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Rethinking Depreciation Deductions: New Opportunities for Immediate Expensing

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Under the prior depreciation regime, taxpayers generally could utilize a special depreciation deduction equal to 50% of the cost of qualified property in the year the property was placed into service, with a phase down beginning after 2017. Qualified property generally was defined as modified accelerated cost recovery system (MACRS) property with a useful life of 20 years or less that was first used by the taxpayer. The Tax Cuts and Jobs Act (TCJA), however, provides businesses the opportunity to take a special depreciation deduction equal to 100% of the cost of qualified property placed in service after September 27, 2017 and before January 1, 2023, with the available deduction phased out, in 20% increments, between 2023 and 2026. Under the TCJA, qualified property generally is defined in the same manner as under prior law, but now also includes used property acquired by the taxpayer in an arm's length transaction. Taxpayers may elect to apply straight-line depreciation in lieu of the 100% depreciation deduction for property on a class-by-class basis in the year it is placed into service. In addition, under a transitional rule, taxpayers may elect to take the 50% depreciation deduction available under prior law for qualified property placed in service during the taxpayer's first taxable year ending after September 27, 2017.

Taxpayers in the energy industry, whether structured as partnerships (or other entities treated as partnerships, such as LLCs) or corporations, already were incentivized to invest in qualified property under the prior depreciation regime. The availability of a 100% depreciation deduction, however, should spur additional capital investment in qualified property as a means to reduce tax liability, and increase cash flow, in the year the property is placed into service. Moreover, taxpayers acquiring used property in basis step-up transactions, including applicable asset acquisitions and acquisitions of equity in pass-through entities holding qualified property, will be able to take an immediate deduction equal to the cost of the qualified property and recognize the same upfront tax benefit, which was not available under prior law. Such taxpayers may further enhance their tax savings by allocating a greater portion of purchase price to qualified property instead of intangibles and goodwill, which must be depreciated over fifteen years.

Regulated gas and power businesses are not eligible for the 100% depreciation deduction for qualified property. For these businesses, if the 100% deduction were available, the resulting tax savings likely would have led to reduced rates for customers and, therefore, the exclusion is not expected to be a significant deterrent to their capital investment.

Taxpayers in the energy industry should understand certain practical limitations to these new rules. First, taxpayers should recognize that the 100% depreciation deduction does not represent a permanent tax savings. This deduction, like all depreciation deductions, will be subject to recapture at ordinary income rates if the qualified property, or equity in a pass-through entity holding the qualified property, is ultimately sold at a gain. In addition, because the 100% depreciation deduction will be phased out after 2022, taxpayers with long-term energy projects requiring capital investment over several years will see their tax savings wane as they place qualified property into service from and after 2023.

Finally, taxpayers should be wary about creating more taxable losses than they can utilize in a given year. Under the TCJA, losses generated by a corporation after December 31, 2017 are no longer eligible to be carried back to previous years and, when carried forward, are available to offset only 80% of taxable income in the carryforward year. Accordingly, a corporate taxpayer expecting little or no income in the early years of a large project may consider electing out of the 100% depreciation deduction in favor of more closely matching income to available deductions over the life of the qualified property, thereby avoiding an immediate net loss that will be subject to limitations.