CHASE

COMMERCIAL BANKING

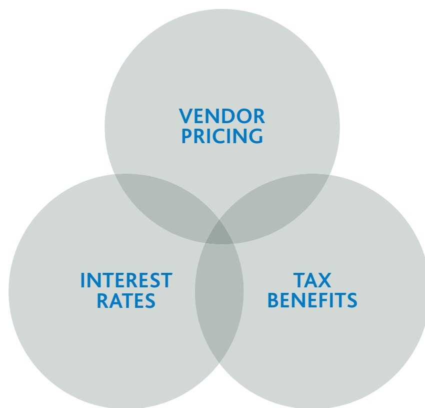
BONUS DEPRECIATION:

Maximizing Capital Investment While Minimizing Tax Bills

During the recession, many companies held off on capital expenditures in order to preserve resources. However, with today's incredibly low interest rates, aggressive vendor pricing and unprecedented tax benefits, there's never been a better time for U.S. companies to reinvest in their businesses by acquiring new equipment.

This report is focused on the 100 percent bonus depreciation tax benefit, which is part of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"). According to the White House, this is "the largest short-term incentive program in U.S. history and has the potential to benefit 1.5 million U.S. corporations." *

In today's buyer's market, bonus depreciation can help businesses by lowering the cost of acquiring equipment, and should be a significant part of every company's capital investment strategy.



Overview

Businesses typically deduct capital expenditures over time according to an asset classification schedule set by the IRS. With 100 percent bonus depreciation, businesses can take the entire deduction up-front in the year the equipment is acquired.

U.S. companies have until the end of this year to take advantage of special tax deductions for qualifying assets purchased in 2011. Even if companies don't have sufficient taxable income to offset, this option can still be beneficial as long as the equipment is ordered and placed in service by December 31, 2011, except for Long-Term Production Property (LTPP) for which more time may be available.

Stimulating the Economy by Encouraging Capital Expenditures

Writing-off or depreciating equipment acquisitions for tax purposes is not a new concept. In 1986, Congress designed a system that is still in use today to help companies depreciate equipment. This system is based on the concept that long-lived equipment (in other words, used over a long period of time) should be written off over an extended timeframe. Conversely, equipment that is short-lived should be written off over a shorter timeframe. Economically speaking, a company prefers to accelerate tax benefits because of the time value of those deductions on its current tax liability.

Back in 2001, Congress capitalized on this time-value concept by creating a 30 percent bonus depreciation rule designed to stimulate economic growth following the events of September 11. This benefit allowed for an immediate 30 percent write off for qualified equipment, which could be taken in addition to the regular depreciation allowed on the remaining 70 percent. This created an economic benefit for companies investing in new equipment in 2002 and 2003. In 2004, 50 percent bonus depreciation was enacted for property placed in service for the latter portion of 2003 and 2004.

The rule proved to be so popular that Congress reintroduced 50 percent bonus depreciation in 2008 and extended the rule into 2009 to continue stimulating capital investment. During 2010, there was significant uncertainty over whether Congress would renew bonus depreciation. In September, it reinstated 50 percent bonus depreciation for 2010 and surprised the marketplace by introducing 100 percent bonus depreciation for the end of 2010 and all of 2011.

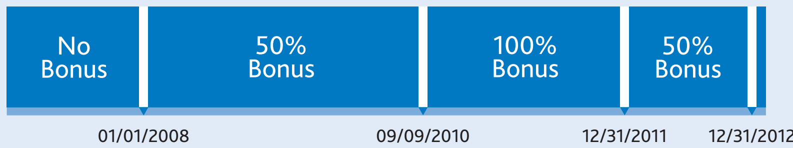
DIGGING INTO THE DETAILS

Given that this benefit is derived from a set of tax rules, paying attention to the details is critical. In order to qualify for 100 percent bonus depreciation, the following criteria must be met:

- The equipment must be new, as the intent of the rule is to induce new capital investment;
- The equipment must be eligible for regular Modified Accelerated Cost Recovery System (MACRS) depreciation, which generally is satisfied for U.S. taxpaying companies with equipment operated within the U.S.;
- The equipment must have been ordered and placed into service between September 8, 2010 and December 31, 2011; and
- The equipment must have a recovery period of 20 years or less.

The program also allows for an extension of 100 percent bonus depreciation for equipment placed into service in 2012 that meets the qualifications of long-term

BONUS DEPRECIATION TIMELINE



production property (LTPP) and for certain aircraft (including corporate aircraft). For example, a tugboat that is ordered in 2011 but delivered in 2012 that meets the qualifications for LTPP would be eligible for 100 percent bonus depreciation in 2012. The criteria are as follows:

- The property must cost more than $1 million;
- The property must have a recovery period of at least 10 years;
- The property must have an estimated construction period of more than one year;
- The property must be placed into service by December 31, 2012;
- The property must either be i) acquired after September 8, 2010 but before December 31, 2012; or ii) acquired pursuant to a binding written contract entered into between January 1, 2008 and December 31, 2012.

Assuming these criteria are met, there's still time for companies to enter into purchase contracts by the end of 2011 to take advantage of 100 percent bonus depreciation next year.

For eligible purchases that are ordered and delivered in 2012 but do not meet the above criteria, the Act extends bonus depreciation into next year at a rate of 50 percent. In addition, 50 percent bonus depreciation will be available in 2013 to eligible businesses that meet the LTPP criteria for acquisitions made in 2012.

Treasurers should be aware that, for planning purposes, taxable income in the future will be greater as the regular depreciation deductions associated with the new equipment will not be available. Bonus depreciation is elective, so if it's determined that taking 100 percent bonus depreciation isn't beneficial, companies can decline it.

Multiple Ways to Participate

Some companies may not have enough taxable income to fully utilize the deduction, but they can still take advantage of the program by entering into a lease, which is generally much more beneficial than opting out of the program entirely. Bank leasing companies can fully utilize the 100 percent bonus depreciation benefit by purchasing the equipment and leasing it to the operator, and then passing the benefit back in the form of reduced cost financing. For example, a market rate for a 10-year lease for a rail car might be around 4.00 percent today, whereas the rate for that same rail car with the lessor receiving 100 percent bonus depreciation would reduce the rate by about 55 basis points to 3.45 percent, which is a significant savings to the corporation.

Per the guidelines, a bank leasing company (or other acquirer) must purchase the asset within 90 days of the asset's "in-service" date or date acquired in order to obtain the benefit. This provision prevents the benefit from being applied to sale/leaseback transactions for older equipment since the intent of the legislation is to stimulate new capital investment.

The rules are intricate, so it's important for companies to consult with their auditors or tax counsel. They can review the specific facts and circumstances of the organization's acquisition and capital budgeting plans to confirm their eligibility for this program.

*White House Fact Sheet, September 2010

MAKING THE MOST OF EXISTING EQUIPMENT

Long-lived equipment such as manufacturing equipment, corporate aircraft, rail cars and marine vessels tend to retain their value and are often easy to refinance during the first third of their economic life. With interest rates at historic lows, this is an opportune time for businesses to consider locking in low-rate, long-term financing through the sale/leaseback of their existing assets.

A sale/leaseback is when a company sells an existing piece of equipment to a financial organization that then leases it back to the company. The company becomes a lessee and continues to use the equipment in exchange for monthly payments, while the financial organization is the lessor and owns the equipment.

Companies with expiring net operating losses (NOL) may find sale/leaseback transactions particularly beneficial. Used equipment with a current fair market value at a low or zero tax basis will generate a taxable gain that can offset expiring NOL. This preserves the value of the NOL that otherwise would have been lost and refreshes it in the form of deductible lease payments.

The sale/leaseback of existing equipment is a great way for companies to raise capital. They can then use the proceeds for capital expenditures and other strategic applications.

For more information, please contact your Chase Commercial Banking representative or visit Chase.com/commercial

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