies to improvements placed into service after December 31, 2015,<sup>14</sup> but excludes expenditures that are attributable to the enlargement of a building, any elevator or escalator, or the internal structural framework of the building.<sup>15</sup>

These assets qualify for bonus depreciation, but not Section 179 expensing.<sup>16</sup> So a portion is moved to the bonus depreciation bucket, and the balance, depending on the percentage for the year, is then depreciated over 39 years (assuming the building is nonresidential in nature).<sup>17</sup>

This category is more expansive than QLP in that there is no lease requirement, so it applies for improvements to a company's owner-occupied facility.<sup>18</sup> Without further change in law, the benefit of this bucket will phase out when bonus depreciation expires after 2019 and these assets revert back to 39-year depreciation.

*Example:* A calendar year subcontractor buys a building and spends \$5 million to turn it into new office space. Of that amount, \$1 million is attributable to upgrading the elevators and revising the building's internal structural framework, and is thus ineligible for bonus depreciation. However, the balance of the QIP qualifies. As a result, the company is entitled to a bonus depreciation deduction of \$2 million for 2016 (\$4 million x 50%). The remaining balance of \$2 million is then depreciated over a 39-year period.



### Qualified Leasehold Improvement Property

QLP differs in three ways. First, the improvements must be placed in service more than three years after the improved building was originally placed in service.<sup>19</sup> Also, certain types of improvements qualify as long as they only benefit the tenant's space and not the common area<sup>20</sup> – e.g., electrical or plumbing systems, permanently installed lighting fixtures, ceilings and doors, and non-load-bearing walls.<sup>21</sup>

Finally, there must be a lease; the tenant cannot be related (generally more than 80% same ownership) to the landlord – a common occurrence in owner-occupied buildings where the property is placed in a single-purpose LLC and rented to the operating business. These three requirements do not apply to the QIP bucket.

It's important to note that the PATH Act permanently extends the 15-year recovery period for QLP.<sup>22</sup> Rather than depreciating these assets over 39 years, the shorter 15-year period applies.<sup>23</sup>

In addition, QLP property assets can be moved into the Section 179 expensing bucket and also qualify for bonus depreciation. Prior to 2016, up to \$250,000 annually could be moved to the Section 179 expensing bucket, but now as much as \$500,000 (i.e., the full Section 179 threshold) can be moved.<sup>24</sup>

**Example One:** If a contractor expanded or improved the physical premises of its operating business (and the landlord is unrelated and the property was placed in service more than three years prior), then up to \$500,000 of the costs of the work can be expensed in the Section 179 bucket. The contractor would likely expense the leaseholds and displace a portion of the other assets already allocated for expensing under Section 179, since those other assets may be equipment that can be depreciated for a period of less than 15 years.

**Example Two (2015 Thresholds):** During 2015, a calendar year taxpayer spends \$750,000 on QLP. If eligible for Section 179 expensing, it can elect under Section 179 to deduct \$250,000 of the cost of QLP for 2015.

The taxpayer can also claim a first-year bonus depreciation allowance of \$250,000 (\$750,000 of QLP - \$250,000 Section 179 expense x 50% = \$250,000). If, for example, the taxpayer

doesn't claim Section 179 for any of its qualified leasehold improvements, then the bonus depreciation deduction would be less beneficial at \$375,000 (\$750,000 of improvements x 50% bonus depreciation = \$375,000).

**Example Three (2016 Thresholds):** A calendar year property owner spends \$1 million to redesign an office for a tenant. The improvements are QLP placed in service during 2016. The owner has no other qualifying Section 179 expenses and the taxable income for the year is \$700,000. Under the PATH Act, the owner may elect to expense \$500,000 of the QLP cost under Section 179 for 2016. The remaining \$200,000 is rolled into the bonus depreciation bucket of which \$100,000 (50% for 2016) can be deducted; the remaining \$100,000 can be depreciated over 15 years.

### Other Buckets

There are other buckets of depreciation to consider that are beyond the scope of this article.

For example, residential rental property is depreciated over 27.5 years vs. 39 years for nonresidential real property. In addition, 15-year depreciation is now permanent and available to qualified *retail* improvement property and qualified *restaurant* property.<sup>25</sup> Moreover, some building improvements may qualify for the § 179D energy deduction.

Many other buckets of depreciation should be considered for specialized industries. In all cases, discuss with your tax advisor the specific definitions that detail what assets will qualify for the various buckets of depreciation.

### Summary

Understanding how tax depreciation is broken down into various buckets is a fundamental knowledge set for the CFM. Effective dates and phase outs continue to change, while new buckets for depreciation come into law.

Consult with your tax advisor to ensure you are maximizing the use of the basic acceleration techniques such as Section 179 expensing and bonus depreciation, coupled with an understanding of what qualifies as QLP (which rolls into both the Section 179 expensing and bonus depreciation buckets) and the new QIP category (which rolls into the bonus depreciation bucket). ■

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## Endnotes

1. IRC § 1.263(a)-3.
2. *Ibid.*
3. *Ibid.*
4. *Protecting Americans from Tax Hikes (PATH) Act of 2015.*
5. *Ibid.*
6. IRC § 179.
7. *Ibid.*
8. *Ibid.*
9. IRC § 168(k)(1).
10. *Protecting Americans from Tax Hikes (PATH) Act of 2015.*
11. IRC § 168(e).
12. IRC § 179(f).
13. IRC § 168(k)(3)(A).
14. IRC § 143(b)(7) Div Q, P.L. 114-113.
15. IRC § 168(k)(3)(B).
16. IRC § 168(k)(3).
17. *Protecting Americans from Tax Hikes (PATH) Act of 2015.*
18. *Ibid.*
19. IRC § 168(e)(6).
20. *Ibid.*
21. Treas. Reg. 1.48-12(b)(3)(iii).
22. IRC § 168(e)(6).
23. *Ibid.*
24. *Protecting Americans from Tax Hikes (PATH) Act of 2015.*
25. *Ibid.*

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**DON'T MISS  
THE QUICK REFERENCE FOR THE  
BUCKETS OF DEPRECIATION**





## Buckets of Depreciation: Quick Reference\*

Type	General Description	Unique Characteristics
<b>Repair Regs</b>	Allows for election to expense certain items costing up to \$2,500. A \$5,000 threshold applies to companies with Applicable Financial Statement (AFS) for that year.	Lower priced items (e.g., tools and equipment) purchased can be expensed rather than capitalized and depreciated or utilized in other buckets.
<b>General Class Lives Characteristics</b>	Includes asset classes of five-year property (e.g., automobiles and work vehicles, office machinery such as computers or copiers). Another common asset class is seven-year property (e.g., office furniture – sofa chairs, file cabinets).	Generally based on 200% declining balance method for lives less than 15 years.  Generally based on 150% declining balance for lives 15 years or greater.
<b>Section 179 Expensing</b>	The maximum deduction of \$500,000 made permanent. Businesses exceeding a total of \$2 million of purchases in qualifying equipment face deduction phase-out dollar-for-dollar (completely eliminated above \$2.5 million). Several limitations may cause carryover of unused Section 179 deductions.	No deduction if the business has a tax loss.  Can be new or used equipment.
<b>Bonus Depreciation</b>	Generally taken after the Section 179 cap is utilized. Scheduled to phase-out through 2019 unless current law is extended.  (2015, 2016, and 2017 = 50%; 2018 = 40%; 2019 = 30%)	Only for new equipment.
<b>Qualified Improvement Property (QIP)</b>	Eligible property must be placed in service after December 31, 2015. Generally applies to interior areas. Building can also be owner-occupied, i.e., not subject to lease and three-year rule does not apply.	Eligible for bonus depreciation, but not Section 179. Thirty-nine-year property for excess over bonus.
<b>Qualified Leasehold Improvement Property (QLP)</b>	New legislation permanently extends 15-year recovery period for QLP. Generally for leased property placed in service more than three years ago.	More limited than QIP, but can be included in Section 179 expensing and/or bonus depreciation buckets.
<b>Residential Rental Property</b>	Rental units, such as apartments and condos.	Depreciated over a life of 27.5 years.
<b>Nonresidential Real Property</b>	Qualifies under IRC § 1250, such as a building, store, or warehouse that is neither residential rental property nor property with a class life less than 27.5 years.	Depreciated over a life of 39 years.
<b>§ 179D Energy Property</b>	The § 179D commercial buildings energy efficiency tax deduction enables building owners (and certain qualifying designers of government buildings) to claim an immediate tax deduction for installing qualifying energy-efficient systems.	A tax deduction of \$1.80 per square foot is available for new or existing buildings.

\* This is a general overview for which all limitations and qualifications are not reflected. Always consult your tax advisor.