Concannon Miller
Certified Public Accountants Business Consultants

# Memorandum

**FROM:** **Tax Services (Milan D. Slak, JD, LL.M, Esq., CPA)**

**DATE:** **January 20, 2011**

**RE:** **New Tax Law Affecting Cost Recovery Deductions and the Estate Tax**

---

2010 certainly provided us with many changes to our tax laws. Part one below summarizes the cost recovery rules for 2010 – 2013. There is a useful chart at the last page. Part two summarizes the return of the estate tax.

## I. Cost Recovery Tax Deductions

### A. Bonus Depreciation – In General

In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, placed in service in 2008, 2009, or 2010 (2011 for certain property), by permitting 50% bonus depreciation. The new law extends and temporarily increases this additional first-year depreciation provision for investment in new business equipment.

For investments placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived and transportation property), the new law provides for 100% bonus depreciation. In other words, the entire cost of qualifying property placed in service during that time frame can be written off, without limit. Note that even though the legislation did not become law until mid-December of 2010, the effective date of this provision was made retroactive, to include qualifying property placed in service after September 8, 2010. 50% bonus depreciation will apply again in 2012. The new law extends through 2012 the election to accelerate the refundable AMT credit instead of claiming bonus depreciation.

The new law leaves in place the existing rules as to what kinds of property qualify for additional first-year depreciation. Generally, the property must be (1) depreciable property with a recovery period of 20 years or less; (2) water utility property; (3) computer software; or (4) qualified leasehold improvements (see below). Also the original use of the property must commence with the taxpayer – used property doesn't qualify. As discussed below, certain real estate improvements are eligible for this bonus depreciation deduction.

**Election Out:** Bonus depreciation is mandatory, unless a taxpayer elects not to claim bonus depreciation for any class of property for any tax year. The election out of bonus depreciation must be made for all additions within an entire class placed in service for the tax year.

**Summary (excluding longer-lived and transportation property):** For property placed in service during…

| | |
|---|---|
| 1/1/2010 – 9/8/2010 | 50% bonus depreciation |
| 9/9/2010 – 12/31/2011 | 100% bonus depreciation |
| 1/1/2012 – 12/31/2012 | 50% bonus depreciation |
| After 12/31/2012 | No bonus depreciation |

## B. Section 179 Expensing – In General

Generally, if useful beyond the year, the cost of property used in a trade or business can't be deducted in the year it's placed in service. Instead, the cost is "capitalized" and depreciation deductions are allowed for most property (other than land), but are spread out over a period of years. However, to help small businesses quickly recover the cost of capital outlays for qualifying personal property, small business taxpayers can elect to write off these expenditures in the year of acquisition instead of recovering the costs over time through depreciation. The expense election is made available, on a tax year by tax year basis, under Section 179 of the Internal Revenue Code, and is often referred to as the "Section 179 expense election." There are three important changes to the Section 179 expense election.

First, the new law provides that for tax years beginning in 2012, a small business taxpayer will be allowed to write off up to $125,000 (indexed for inflation) of capital expenditures subject to a phaseout once capital expenditures exceed $500,000 (indexed for inflation). The new maximum expensing amount and phaseout level for tax years beginning in 2012 is actually lower than the levels in effect for tax years beginning in 2010 or 2011 (maximum expensing amount of $500,000, and a phaseout level of $2,000,000). For tax years beginning after 2012, the maximum expensing amount will drop to $25,000 and the phaseout level will drop to $200,000. Second, the rule that treats off-the-shelf computer software as qualifying property is extended through 2012. Finally, the new law extends, through 2012, the provision permitting a taxpayer to amend or irrevocably revoke a Section 179 expense election for a tax year without IRS's consent.

Let's not forget that under the 2010 Small Business Jobs Act, enacted in early 2010, (1) for tax years beginning in 2010 and 2011, the $250,000 limit is increased to $500,000 and the investment ceiling to $2,000,000, and (2) the up-to-$500,000 of property that can be expensed can include up to $250,000 of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property), discussed below.

**Summary** For property placed in service during tax years beginning in…

| | |
|---|---|
| 2010 * | $500,000 Section 179 Expense Limit / $2,000,000 investment ceiling |
| 2011 * | $500,000 Section 179 Expense Limit / $2,000,000 investment ceiling |
| 2012 | $125,000 Section 179 Expense Limit / $ 500,000 investment ceiling |
| 2013 | $ 25,000 Section 179 Expense Limit / $ 200,000 investment ceiling |

* For 2010 and 2011, up to $250,000 of the expense limit may include qualified real property.

## C. Qualified Real Property

The 15 year depreciable life for qualified real property has been extended for tax years 2010 and 2011. New for tax years beginning in 2010 and 2011, qualified real property is eligible for up to $250,000 of Section 179 expensing. Unlike other qualified property, any Section 179 deduction for qualified real property that is unused due to the taxable income limit cannot be carried to a year beginning after 2011. For tax years starting after 2011, the depreciable life for qualified real property will return to 39 years.

Qualified real property includes the following (defined below):

- Qualified leasehold improvement property
- Qualified restaurant property
- Qualified retail improvement property

### 1. Qualified Leasehold Improvement Property

**Definition.** Any improvement to an <u>interior portion of a building</u> that is nonresidential real property provided the following requirements are met:

1. The improvement must be Section 1250 property (and thus, generally, a structural component of the building),
2. The improvement must be made under or pursuant to a lease either by the lessee, sublessee, or lessor of that interior building portion, and the portion must be occupied exclusively by the lessee or sublessee, and
3. The improvement must be placed in service more than three (3) years after the date the building was placed in service.

Qualified leasehold Improvements do not include any improvement for which the expenditure is attributable to:

1. The enlargement of the building,
2. Any elevator or escalator,
3. Any structural component benefiting a common area, or
4. The internal structural framework of the building.

**179 Expensing.** For tax years beginning in 2010 and 2011, qualified leasehold improvement property is eligible for up to $250,000 of Section 179 expensing. Thereafter, it's not. 179 Expensing is elective.

**Bonus Depreciation.** Qualified leasehold Improvement property **<u>is</u>** considered qualified property for purposes of Code Sec. 168(k), which provides additional bonus depreciation for certain property. Bonus depreciation is mandatory, unless elected out.

**15 v. 39 Year Depreciation.** Qualified leasehold improvement property placed in service after October 22, 2004 and before January 1, 2012 (including 2009, 2010, and 2011) can be depreciated using the straight-line method, over a 15 year recovery period. Thereafter, it's depreciated using the straight-line method, over a 39 year recovery period.

### 2. Qualified Restaurant Property

**Definition.** Any Section 1250 property that is:

1. A <u>building</u>, if that building is placed in service after December 31, 2008 and before January 1, 2012, or
2. An improvement to a building placed in service after December 31, 2008 and before January 1, 2012, if more than 50% of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.

Note: The deduction is taken when the building is placed in service, not when it is built.

**179 Expensing.** For tax years beginning in 2010 and 2011, qualified restaurant property is eligible for up to $250,000 of Section 179 expensing. Thereafter, it's not. 179 Expensing is elective.

**Bonus Depreciation.** Qualified restaurant property **<u>is not</u>** considered qualified property for purposes of Code Sec. 168(k), which provides additional bonus depreciation for certain property.

**15 v. 39 Year Depreciation.** Qualified restaurant property placed in service after December 31, 2008 and before January 1, 2012 (2009, 2010, and 2011) can be depreciated using the straight-line method, over a 15 year GDS recovery period. Thereafter, it's depreciated using the straight-line method, over a 39 year GDS recovery period.

### 3. Qualified Retail Improvement Property

**Definition.** Any improvement to an interior portion of a building that is nonresidential property if:

1. That portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and
2. The improvement is placed in service more than there (3) years after the date the building was first placed in service.

Qualified retail improvement property does not include any improvement for which the expenditure is attributable to:

1. The enlargement of the building,
2. Any elevator or escalator,
3. Any structural component benefiting a common area, or
4. The internal structural framework of the building.

**179 Expensing.** For tax years beginning in 2010 and 2011, qualified retail improvement property is eligible for up to $250,000 of Section 179 expensing. Thereafter, it's not. 179 Expensing is elective.

**Bonus Depreciation.** Qualified retail improvement property **is not** considered qualified property for purposes of Code Sec. 168(k), which provides additional bonus depreciation for certain property.

**15 v. 39 Year Depreciation.** Qualified retail improvement property placed in service after December 31, 2008 and before January 1, 2012 (2009, 2010, and 2011) can be depreciated using the straight-line method, over a 15 year GDS recovery period. Thereafter, it's depreciated using the straight-line method, over a 39 year GDS recovery period.

## II. Return of the Estate Tax

The estates of wealthy individuals who died in 2010 didn't pay any federal estate tax, but that situation just changed. Under recently enacted tax law, the federal estate tax, which disappeared for 2010, springs back to life in 2011 and is imposed at the top rate of 35% of the estate's value after the first $5 million.

### Background

The modern estate tax dates back to 1916, when it was imposed at a rate of 10% on the portion of estates above $50,000. Over the following years, the rates and exemption amounts have varied, reaching a high of 77% from 1941 to 1976 with a $60,000 exemption amount.
In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the first of the two large legislative packages that contain most of what are now commonly referred to as the Bush tax cuts. EGTRRA gradually lowered the maximum estate tax rate and substantially raised the applicable exclusion amount over the years 2002 through 2009. The maximum tax rate fell from 60% under prior law in 2001 (a 55% marginal rate on taxable estate values over $3 million plus a 5% surtax from $10 million to $17 million) to 45% in 2007-2009. EGTRRA repealed the estate tax completely for decedents dying in 2010. That led to several well-publicized instances in which famous people died in 2010 leaving multibillion-dollar estates that will pass to their heirs without paying so much as a penny in federal estate tax. However, all of those provisions were scheduled to sunset on December 31, 2010, meaning that if Congress had not acted, starting January 1, 2011, the estate tax would have sprung back at a level that no one seemed to want. Where the exclusion was $3.5 million

($7 million for couples) in 2009 – a level at which it affected relatively few households – it would have been $1 million ($2 million for couples) in 2011. The tax rate would also have risen, from a top rate of 45% in 2009, to a top rate of 55% in 2011.

**New law**

The new law brings back the estate tax, for 2011 and 2012 anyway. During 2011 and 2012, the top rate will be 35%. For 2011, the exemption amount will be $5 million per individual (indexed for inflation after 2011). At those levels, the vast majority of estates (all but an estimated 3,500 nationwide in 2011) will not be subject to any federal estate tax, and the tax will raise about $11.4 billion for the government. By way of comparison, the 55% tax with a $1 million exemption would have resulted in about 43,540 taxable estates in 2011, and raised about $34.4 billion. Tax historians would also note that except for the temporary repeal of the estate tax in 2010, the estate tax rate has not been less than 45% since 1931.

The new law also gives heirs of decedents dying in 2010 a choice of which estate-tax rules to apply – 2010's or 2011's. That's important because although there is no estate tax in 2010, some inherited assets are subject to higher capital gains tax under the 2010 rules, a situation that actually raises the tax burden for some heirs. Inherited assets under the 2010 rules have a tax basis equal to the price when they were purchased (referred to in tax parlance as "carryover basis") rather than their value at death. That could lead to a significant tax burden for heirs who sell assets such as stocks that had been held for many years and have greatly appreciated in value. Under the 2011 rules, by contrast, heirs will be allowed to inherit assets with a "stepped-up basis." While most heirs would choose the 2011 regime ($5 million exemption from both estate and generation-skipping tax and an unlimited step-up in the basis of assets to their current market value), the heirs of superrich decedents could find it more advantageous to elect the original 2010 law (limited step-up in the basis of assets and no estate tax). If the executor does not elect to have the original 2010 rules apply, the estate tax return's due date will not be earlier than the date that's nine months after the new law's enactment date (Sept. 19, 2011).

For gifts made after December 31, 2010, the gift tax will be reunified with the estate tax. Under the new law, the estate and gift tax exemptions will be reunified starting in 2011, which means that the $5 million estate tax exemption will also be available for gifts. The law in effect prior to 2010 provided a $3.5 million lifetime exemption for estates, but only $1 million for gifts. The gift tax rate, starting in 2011, will be 35%. The exemption from the generation-skipping tax (GST) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to $5 million from the $1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%.

From a planning standpoint, a nice feature of the new law is that it makes it easier to transfer the $5 million exemption to a surviving spouse, so married couples can shield $10 million of their assets from taxes. In the language of tax professionals, the estate tax exemption will be "portable."
I hope this information is helpful. If you would like more details about the cost recovery rules as they apply to real estate, the estate tax, or any other aspect of the new law, please do not hesitate to contact us.

This memo is intended to be a general overview for you to consider in your tax planning. This memo is not intended to address all of the issues that may affect you. This letter is not intended nor meant to be legal or tax advice. You are encouraged to consult with your own tax advisors for specific advice regarding the topics discussed herein may affect you.

**BONUS DEPRECIATION, SECTION 179 EXPENSING, AND 15 YEAR DEPRECIATION FOR LEASEHOLD IMPROVEMENTS**

| **BONUS DEPRECIATION** | 1/1/2010 - 9/8/2010 | 9/9/2010 - 12/31/2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| BONUS DEPRECIATION PERCENTAGE<br>(MANDATORY, MUST ELECT OUT BY CLASS) | 50% | 100% | 100% | 50% | 0% |

| **SECTION 179 EXPENSING** | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| SECTION 179 EXPENSE LIMIT | $ 500,000 | $ 500,000 | $ 125,000 | $ 25,000 |
| SECTION 179 INVESTMENT CEILING<br>(ELECTIVE, MUST ELECT EXPENSE AMOUNT) | $ 2,000,000 | $ 2,000,000 | $ 500,000 | $ 200,000 |

| **QUALIFIED REAL PROPERTY** | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| QUALIFIED LEASEHOLD IMPROVEMENTS | | | | |
| ELIGIBLE FOR UP TO $250,000 OF SECTION 179 EXPENSING | YES | YES | NO | NO |
| ELIGIBLE FOR BONUS DEPRECIATION | YES | YES | YES | N/A |
| DEPRECIABLE LIFE | 15 YEARS | 15 YEARS | 39 YEARS | 39 YEARS |
| QUALIFIED RESTAURANT PROPERTY | | | | |
| ELIGIBLE FOR UP TO $250,000 OF SECTION 179 EXPENSING | YES | YES | NO | NO |
| ELIGIBLE FOR BONUS DEPRECIATION | NO | NO | NO | NO |
| DEPRECIABLE LIFE | 15 YEARS | 15 YEARS | 39 YEARS | 39 YEARS |
| QUALIFIED RETAIL IMPROVEMENT PROPERTY | | | | |
| ELIGIBLE FOR UP TO $250,000 OF SECTION 179 EXPENSING | YES | YES | NO | NO |
| ELIGIBLE FOR BONUS DEPRECIATION | NO | NO | NO | NO |
| DEPRECIABLE LIFE | 15 YEARS | 15 YEARS | 39 YEARS | 39 YEARS |