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Depreciation: Election to Expense Qualifying Assets (Section 179 Deduction)*

***Joseph A Bennett**, Senior Extension Associate*
Cornell University
and
***Ruby Ward**, Extension Economist and Associate Professor*
Utah State University

Introduction

The Internal Revenue Code (IRC) recognizes two major types of expenses by producers and other businesses. One is for items that are normally used during a single year. For example, if a farmer purchases fertilizer, the cost can be expensed (or deducted) in the year of purchase. The other type of expense is for assets that would normally be used over more than one year. For example, if a farmer buys a tractor, the tractor would be expensed (deducted) over a period of time. The logic is that the tractor would be used over a period of several years, while the fertilizer would only be used in the current year. To spur investment, the IRC Section 179 allows certain qualifying assets, that normally cannot be entirely deducted in one year, to be expensed (as an ordinary and necessary business cost) in whole or in part during the first year the asset is put into service. This is known as a Section 179 expense election.

There are restrictions on which assets qualify, limits on the total amount that can be deducted or expensed in any tax year, and phase out limitations if the farmer purchases assets exceeding a specified cost during the tax year. Phase out limitations apply when total purchases of qualifying assets reach a certain threshhold; at that point, the amount of the deduction is reduced and eventually completely phased out. Section 179 deductions cannot create a farm, a trade, or a business loss. Recent legislative changes have temporarily increased both the deduction and phase out amounts. The application of the Section 179 expense elections are outlined below. The Section 179 expensing election is made on Form 4562 for each individual asset.

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Qualifying Property

Generally only personal property used in a business qualifies for the deduction. The asset or qualified property may be new or used. Eligible property includes most breeding livestock, farm equipment and single purpose agriculture structures[1]. In addition, off-the-shelf computer software is currently eligible property. Property must be used more than 50% of the time in the business to qualify. General-purpose farm or business buildings, property acquired from a "related person", and certain property leased by noncorporate lessors do not qualify. Property used outside the United States, property used by tax-exempt organizations, property used with furnished lodging, property used by governments and foreigners, and air-conditioning and heating units does not qualify. IRC Section 179 deductions may not be claimed on the basis of a trade-in when property is acquired by trade-- only the "boot" is eligible. Boot is the cash and/or loans that are used to acquire the asset in addition to the value of the equipment traded for another piece of equipment. The amount taken as a Section 179 deduction reduces the assets basis prior to applying MACRS for the first year of service.

Example 1: P. Harris, a farmer, purchased and placed in service during the first 9 months of the current tax year a used tractor and used planter, 7-year MACRS property, totalling $100,000. Farmer Harris chose to use $60,000 as a Section 179 deduction and then claims the first year's depreciation on the remaining $40,000. The depreciation is $4,284 for the current year ($100,000 – 60,000 = $40,000 × 10.71% = $4,284) under the half-year convention rules. The total deduction would be $60,000 from the Section 179 deduction plus the $4,284 of depreciation for a total deduction of $64,284.

If P. Harris had not used the $60,000 of Section 179 deduction the first year, his depreciation would be $100,000 x 10.71% = $10,710.

This is creates a large variation. Using the Section 179 deduction increases the deduction in the initial year, but leaves smaller deductions available in future years. Section 179 does not change the total deduction of the asset over multiple years. It only changes the timing of the deduction, putting a larger deduction in the initial year, leaving smaller deductions for later years.

Limitations and Phase Out of Section 179 Deductions

To figure out the total amount that can be deducted in any year, three things must be considered: 1) The maximum amount of the deduction for the tax year, 2) Phase outs of the maximum amount, and 3) Limitations due to taxpayers income.

[1] A single purpose agriculture structure is one that is strictly used for a single purpose. For example, a grain bin. If the structure is used for more than one function even temporarily, it does not qualify.

Limits on the Total Amount

There is a set amount each year that limits the maximum amount of this deduction. The maximum amount that can be deducted was increased to $500,000 for 2010 and 2011, including $250,000 for certain leasehold improvements. In 2012, Section 179 Deduction is scheduled to revert to the pre-2003 tax law of $25,000. Legislation was inacted that altered these amounts for tax years beginning 2010 and 2011.

Phase Out of the Deduction

The expense deduction continues to be phased out dollar for dollar for any taxpayer that places over $2,000,000 of eligible property in service in 2010 and 2011, with a complete phase out of the use of Section 179 Deduction occurring at $2,500,000.

In the case of partnerships, the $500,000 limit applies to the partnership as well as to each partner as an individual taxpayer. A partner who has IRC Section 179 allocations from several sources could be in a situation where only $500,000 may be expensed because of the $500,000 limitation. Any allocations in excess of $500,000 are lost forever, which is a different result from the limitation discussed in the next paragraph. The same concept applies to allocated IRC Section 179 deductions from S corporations. Farm operators, who are also partners, need to consider this as “a tax return limitation” as it applies to the individual’s tax return.

Example 2: Emily Partner receives a $300,000 Section 179 Deduction from Emily and Guido Partnership and $300,000 from Emily and Amanda Partnership. She is limited to a $500,000 deduction on her personal tax return. Emily needs to work with each of the partnerships to manage the timing and amount of Section 179 Deductions.

“Active” Income Limitations

The amount of the Section 179 deduction is limited to the amount of taxable income of the taxpayer that is derived from the *active* conduct of all trades or businesses of the taxpayer during the year. Taxable income for the purpose of this rule is computed excluding the Section 179 deduction. Any disallowed Section 179 deductions due to this taxable income limitation are carried forward to succeeding years. The deduction of current plus carryover amounts is then limited to the taxable business income of that carryover year.

IRC Section 179 regulations provide that wage and salary income qualifies as income from a trade or business. Therefore, such income can be combined with income (or loss) from Form 1040 Schedules C (Profit or Loss from Business) and/or F (Profit or Loss from Farming) in determining income from the “active conduct of a trade or business” when calculating the allowable deduction. Gains and losses from a business actively conducted by the taxpayer are reported on Form 4797, Sales of Business Property, are also included. Trade or business income includes the amount of such items flowing through to the taxpayer’s return from S corporations and partnerships.

Gains from the Sale of Section 179 Assets

Gains from the sale of Section 179 assets are treated as IRC Section 1245 gains. The amounts expensed are recaptured as ordinary income in the year of sale. The Section 179 expense deduction is combined with depreciation allowed in determining the amount of gain to report as ordinary income on Part III of Form 4797. See the end of this article for information on related topics that address this in more detail.

Reporting the Expense Election

Form 4562, Depreciation and Amortization, is used to report the Section 179 Expense Election, along with any additional first year depreciation, the depreciation of recovery property, the depreciation of non-recovery property, any amortization, and specific information concerning automobiles and other listed property. The Section 179 expense election is made by reporting in Part I the description, cost and elected amount asset by asset. Depreciation or cost recovery and Section 179 expenses are combined on Form 4562 and entered on Form 1040 Schedule F, Profit or Loss From Farming. However, partnerships and S corporations will transfer the Section 179 expense election to Schedule K (Form 1065 or 1120S), rather than combining it with other items on Form 4562. Furthermore, Section 179 is excluded when calculating net earnings for self-employment at the partnership level on Schedules K and K-1. Therefore, Section 179 must be included as an adjustment on the partner's Form 1040 Schedule SE, Self-Employment Tax, if the partner meets the test for the Section 179 expense election to be taken (i.e., business income limitation and overall $500,000 limit).

Recapture of Deduction

If Section 179 property is converted to personal use or if business use drops to 50% or less in any one year, Section 179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the Section 179 expense election over the amount that would have been deducted as depreciation[2]. This additional amount of recapture is subject to self-employment tax.

Considerations for Using the Expense Election

Amount of Adjusted Gross Income

Every business owner who has purchased qualifying property should consider Section 179 expense election. For long term tax planning purposes, Section 179 should NOT be used to reduce Adjusted Gross Income below standard (or itemized) deductions PLUS exemptions, unless an additional reduction in self-employment tax is worth more than lost depreciation in future tax years. Taxpayers may not use more Section 179 expense election than the amount of taxable income from their "active conduct of a trade or business."

[2] The recapture is reported on Part IV of Form 4797 and then on Form 1040 Schedule C or F, whichever applies.

The ability to make or revoke a Section 179 expensing election on an amended return for tax years before 2012 without consent of the commissioner is available under current rules. This may provide additional flexibilty in income tax management. In 2012 and future years, the ability to revoke or make a Section 179 expensing election on an amended return will require approval by the commissioner.

Mid-Quarter Convention

Section 179 deduction can also be used to manage the triggering of the mid-quarter convention in order to maximize depreciation deductions.

Example 2. Farmer Harris purchased and placed in service a used drill for $25,000 during the second quarter of the tax year. He also purchased a used tractor for $75,000 during the last quarter of the tax year. This was the only equipment he purchased and put into service during the year. He chose to use $60,000 as a Section 179 deduction election which he applied to the $75,000 tractor. $15,000 of the tractor purchase is left to be considered for the 40% mid-quarter convention test. Thus, $15,000 ÷ ($100,000 – 60,000) = 37.5%, which is less than 40%. This test uses the percentage of property purchased during the last quarter of the year as a percentage of the total property purchased after the application of Section 179. By taking the Section 179 expense election on the tractor Harris avoids the mid-quarter convention rules. However, without using any Section 179 expense election, he would fall under the 40% (mid-quarter convention) rule. That is, $75,000 ÷ $100,000 = 75%, and all the depreciation items put into service in the current year would be subject to the mid-quarter convention rules.

Cashflow Needs in Future Years

When depreciation expenses are matched to principal and down payments of equipment, the cash flow required to service the debt is minimized for that year. If aggressive use of Section 179 is elected on equipment purchases with small down payments and heavy financing, it will generally trigger higher cash flow needs in future years because principal payments are not tax deductible. Therefore enough after tax income must be generated to make the principal portion of the payment which may limit the funds left over for future purchases or for withdrawals from the business.

Conclusion

Section 179 expensing election is a powerful tool to manage income taxes. It does not increase the deduction relating to a purchase; rather, it allows a farmer to time manage purchases and deductions. Section 179 allows for a larger deduction in the first year and smaller deductions in future years. Since Section 179 can have both a cash flow and income tax effect, it is important for the taxpayer to understand its capabilities and be involved in the decision to use it with his or her tax professional.

IRS Publications

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IRS Publication 946: How to Depreciate Property. This publication specifically covers depreciation with great detail.

IRS Publication 225, Farmer's Tax Guide. This publication addresses many of the issues for depreciation including separate sections for: Depreciation, Chapter 7; Basis of Assets, Chapter 6; and Dispositions of Property Used in Farming, Chapter 9.

Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities, to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

Fact sheets that might be of particular interest include:

- Depreciation: An Introduction
- Depreciation: Class Life
- Depreciation: Cost Recovery Methods and Options
- Depreciation: Special Rules on Pickups, SUVs, Other Autos and Listed Property
- Depreciation: Bonus or Additional First-Year Depreciation (AFYD)
- Depreciation: Other Topics
- Depreciation: Alternative Minimum Tax Considerations
- Depreciating Your Home Office