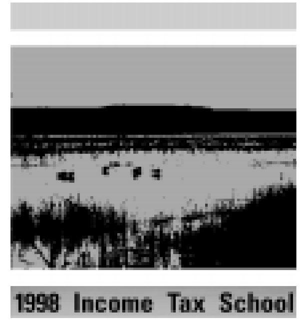

Depreciation

1998 Income Tax School

DEPRECIATION

I. HISTORY

A. PROPERTY PLACED IN SERVICE PRIOR TO 1981

- Before ACRS was enacted, other methods were used to figure depreciation. If property was placed in service before 1981, or if it does not qualify for ACRS or MACRS, it must still be depreciated by these methods. However, these methods cannot be used for property that qualifies for ACRS or MACRS.

B. ACRS (1981-1986)

ACRS was a mandatory system for most tangible depreciable property placed in service **after** 1980 and **before** 1987. Under regular ACRS the half-year convention applied to the year of purchase, and there was no deduction in the year of sale or disposition. ACRS **recovery periods** are: 3-year class; 5-year class; 10-year class; 15-year class; 18-year class; 19-year class.

Alternate ACRS method. Instead of using the prescribed ACRS percentages, a taxpayer could elect to use **straight-line depreciation** over varying recovery periods. If this alternate method was elected for 3-, 5-, or 10-year property, a half-year convention was required for the year the property was placed in service. (No depreciation was permitted in the year of disposition.)

In the Case of	You Could Have Elected a Recovery Period of
3-year property	3, 5, or 12 years
5-year property	5, 12, or 25 years
10-year property	10, 25, or 35 years
15-year property	15, 35, or 45 years

II. THE MACRS SYSTEM

A. INTRODUCTION

(a) The Accelerated Cost Recovery System (ACRS) was modified for property placed in service after December 31, 1986. **The IRS uses the acronym MACRS for the modified system.**

(b) **Property classes under MACRS.** The property classes (and recovery periods) of property are 3-, 5-, 7-, 10-, 15-, and 20-year property. In addition, most real property is classified as residential rental property or nonresidential real property (27.5- or 31.5-year property).

Note. Nonresidential real property placed in service after 5-12-93 is 39-year property.

General purpose farm buildings are 20-year property.

The recovery class to which property is assigned is determined by its class life. **The class life of an item of property determines its recovery period and the method of depreciation used.**

Very important Practitioner Note: The 1998 Act allows a taxpayer to elect to use AMT depreciation for regular tax purposes using the regular tax life instead of the alternate depreciation lives of the ADS for assets placed in service after 1998.

The Act

Act §6006(b). Election to use AMT depreciation for regular tax purposes:
[Code §168]

Present Law. For regular tax purposes, depreciation deductions for certain shorter-lived tangible property may be determined using the 200-percent declining balance method over 3-, 5-, 7-, or 10-year recovery periods (depending on the type of property). **For alternative minimum tax ("AMT") purposes, depreciation on such property placed in service after 1986 and before 1999 is computed by using the 150-percent declining balance method over the longer class lives prescribed by the alternative depreciation system of § 168(g).** A taxpayer may elect to use the methods and lives applicable to AMT depreciation for regular tax purposes.

The 1997 Act conformed the recovery periods (but not the methods) used for purposes of the AMT depreciation to the recovery periods used for purposes of the regular tax, for property placed in service **after 1998.** The 1997 Act did not make a conforming change to the election to use the pre-1998 AMT recovery methods and recovery periods for regular tax purposes.

Explanation of Provision. For property placed in service **after 1998,** a taxpayer would be allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200-percent declining balance method by using the **150-percent declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system of §168(g)) to avoid an AMT adjustment (Straight line depreciation can still be claimed for regular tax purposes over the regular life for assets placed in service after 1998.)**

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B. EXAMPLES OF PROPERTY INCLUDED IN PROPERTY CLASSES—MACRS

1. **3-year property (class life of 4 years or less):**

- Breeding hogs
- Over-the-road tractor
- Horses assigned to 3-year class under prior law (race horse more than two years old at the time it is placed in service and any horse other than a race horse that is more than 12 years old at the time it is placed in service)

2. **5-year property (class life of more than 4 years but less than 10 years):**

- Automobiles
- Light and heavy general-purpose trucks
- Computers and peripheral equipment
- Typewriters, copiers, adding machines
- Airplanes

- Trailers
- Cattle held for breeding or dairy purposes
- Sheep and goats held for breeding purposes
- Assets used in construction by general building, special trade, heavy and marine operative and investment builders, real estate subdividers and developers, and others, except railroads
- Logging machinery and equipment
- Qualified technological equipment
- Research and experimentation property
- Solar and wind energy properties

3. 7-year property (class life of 10 years or more but less than 16 years):

- Single-purpose agricultural and horticultural structures placed in service **prior to 1989**
- Office furniture, fixtures, and equipment
- Machinery and equipment, grain bins, and fences but no other land improvements that are used in the production of crops or plants, vines, and trees; the production of livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushroom cellars, cranberry bogs, apiaries, and fur farms; the performance of agriculture, animal husbandry, and horticultural services
- Cotton-ginning assets
- Breeding or working horses
- Assets used in the provision of entertainment services on payment of a fee or admission charge as in the operation of bowling alleys, billiard and pool establishments, theaters, concert halls, and miniature golf courses. Does not include amusement and theme parks and assets that consist primarily of specialized land improvements or structures such as golf courses, sports stadia, race tracks, ski slopes, and buildings that house the assets used in entertainment services (Added to this category are assets that have no ADR midpoint and that are not classified.)

4. 10-year property (class life of 16 years or more but less than 20 years):

- Manufacture of grain and grain mill products: includes assets used in the production of flours, cereals, livestock feeds, and other grain and grain mill products
- Manufacture of sugar and sugar products: includes assets used in the production of raw sugar, syrup, or finished sugar from sugar cane or sugar beets
- Manufacture of vegetable oils and vegetable oil products: includes assets used in the production of oil from vegetable materials and the manufacture of related vegetable oil products
- Single-purpose agricultural and horticultural structures placed in service **after 1988**
- Fruit trees

5. 15-year property (class life of 20 years or more but less than 25 years):

- Municipal wastewater treatment plants
- Land improvements: includes improvements directly to or added to land, whether such improvements are §1245 property or §1250 property, provided such improvements are depreciable. Examples of such assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences (other than farm fences), landscaping, shrubbery, or radio and television transmitting towers. Does not include land improvements that are explicitly included in any other class.
- Distributive trades and service-billboards, service station buildings, and petroleum marketing land improvements: includes §1250 assets, including service station buildings and depreciable land improvements, whether §1245 property or §1250 property, used in the marketing of

petroleum and petroleum products, but not including any of these facilities related to petroleum and natural gas trunk pipelines. Includes car wash buildings and related land improvements. Includes billboards, whether such assets are §1245 property or §1250 property. Excludes all other land improvements

6. **20-year property (class life of 25 years or more other than §1250 property with class life of 27.5 years or more):**

- Farm buildings such as general purpose and machine sheds
- Municipal sewers

7. **Residential rental property (27.5-year recovery period):**

- Building or structure if 80% or more of the gross rental income is rental income from dwelling units [Code §168(e)(2)(A)(I)]
- Dwelling unit is a house or an apartment used to provide living accommodations in a building or structure; it does not, however, include a unit in a hotel, motel, inn, or other establishment in which more than one-half of the units are used on a transient basis.

8. **Nonresidential real property (31.5-year recovery period for property placed in service before 05/13/93; 39-year recovery period for property placed in service on or after 05/13/93):**

- Section 1250 class property that is not residential rental property and does not have an ADR midpoint of less than 27.5 years.

C. ALTERNATIVE DEPRECIATION SYSTEM (ADS)

1. The Alternative Depreciation System covers assets that MACRS does not apply to:
   a. Tangible property used predominantly outside the United States during the tax year, **or**
   b. Tax-exempt used property, **or**
   c. Tax-exempt bond-financed property, **or**
   d. Property covered by an Election to Use Alternative Depreciation System.

   Election: If the taxpayer makes an election with respect to any class of property for any taxable year, the **alternative depreciation system shall apply to all property in such class** placed in service during such taxable year. Notwithstanding the preceding sentence, in the case of nonresidential real property or residential rental property, such election may be **made separately with respect to each property.**

2. The life is used for the purpose of computing the alternative minimum tax adjustment item.

3. The computation method under ADS is the straight-line method using the applicable convention over the specified recovery period (alternate MACRS life).
4. **Recovery period**

- Property with a class life (midpoint of ADR [§168(i)(1)(A)]).
- Property with no class life: 12 years
- Nonresidential real and residential rental: 40 years.
- Section 1245 property that is real property with no class life: 40 years

5. The following table lists the ADR midpoint for selected assets is listed in Depreciation Practice Guides 2 and 3 below.

> **Practice pointer.** For alternative minimum tax purposes, depreciation for asssets placed in service after 1986 and before 1999, is computed using the 150% declining balance method for 3-, 5-, 7-, and 10-year property over the ADS life. Any taxpayer can elect to use the prescribed alternative minimum tax depreciation method in computing regular taxable income. **But note that if straight-line depreciation is elected for regular tax purposes, it must be used for AMT**

D. ELECTION TO EXCLUDE CERTAIN PROPERTY

1. A taxpayer may elect to exclude property from MACRS by using a method of depreciation that is not based on a term of years, such as the unit-of-production method.
2. If a taxpayer uses the standard mileage rate for an automobile purchased and used for business, the taxpayer is considered to **have elected to exclude** that automobile from ACRS and MACRS.

III DEPRECIATION PRACTICE GUIDES

A. GUIDE 1: GENERAL DEPRECIATION SYSTEM

Personal property other than listed property–option chosen must apply to all property placed in service in each class during the tax year

Option	Method	Recovery Period	AMT Adjustment Required?	Convention	Tables (IRS Pub. 946 Appendix A)
A. MACRS—Regular	1. 200% declining Balance for 3-, 5-,7-, and 10-year property other than property used in farming	3 years 5 years 7 years 10 years 15 years 20 years	Yes, AMT requires 150% declining balance over alternate MACRS (ADS) (longer) life. **But regular life after 1998.**	Half-year or midquarter (depreciation allowed in year of disposition)	**Nonfarm** Half-year—Table 1 Midquarter—Tables 2—5 **Farm** Half-year—Table 14 Midquarter—Tables 15—18
	2. 150% declining balance for 3-, 5-, 7-, and 10-year property used in farming	See Depreciation Practice Guides 2 and 3			
	3. 150% declining balance for 15- and 20-year property				

B. MACRS—Straight-line over regular MACRS recovery period	Straight-line	3 years 5 years 7 years 10 years 15 years 20 years See Depreciation Practice Guides 2 and 3	Yes, AMT requires straight-line over alternate MACRS (ADS) (longer) life. (If straight-line is used for regular tax, it must be used for AMT.) **But no for property placed in service after 1998.**	Half-year or midquarter	**Farm and Nonfarm** Half-year—Table 8 Midquarter—Tables 9–12
C. Alternate Depreciation System	Straight-line	Alternate MACRS life (ADS) See Depreciation Practice Gudes 2 and 3	No	Half-year or midquarter	**Farm and nonfarm** Half-year—Table 8 Midquarter—Tables 9–12
D. AMT Method	150% declining balance	Alternate MACRS life (ADS) See Depreciation Practice Guides 2 and 3, **but must use regular life after 1998.**	No	Half-year or midquarter	**Farm and nonfarm** Half-year—Table 14 Midquarter—Tables 15–18
Real property option—option chosen can be on a property-by-property basis.					
A. MACRS	Straight-line	27.5 years—residential rental *39 years—nonresidential real	Yes, AMT requires straight line over 40 years. No for property placed in service after 1998.	Midmonth	Residential rental—Table 6 Nonresidential real—Table 7
B. ADS	Straight-line	40 years	No	Midmonth	Residential rental and nonresidential real—Table 13
C. AMT	Straight-line	40 years but must use regular life after 1998	No	Midmonth	Residential rental and nonresidential real—Table 13

*31.5 years for property placed in service before 5/13/93

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B. GUIDE 2: RECOVERY PERIODS: SELECTED FARM ASSETS—ACRS, MACRS, AND ALTERNATE MACRS

Asset	ACRS	MACRS	Alternate MACRS Life
	Property Class and Recovery Period		
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators	5	5	6
Cattle (dairy or breeding)	5	5	7
Citrus groves	5	10	20
Communication equipment	5	7	10
Computer and peripheral equipment	5	5	5
Copiers	5	5	6
Cotton-ginning assets	5	7	12
Farm buildings (general purpose)	19	20	25
Fences (agricultural)	5	7	10
Goats (breeding or milk)	3	5	5
Grain bin	5	7	10
Greenhouse (single-purpose structure)	5	10	15
Helicopter (agricultural use)	5	5	6
Hogs (breeding)	3	3	3
Horses (nonrace, less than 12 years of age)	5	7	10
Horses (nonrace, 12 years of age or older)	3	3	10
Logging equipment	5	5	6
Machinery (farm)	5	7	10
Mobile home	10	27.5	40
Office equipment (other than calculators, copiers, or typewriters)	5	7	10
Office fixtures	5	7	10
Office furniture	5	7	10
Orchards	5	10[2]	20
Paved lots	5	15	20
Property with no class life (personal property)	5	7	12
Rental property (nonresidential)	19	39[3]	40
Rental property (residential)	19	27.5	40
Research property	5	5	12*
Sheep (breeding)	3	5	5
Single-purpose agricultural structure	5	10[1]	15
Single-purpose horticultural structure	5	10[1]	15
Solar property	5	5	12*
Tile (drainage)	5	15	20
Tractor units for over-the-road use	3	3	4
Trailer for over-the-road use	5	5	6
Truck (heavy-duty, general purpose)	5	5	6
Truck (light, less than 13,000 lbs.)	3	5	5
Typewriter	5	5	6
Vineyard	5	10[2]	20
Wind energy property	5	5	12*

*No class life specified. Therfore, 12-year default life assigned.

[1] 7 years if placed in service before 1989.

[2] Straight-line depreciation.

[3] 31.5 years for property placed in service before 5/13/93.

C. GUIDE 3: RECOVERY PERIOD, SELECTED NONFARM ASSETS—MACRS AND ALTERNATE MACRS

Asset	MACRS	Alternate MACRS Life
Office furniture	7	10
Office fixtures that are not structural components of a building	7	10
Desks, files, and safes	7	10
Communications equipment	7	10
Computers and peripheral equipment	5	5
Data handling equipment other than computers, such as typewriters, calculators, copiers, dictating equipment	5	6
Noncommercial airplanes	5	6
Automobiles	5	5
Buses	5	9
Light general-purpose trucks (actual weight is less than 13,000 lbs.)	5	5
Heavy general-purpose trucks (unloaded weight of 13,000 lbs. or more)	5	6
Tractor units for over-the-road use	3	4
Trailers and trailer-mounted containers	5	6
Improvements directly to or added to land that are depreciable, such as sidewalks, roads, drainage facilities, sewers, fences, landscaping shrubbery, radio or television transmitting towers	15	20
Residential rental property	27.5	40
Nonresidential rental property	39*	40
Mobile home (Pub. 534)	27.5	40

*31.5 years for property placed in service before 5/13/98.

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IV. CODE §179

A. 1996 ACT

Explanation of Provision

Part 1: The act **increases** the $17,500 amount of qualified property allowed to be expenses under Code §179 to **$25,000.** The increase is **phased** in as follows:

Taxable Year Beginning in—	Maximum Expensing
1997	$18,000
1998	18,500
1999	19,000
2000	20,000
2001	24,000
2002	24,000
2003 and thereafter	25,000

Part 2: The act provides that the following is added to the list of property not qualifying for the I.R.C. §179 expensing election [effective for property placed in service after December 31, 1990]:

1. Property used outside the United States
2. Property used in connection with furnishing lodging
3. Property used by certain tax exempt organizations
4. Property used by governmental units or foreign persons or entities
5. Air conditioning or heating units

Note: See I.R.C. §50(b) for a more detailed discussion of these four items.

Also Note: Horses that meet the requirement of I.R.C. §179(d) are eligible for §179 expensing.

The Committee also believes that horses should qualify as §179 property. The Committee believes that horses are similar to other tangible personal property for which expensing is allowed and that any potential tax shelter abuses inherent in allowing the cost of a horse to be expensed are better addressed by the phase-out and taxable income limitations of §179, the hobby loss rules of §183, and the passive loss rules of §469. Thus, the Committee bill **does not** adopt a technical correction that would deny §179 expensing for horses.

[Senate Committee Report]

B. CODE §179 REGULATIONS

In T.D. 8455, issued on December 23, 1992, the IRS adopted regulations under Code §179. The regulations clarify several provisions under Code §179.

1. Taxable Income Limitation

The final regulations clarify two rules regarding calculation of taxable income from a trade or business for purposes of the limit on the Code §179 deduction.

Suspended losses. Regulation §1.179-2(c)(1) makes it clear that taxable income is to be computed without regard to losses that are suspended under other income tax provisions.

Example 1. Alice owns and operates an auto repair shop for which she purchased $15,000 of §179 property in 1998. Her taxable income from the auto repair shop was $21,000. Alice also owns part of a pottery business in which she does not materially participate under the passive loss rules of Code §469 but does actively participate for purposes of Code §179. She realized a $10,000 pottery business loss from the pottery business but is not allowed to deduct it in 1998 because of the passive loss limitations.

Alice is not required to reduce her $21,000 taxable income from her auto repair business by the $10,000 pottery business loss for purposes of limiting her Code §179 deduction in 1998. She will be required to include the pottery business loss in the year she is allowed to deduct it under the passive loss rules.

b. Unreimbursed employee expenses. Regulation §1.179-2(c)(6)(iv) makes it clear that a taxpayer is not required to reduce taxable income by unreimbursed employee expenses, even though the employee wages, salaries, tips, and other compensation are included in taxable income.

2. Carryover of Disallowed Deductions

T.D. 8455 added Regulation §1.179-3, dealing with the carryover of disallowed deductions. In general, that section states the rule of Code §179(b)(3)(B) that allows a taxpayer to carry over the Code §179 expense that is disallowed because of the trade or business income limitation. **No carryover is created by the $18,500 (1998) limitation.** That is true even if the limitation is reduced by purchases of Code §179 property in excess of $200,000.

Example 2. Michael purchased $203,000 of Code §179 property in 1998. The limit on his Code §179 election is $14,500. He is **not** allowed to elect the full $18,500 and carry over the $4,000 excess.

Taxpayers can claim a deduction in the carryover years equal to the lesser of

(1) The sum of the disallowed expenses for which the Code §179 election has been made in prior years, reduced by the amount that has been claimed as a deduction in prior years under this carryover provision; **or**

Observation. Note that this limitation simply requires the taxpayer to keep a running balance of the carryover amount. It is **increased** by any amounts that are elected under Code §179 but are disallowed by the trade or business taxable income limitation and **decreased** by any amounts that are allowed as a deduction under the carryover provisions. There is no limit to the number of years the excess can be carried forward.

(2) The excess of the effective limit for the current year ($18,500 [1998] reduced by purchases over $200,000) over the amount that would be deductible if the carryover were not available (the amount elected for the current year)

Observation. Note that the carryover deduction is subject to **both** the $18,500 (1998) limitation (reduced by the cost of Code §179 property in excess of $200,000) and the trade or business income limitation. Furthermore, those limitations are reduced by any current year expenses that are elected to be deducted under Code §179.

Example 3. Freida had no Code §179 carryover from prior years at the beginning of 1998. Her purchases of §179 property, amount of §179 election, taxable income from trades or businesses, and carryover of unused §179 deductions for 1998 and 1999 are shown below.

Year	§179 Property Purchased	Taxable Income from Trade or Business	§179 Election	Carryover of Unused §179
1998	$15,000	$ 4,000	$10,000	$6,000
1999	17,000	22,000	15,000	$2,000*

*Freida was allowed to deduct $4,000 of her §179 carryover. That was the lesser of her $6,000 carryover and the $19,000 limit reduced by her 1999 §179 deduction. The use of $4,000 of the carryover reduced her carryover into 2000 to $2,000.

Observation. If Freida's trade or business taxable income had been $17,000, she would have been allowed to deduct only $2,000 of her carryover and would have had a $4,000 carryover into 2000.

a. Disposition of Code §179 property. If a taxpayer sells or otherwise disposes of property for which there is a carryover of Code §179 expenses, care must be taken to properly account for the carryover.

If gain or loss is not recognized on the transfer, then the basis of the property transferred is increased **immediately before the transfer** by the amount of Code §179 carryover attributable to that property. Neither the transferee not the transferor is allowed to claim the unused carryover as a deduction.

Example 4. Zeke purchased a copier to use in his trade or business in 1997 for $15,000. He elected to deduct $10,000 of the purchase under Code §179 but could deduct only $3,000 because of the taxable income limitation. Consequently, he has a $7,000 §179 carryover. His §179 election reduced his basis in the copier to $5,000. Zeke's 1997 depreciation was $5,000 × 20% = $1,000, which further reduced his basis to $4,000.

In 1998, he gave the copier to his daughter. No gift taxes were due on the gift. His 1998 depreciation on the copier was $5,000 × .16 = $800, which reduced his basis to $3,200. Because he had not yet used $7,000 of his $10,000 §179 election for 1997, Zeke is allowed to increase his basis by that $7,000 to $10,200 before the transfer to his daughter. Consequently, his daughter's initial basis in the copier is $10,200 as long as the fair market value at the time of the gift is $10,200 or more. Zeke's §179 carryover is reduced by the $7,000.

If gain or loss is recognized on the transfer, the Code §179 carryover attributable to the transferred property is not recaptured, but the total §179 carryover is reduced by that amount.

Example 5. If Zeke (from the previous example had sold his copier for $13,000 rather than given it to his daughter, the $7,000 he has not yet deducted is not treated as an amount expensed under Code §179 [Reg. §1.179-3(f)(2)]. Consequently, the amount Zeke must recapture under Code §1245 is the lesser of

(1) His $2,800 gain calculated as follows:

Amount realized			**$13,000**
Less basis:			
Purchase price		$15,000	
IRC §179	3,000		
1997 depr.	1,000		
1998 depr.	800	4,800	10,200
Gain			$ 2,800

or

(2) The $4,800 of depreciation and §179 deductions as calculated above.

Zeke must also reduce his §179 carryover by the $7,000.

b. Record keeping. As the above examples illustrate, taxpayers must be able to show how much of their Code §179 carryover is attributable to a particular piece of property at the time it is transferred. Regulation §1.179-3(e) requires taxpayers to select the property to which the carryover is attributed in the year the property is placed in service and make a record of that selection in their books. If the selection is not made or is not recorded, the carryover is apportioned equally over the items for which the §179 election was made.

Example 6. Glenda paid $10,000 for a lathe and $5,000 for a saw in 1998. She elected to expense all $15,000 but her taxable income limited her deduction to $5,000.

Glenda can select the properties to which the $10,000 carryover is attributable. For example, she could attribute the whole $10,000 carryover to the lathe, or she could attribute $5,000 to the lathe and $5,000 to the saw.

Note: If Glenda does not select the properties to which the carryover is attributable and make a record of that selection, the IRS will allocate two-thirds ($6,667) to the lathe and one-third ($3,333) to the saw.

When only part of the carryover is used in a subsequent year, the taxpayer is required to first use up the carryover from the earliest years [Reg. §1.179-3(e)]. The regulations are silent on the ordering of the use of carryover attributable to property placed in service in the same year. Therefore, taxpayers are apparently allowed to choose the order of using carryover attributable to property placed in service in the same year.

Example 7. Glenda (from the previous example) elected to attribute $5,000 of her 1998 carryover to her lathe and $5,000 to her saw. In 1999, she purchased a plane that added another $6,000 of Code §179 carryover and in 2000 she is allowed to use $5,000 of her carryover.

Glenda cannot use any of the $6,000 from the plane but could elect to use the full $5,000 carryover attributable to the lathe. Consequently, of her remaining $11,000 carryover, $5,000 is attributable to her saw and $6,000 is attributable to her plane.

3. Active Conduct of a Trade or Business

The definition of "§179 property" in Code §179(d)(1) required the property to be **"acquired by purchase for use in the active conduct of a trade of business."**

The taxable income limitation of Code §179(b)(3)(A) includes only income from the "active conduct by the taxpayer of any trade or business." Notice that the taxable income limitation language adds the phrase "by the taxpayer" between "active conduct" and "of any trade or business."

Apparently the IRS does not consider that difference in language to be significant. Regulation §1.179-4(a) defines "§179 property" by reference to the discussion of the term "active conduct" for purposes of the taxable income limitation. That discussion, from Regs. §179-2(c)(6)(ii) and (iii), is as follows:

> (ii) **Active conduct.** For purposes of this section, the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of §179, the purpose of the active conduct requirement is to **prevent** a passive investor in a trade or business from deducting §179 expenses against taxable income derived from that trade or business.
>
> Consistent with this purpose, **a taxpayer generally is considered to actively conduct a trade or business** if the taxpayer **meaningfully participates in the management or operations of the trade or business.** Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.
>
> (iii) *Example.* The following example illustrates the provisions of paragraph (c)(6)(ii) of this section.

Example. A owns a salon as a sole proprietorship and employs B to operate it. A periodically meets with B to review developments relating to the business. A also approves the salon's annual budget that is prepared by B. B performs all the necessary operating functions, including hiring beauticians, acquiring the necessary beauty supplies, and writing the checks to pay all bills and the beauticians' salaries. In 1991, B purchased, as provided for in the salon's annual budget, equipment costing $9,500 for use in the active conduct of the salon. There were no other purchases of §179 property during 1991. A's net income from the salon, before any §179 deduction, totaled $8,000. A also is a partner in PRS, a calendar-year partnership, which owns a grocery store. C, a partner in PRS, runs the grocery store for the partnership, making all the management and operating decisions. PRS did not purchase any §179 property during 1991. A's allocable share of partnership net income was $6,000. Based on the facts and circumstances, A meaningfully participates in the management of the salon. However, A does not meaningfully participate in the management or operations of the trade or business of PRS. Under §179(b)(3)(A) and this paragraph (c), A's aggregate taxable income derived from the active conduct by A of any trade or business is $8,000, the net income from the salon.

T.D. 8455 considers the meaning of the term "active conduct of a trade or business" and concludes, "The definition of the active conduct standard under §179 is a different standard than the material participation standard under §469; however, it was not deemed necessary to modify the regulations to so state specifically."

Conclusion. The above regulations apparently require some personal involvement of the taxpayer in the trade or business for both the taxable income limitation and the qualification of property as Code §179 property. Although the requirement of personal involvement for property to be §179 property is not clear on the face of the statute, that is a logical conclusion because it would be inconsistent to allow property purchased in a trade or a business to qualify for the §179 election but then to exclude income from that same trade or business from the taxable income limitation.

4. Section 179—Taxable Income Limit

Question 1. **How do I compute the taxable income limit on line 5 of Form 4562?**

Form **4562** — Department of the Treasury, Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

► See separate instructions. ► Attach this form to your return.

OMB No. 1545-0172 — **1998** — Attachment Sequence No. 67

Name(s) shown on return | Business or activity to which this form relates | Identifying number

Part I **Election To Expense Certain Tangible Property (Section 179)** (Note: *If you have any "listed property," complete Part V before you complete Part I.*)

1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions			1	18,500
2	Total cost of section 179 property placed in service. See page 2 of the instructions			2	
3	Threshold cost of section 179 property before reduction in limitation			3	200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-			4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions			5	
	(a) Description of property	(b) Cost (business use only)	(c) Elected cost		
6					
7	Listed property. Enter amount from line 27		7		
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7			8	
9	Tentative deduction. Enter the smaller of line 5 or line 8			9	
10	Carryover of disallowed deduction from 1997. See page 3 of the instructions			10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)			11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11			12	
13	Carryover of disallowed deduction to 1999. Add lines 9 and 10, less line 12 ►		13		

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

8

Answer 1

- Figure taxable income for this purpose by totaling the net income (or loss) from all trades and businesses actively conducted during the tax year.
- Items of income derived from a trade or business actively conducted include §1231 gains (or losses) and interest from working capital of any trade or business.
- Also include in total taxable income any **wages, salaries, tips,** or other pay earned as an employee.
- When figuring taxable income, do not take into account any unreimbursed employee business expenses.
- In addition, figure taxable income without regard to:

  (1) The §179 deduction,

  (2) The self-employment tax deduction, and

  (3) Any net operating loss carryback or carryforward.

- **Section 1231 gains and losses.** Any recognized gains or losses from the following types of transactions are §1231 gains or losses:

  (1) The sale or exchange of real property or depreciable personal property used in a trade or business if held for more than 1 year,

  (2) The sale or exchange of cattle or horses held for draft, breeding, dairy, or sporting purposes if held for 2 years or more,

(3) The sale or exchange of livestock (other than cattle, horses, and poultry) held for draft, breeding, dairy, or sporting purposes if held for 1 year or more,

(4) The sale, exchange, or involuntary conversion of unharvested crops on land used in farming if sold, exchanged, or if the taxpayer had to involuntarily convert the crop and land at the same time and to the same person and held the land for more than 1 year,

(5) The cutting of timber for sale or for use in the trade or business if the taxpayer meets both of the following requirements:

(a) He elects to treat the cutting as a sale or exchange.

(b) He either owned the timber for more than 1 year or held a contract right to cut the

(6) The disposal of timber held for more than 1 year under a cutting contract if the taxpayer treats the disposal as a sale or exchange and retains an economic interest in the timber.

(7) The disposal of coal (including lignite) or iron ore (mined in the United States) owned for more than 1 year under a contract in which the taxpayer retains an economic interest in the coal or iron ore.

Question 2. Does a §179 deduction flow through from a partnership or S corporation?

Answer 2

- **Partnerships and Partners**
- The §179 deduction limits apply to both the partnership and to each partner. The partnership determines its §179 deduction subject to the limits. It allocates the deduction among its partners.
- Each partner adds the amount allocated from the partnership as shown on Schedule K-1 to his or her other nonpartnership business §179 costs.
- Next the partner applies the maximum dollar limit to this total.
- This allows the partner to figure his or her §179 deduction.
- To determine if a partner has passed the $200,000 investment limit, the business cost of §179 property placed in service by the partnership **is not** attributed to any partner.
- The total amount of each partner's (partnership and nonpartnership) §179 deduction is subject to both the taxable income limit and the maximum dollar limit.
- The rules that apply to a partnership and its partners **also apply to an S corporation and its shareholders.** The limits apply to an S corporation and to each shareholder. The corporation allocates the deduction to the shareholders who then take their §179 deduction subject to the limits.

Practitioner Note:

- **Basis adjustment.** The taxpayer must reduce the basis of his or her partnership interest by the total amount of §179 expenses allocated from the partnership regardless of whether he or she can currently deduct the full amount of allocated §179 expense.
- If the taxpayer disposes of his or her interest in a partnership, the basis for determining gain or loss is increased by any outstanding carryover of disallowed deduction of §179 expenses allocated from the partnership.
- The basis of a partnership's §179 property must be reduced by the §179 deduction elected by the partnership.
- This reduction of basis must be made **even if a partner cannot deduct all or part of the §179 deduction allocated to that partner by the partnership because of the limits.**

Question 3. How do you Figure the taxable income for a partnership and the partner's share of that taxable income?

Answer 3

- **Figuring taxable income for a partnership.** To figure taxable income (or loss) from the active conduct by a partnership of any trade or business, total the net income (or loss) from all trades or businesses actively conducted by the partnership during the tax year. To determine the total amount of partnership items, treat deductions and losses as negative income.
- **Partner's share of partnership taxable income.** For purposes of §179, if the taxpayer is a partner engaged in the active conduct of one or more of a partnership's trades or businesses, he includes some of the partnership's taxable income as his taxable income from the active conduct of a trade or business. He includes his allocable share of taxable income derived from the partnership's active conduct of any trade or business.

Question 4. If I acquire property from a related person, does the cost qualify for IRC §179 expensing?

Answer 4. Property does not qualify for the §179 deduction if:

(1) The property is acquired by one member of a controlled group from a member of the same group, or

(2) The property's basis is either:

- **(a)** Determined in whole or in part by its adjusted basis in the hands of the person fromwhom it was acquired, or
- **(b)** Determined under stepped-up basis rules for property acquired from a decedent, or

(3) The property is acquired from a related person.

Related persons. For the purpose of determining what property does not qualify for the section 179 deduction, related persons are:

(1) An individual and his or her spouse, child, parent, or other ancestor or lineal descendant.

(2) A corporation and any individual who owns directly or indirectly more than 50% of the value of the corporation's outstanding stock.

(3) Two corporations that are members of the same controlled group.

(4) A fiduciary of a trust and a corporation if more than 50% of the value of the outstanding stock of the corporation is owned directly or indirectly by or for the trust or the grantor of the trust.

(5) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.

(6) The fiduciaries or the fiduciaries and beneficiaries of two different trusts if the same person is the grantor of both trusts.

(7) Certain educational and charitable organizations and any person (including members of the person's family) who directly or indirectly controls the organization.

(8) A partnership and a person who owns directly or indirectly an interest of more than 50% of the partnership's capital or profits.

(9) Two partnerships if the same persons directly or indirectly own more than 50% of the capital or profits of each.

(10) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.

(11) An S corporation and a corporation that is not an S corporation is the same persons own more than 50% in value of the outstanding stock of each corporation.

(12) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

Example. Ken Larch is a tailor. He bought two industrial sewing machines from his father. He placed both machines in service in the same year he bought them. They do not qualify for §179 because Ken and his father are related parties. He cannot claim a §179 deduction for the cost of these machines.

Observation. The instructions for Schedule E require income from the business of renting personal property to be reported on Schedule C or C-EZ (Form 1040) even if the taxpayer is not personally active in the trade or business of leasing property. Therefore, a taxpayer could be denied the benefits of Code §179 for a rental trade or business from which the income is subject to the self-employment tax.

C. DEFINITION OF CODE §179 PROPERTY

The replacement of the reference to "§38 property" with a reference to "§1245 property" by the 1990 Tax Act, continues to cause some confusion about what property qualifies for the Code §179 election. **But see the clarification provided by the 1996 Act discussed earlier.**

Code §179(d)(1) defines "§179 property" as "any tangible property. . . which is §1245 property (as defined in §1245(a)(3). . . " Code §1245(a)(3) reads as follows:

> SECTION 1245 PROPERTY.–For purposes of this section, the term "§1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in §167 (or subject to the allowance of amortization provided in §185 or 1253(d)(2) or (3)) and is either–

(A) personal property,

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)–

- **(i)** was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or
- **(ii)** constituted a research facility used in connection with any of the activities referred to in clause (i), or
- **(iii)** constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).

(C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under §169, 179, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194,

(D) a single-purpose agricultural or horticultural structure (as defined in §168(i)(13)),

(E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, or

(F) any railroad grading or tunnel bore (as defined in §168(e)(4)).

V. DEPRECIATION OF IDLE ASSETS

To be depreciable, property must be used in a trade or business or held for the production of income [§167(a)(1) and (2)]. The phrase "used in the trade or business" has been broadly interpreted to include property that is temporarily idle but has been or will be used in the trade or business or held for the production of income.

Example 8. Benjamin purchased a winery in 1996 for $250,000 and leased it to a tenant who agreed to operate it as a grape juice plant on a profit-sharing basis. Early in 1998, the tenant abandoned the grape juice project as a failure, and the lease was terminated by agreement. Thereafter, Benjamin neither leased the winery nor used it for any purpose whatsoever. In 1998, he sold the winery for $120,000.

To calculate his gain or loss from the sale of the winery, Benjamin must reduce his basis in the winery for depreciation that is allowable for the years 1996 through 1998. In *Kittredge v. Commissioner*, 88 F.2d 632 (2d Cir. 1937), the court stated:

> To read the phrase "used in the trade or business" as meaning only active employment of property devoted to the business would lead to results which we cannot believe Congress intended. . . . Hence, we think the phrase should be read as equivalent to "devoted to the trade or business"; that is to say, that property once used in the business remains in such use until it is shown to have been withdrawn from business purposes.

Other examples of idle assets that were allowed to be depreciated include:

- Poultry buildings [*Lenington v. Commissioner,* T.C. Memo 1966-264, 25 TCM 1350 (1966)]
- Airplane held for sale or lease [*Riss & Company, Inc. v. Commissioner,* T.C. Memo 1964-190, 23 TCM 1113 (1964), aff'd, rev'd and rem'd on other issues 374 F.2d 161 (8th Cir. 1967), 374 F.2d 173 (8th Cir. 1967)]
- Railroad track [*Boston Elevated Railroad Company v. Commissioner,* 16 T.C. 1084 (1951), aff'd on other grounds 196 F.2d 923 (1952)]
- Taxicabs [*Yellow Cab Co. Of Pittsburgh v. Driscoll*, 24 F.Supp. 993 (W.D. Pa. 1938)]
- Barge [*P. Dougherty Co. v. Commissioner,* 159 F.2d 269 (4th Cir. 1946), cert. Denied 331 U.S. 838 (1947)]

VI. DEPRECIATION ISSUES

ISSUE 1: USE OF AN AUTOMOBILE FOR BOTH BUSINESS AND EMPLOYMENT

Bill Broderick used his automobile for travel connected with his employment and also used his automobile for the popcorn business he runs out of his home on a part-time basis. He does not make personal use of the automobile. In 1998, Bill drove his car 4,500 miles for his employer and was reimbursed at the rate of 34.5 cents per mile for a total of $1,552.50. He drove his car another 5,000 miles in his popcorn business. He drove his car 1,000 miles commuting to and from work. Bill keeps records that meet the substantiation requirements of Reg. §1,62-2(e).

Bill's car expenses for the year are as follows:

Depreciation	$1,675
Gas	570
Maintenance and repairs	650
Insurance	520
License	75
TOTAL	$3,490

Question 1A

What are Bill's options for claiming depreciation and other expenses for his car on his income tax return?

Answer 1A

Bill's car expenses are deductible under Code §162. His expenses for the business use of his car are claimed on Schedule C (Form 1040). He can claim his expenses for use of his car as an employee on Form 2106 and Schedule A (Form 1040).

Bill meets the following requirements and therefore can claim the 32.5 cents per mile standard mileage deduction for his use of the car both as an employee and as a self-employed person.

1. He owns the car.
2. He does not use the car for hire (such as a taxi).
3. He does not operate more than one car at a time.
4. He did not claim a deduction for this car using ACRS or MACRS depreciation or claim a §179 expense deduction.

Bill could also claim actual expenses on Schedule C (Form 1040), Form 2106, and Schedule A (Form 1040).

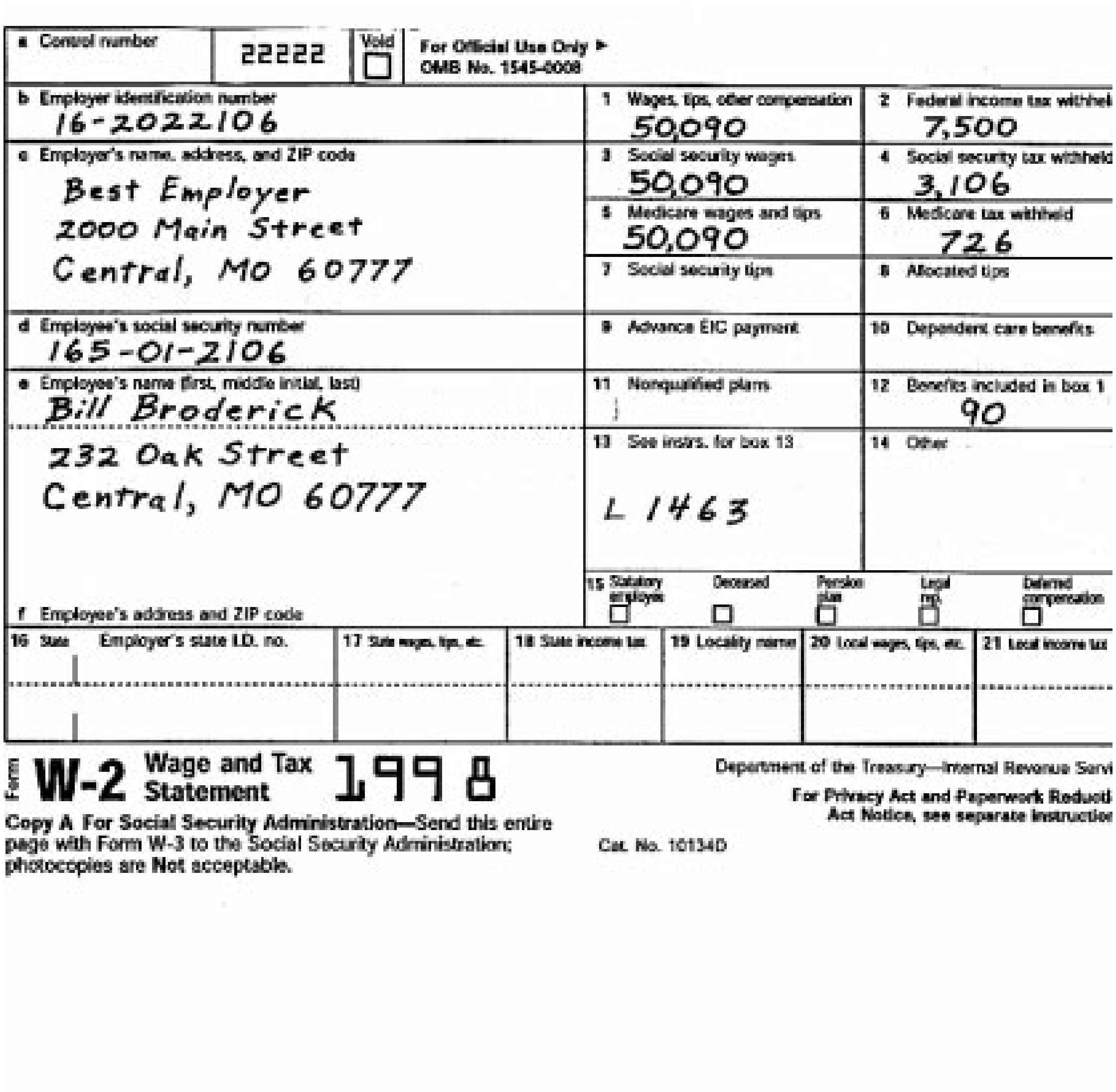
Question 1B

How does Bill claim the standard mileage deduction?

Answer 1B

To claim the standard mileage deduction for the business use of his car, Bill reports 5,000 x $.325 = $1,625 on line 10 of his Schedule C (Form 1040) and completes Part IV (new for 1993) on the back side of Schedule C (Form 1040).

Bill's employer is required to report the $.02 per mile (4,500 miles x $.02 = $90) that he was reimbursed in excess of the standard mileage rate in boxes 1, 3, and 5 of the 1998 Form W-2. The remaining 32.5 cents per mile (4,500 miles x $.325 = $1,463) is reported in box 13 (coded for Substantiated Employee Business Expense) of Form W-2. Therefore, if Bill claims the standard mileage rate for his car, he reports nothing on this income tax return for his use of his car as an employee other than carrying the total from box 1 of Form W-2 (which includes the $90 excess reimbursement) to line 7 of his Form 1040.



a Control number 22222 Void
For Official Use Only ►
OMB No. 1545-0008

b Employer identification number
16-2022106

c Employer's name, address, and ZIP code
Best Employer
2000 Main Street
Central, MO 60777

d Employee's social security number
165-01-2106

e Employee's name (first, middle initial, last)
Bill Broderick
232 Oak Street
Central, MO 60777

f Employee's address and ZIP code

1 Wages, tips, other compensation 50,090	2 Federal income tax withheld 7,500
3 Social security wages 50,090	4 Social security tax withheld 3,106
5 Medicare wages and tips 50,090	6 Medicare tax withheld 726
7 Social security tips	8 Allocated tips
9 Advance EIC payment	10 Dependent care benefits
11 Nonqualified plans	12 Benefits included in box 1 90
13 See instrs. for box 13 L 1463	14 Other

15 Statutory employee / Deceased / Pension plan / Legal rep. / Deferred compensation

16 State	Employer's state I.D. no.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax

Form W-2 Wage and Tax Statement 1998

Department of the Treasury—Internal Revenue Servi

For Privacy Act and Paperwork Reducti
Act Notice, see separate instructio

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are Not acceptable.

Cat. No. 10134D

8

Question 1C

How would Bill report his actual expenses if he chooses that method?

Answer 1C

Bill reports his actual expenses on Schedule C (Form 1040) and completes Part IV of Schedule C (Form 1040). His actual expenses for his 5,000 business miles are computed by prorating his total expenses. He must report his depreciation on line 13 and the rest of his expenses on line 10 of Schedule C (Form 1040). Therefore, he prorates his depreciation and other expenses separately as follows:

Depreciation:	$1,675 x 5,000/10,500 = $798
Other:	$1,815 x 5,000/10,500 = $864

For his employment use of his car, Bill can claim a pro rata share of his total expenses on Form 2106 and deduct those expenses that exceed the standard mileage rate as a miscellaneous itemized deduction on Schedule A (Form 1040).

His employee share of the total expenses are calculated as follows:

Depreciation:	$1,675 x 4,500/10,500 = $718
Other:	$1,815 x 4,500/10,500 = $778

Line 17 of Form 2106 is the residual of the total miles driven after Bill's employee and commuting miles are taken out. The instructions do not indicate how Bill's business miles should be reported on Form 2106. We have included a note in the margin to let the IRS know that Bill qualifies for accelerated depreciation since his total business use–employee plus self-employed– is greater than 50%.

Observation. Only the reimbursement in excess of the standard mileage rate ($90) was included in Bill's income. Therefore, he must omit an amount equal to the standard mileage rate when he claims his actual expenses.

Form **2106** | **Employee Business Expenses** | OMB No. 1545-0139

▶ See separate instructions.

▶ Attach to Form 1040.

Department of the Treasury Internal Revenue Service (99)

1998 Attachment Sequence No. 54

Your name	Social security number	Occupation in which you incurred expenses
Bill Broderick		

Proof as of 8/24/1998

Part I Employee Business Expenses and Reimbursements

STEP 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1	1496	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3		
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		
5 Meals and entertainment expenses (see instructions)	5		
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	1496	

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

STEP 2 Enter Reimbursements Received From Your Employer for Expenses Listed in STEP 1			
7 Enter reimbursements received from your employer that were **not** reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 13 of your Form W-2 (see instructions)	7	1463	

STEP 3 Figure Expenses To Deduct on Schedule A (Form 1040)			
8 Subtract line 7 from line 6	8	33	
Note: *If both columns of line 8 are zero, stop here. If Column A is less than zero, report the amount as income on Form 1040, line 7.*			
9 In Column A, enter the amount from line 8. In Column B, multiply the amount on line 8 by 50% (.50). If either column is zero or less, enter -0- in that column. (Employees subject to Department of Transportation (DOT) hours-of-service limits: Multiply by 55% (.55) instead of 50%. For more details, see instructions.)	9	33*	
10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 20.** (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10		

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (1998)

* Report this amount on Schedule A Line 20

8

Proof as of 8/1/1998

Part II **Vehicle Expenses** (See instructions to find out which sections to complete.)

Section A—General Information		(a) Vehicle 1	(b) Vehicle 2
11 Enter the date vehicle was placed in service	11	3 / 15 / 94	/ /
12 Total miles vehicle was driven during 1998	12	10,50[illegible] miles	miles
13 Business miles included on line 12	13	4,50[illegible] miles	miles
14 Percent of business use. Divide line 13 by line 12	14	4[illegible] %	%
15 Average daily round trip commuting distance	15	5 miles	miles
16 Commuting miles included on line 12	16	[illegible] miles	miles
17 Other miles. Add lines 13 and 16 and subtract the total from line 12	17	5,[illegible] ★ miles	miles

18 Do you (or your spouse) have another vehicle available for personal purposes? ☒ Yes ☐ No

19 If your employer provided you with a vehicle, is personal use during off duty hours permitted? ☐ Yes ☐ No ☒ Not applicable

20 Do you have evidence to support your deduction? ☒ Yes ☐ No

21 If "Yes," is the evidence written? ☒ Yes ☐ No

Section B—Standard Mileage Rate

22 Multiply line 13 by 32½¢ (.325). Enter the result here and on line 1 . . . 22

Section C—Actual Expenses		(a) Vehicle 1		(b) Vehicle 2	
23 Gasoline, oil, repairs, vehicle insurance, etc.	23		1815		
24a Vehicle rentals	24a				
b Inclusion amount (see instructions)	24b				
c Subtract line 24b from line 24a	24c				
25 Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25				
26 Add lines 23, 24c, and 25	26		1815		
27 Multiply line 26 by the percentage on line 14	27		778		
28 Depreciation. Enter amount from line 38 below	28		718		
29 Add lines 27 and 28. Enter total here and on line 1	29		1496		

Section D—Depreciation of Vehicles (Use this section only if you own the vehicle.)

		(a) Vehicle 1		(b) Vehicle 2	
30 Enter cost or other basis (see instructions)	30	15,000			
31 Enter amount of section 179 deduction (see instructions)	31				
32 Multiply line 30 by line 14 (see instructions if you elected the section 179 deduction)	32	6429			
33 Enter depreciation method and percentage (see instructions)	33	200% DD 11.52%			
34 Multiply line 32 by the percentage on line 33 (see instructions)	34		741		
35 Add lines 31 and 34	35		741		
36 Enter the limit from the table in the line 36 instructions	36	1675			
37 Multiply line 36 by the percentage on line 14	37		718		
38 Enter the smaller of line 35 or line 37. Also, enter this amount on line 28 above	38		718		

★ 5000 business miles are claimed on Sch. C.

ISSUE 2: SALE OF AN ASSET AFTER PARTIAL BUSINESS USE

Marie Johnson sold her car on June 20, 1998, for $18,000. She purchased the car on May 1, 1995, for $28,000. She used the car 70% for business and 30% for personal reasons. She did not claim a Code §179 deduction and properly claimed the following depreciation:

Year	§280F Limit		Business Percentage		Depreciation
1995	$3,060	x	.70	=	$2,142
1996	4,900	x	.70	=	3,430
1997	2,950	x	.70	=	2,065
1998	1,775	x	.70	=	1,243
Total					$8,880

*The Code §280F limitation is not reduced because of the sale during the tax year.

Question 2

How does Marie report gain or loss on the sale of her car?

Answer 2

Upon sale of the car, Marie must treat the car as being two different assets for purposes of calculating gain or loss—a business asset and a personal use asset. Her $620 gain on the business portion of the car is calculated as follows:

Sales price allocated to business use:		
$18,000 x .70 =		$12,600
Less basis allocated to business use		
Beginning basis: $28,000 x .70 =	$19,600	
Less depreciation	8,880	
Adjusted basis		10,720
Gain		$ 1,880

That gain is subject to the Code §1245 recapture rules. Since depreciation claimed is greater than the gain, all of the gain is treated as ordinary income, on the 4797.

Marie's loss on the personal portion of her car is calculated as follows:

Sales price allocated to personal use:	
$18,000 x .30 =	$5,400
Less basis allocated to personal use:	
$28,000 x .30 =	8,400
Loss	$3,000

The personal loss is not deductible.

ISSUE 3: DEPRECIATION ADJUSTMENTS ON LIKE-KIND EXCHANGE

Property that is acquired in a like-kind exchange under Code § 1031 has an income tax basis determined by the remaining basis in the property that is given up in the exchange. The basis is the property acquired is the remaining basis in the peoperty given up adjusted by:

1. **Adding** any gain recognized on the exchange and any cash paid, and
2. **Subtracting** any loss recognized on the exchange and any cash received.

These adjustments affect the **amount of depreciation** that can be claimed on the property acquired in the exchange.

Question 3A

Steve Aderholdt reported the following information on his depreciation worksheel.

Depreciation Worksheet

Item Purchased	Date Purchased	Purchase Price	Item Traded (if any)	Value of Item Traded	Boot Paid
Sod cutting machine B	9/20/98	$7,000	Sod cutting machine A	$2,000	$4,000

His depreciation records show that he purchased machine A on May 10, 1995 for $5,000. He had properly claimed $3,848 in depreciation and had a $1,152 adjusted basis in machine A

How does Steve report the trade, and how much depreciation can Steve claim on machine B for 1998?

Answer 3A

Steve reports the trade on Form 8824, as shown below. Steve can claim $5,152 × .20 = $1,030 of depreciation on machine B in 1998.

Form **8824** Department of the Treasury Internal Revenue Service

Like-Kind Exchanges
(and nonrecognition of gain from conflict-of-interest sales)
► See separate instructions. ► Attach to your tax return.
► Use a separate form for each like-kind exchange.

OMB No. 1545-1190 **1998** Attachment Sequence No. 109

Name(s) shown on tax return: Steve Aderholt — Identifying number: 111-11-1111

Part I — Information on the Like-Kind Exchange

Note: *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1	Description of like-kind property given up ► Sod cutting machine A		
2	Description of like-kind property received ► Sod cutting machine B		
3	Date like-kind property given up was originally acquired (month, day, year)	3	5 / 10 / 93
4	Date you actually transferred your property to other party (month, day, year)	4	9 / 20 / 98
5	Date the like-kind property you received was identified (month, day, year). See instructions	5	9 / 20 / 98
6	Date you actually received the like-kind property from other party (month, day, year)	6	/ /
7	Was the exchange made with a related party? If "Yes," complete Part II. If "No," go to Part III. See instructions. a ☐ Yes, in this tax year b ☒ Yes, in a prior tax year c ☐ No		

Part III — Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see* ***Reporting of multi-asset exchanges*** *in the instructions.*

Note: *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions	15	0
16	FMV of like-kind property you received	16	6,000
17	Add lines 15 and 16	17	6,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions 1152 + 4000	18	5152
19	**Realized gain or (loss).** Subtract line 18 from line 17	19	848
20	Enter the smaller of line 15 or line 19, but not less than zero	20	0
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions	21	0
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions	22	0
23	**Recognized gain.** Add lines 21 and 22	23	0
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	848
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23	25	5152

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ISSUE 4: ALLOCATION OF PURCHASE PRICE OF APARTMENT BUILDINGS TO SHRUBS, SIDEWALKS, AND PARKING LOT

Sandra Hampton paid $425,000 for an apartment building in 1998. The apartment building had 2,400 square feet of asphalt parking behind it lined with 20 evergreen bushes that had been planted in 1998. There was 150 linear feet of sidewalk in front of the building.

Question 4

How much of the purchase price can Sandra allocate to the parking log, bushes, and sidewalk?

Answer 4

If the buyer and seller allocated the purchase price among the assets and had adverse interests, the IRS is likely to accept that allocation. If Sandra did not agree on an allocation with the seller, she must allocate her purchase price among the assets based on their fair market value.

Parking lot. Sandra can estimate the fair market value of the parking lot be multiplying the cost of replacing the parking lot by a fraction. The numerator of the fraction is the number of years left in the useful parking lot. The denominator of the fraction is the total number of years in the useful life of the parking lot.

For example, assume it would cost Sandra $2,400 to replace the parking lot. The parking lot is 15 years old and will last another 5 years. Sandra would allocate $2,400 × 5/20 = $600 to the basis of the parking lot.

Shrubs. Sandra can estimate the value of the shrubs by finding the cost of buying and planting similar shrubs. Therefore, if it would cost $50 per shrub to buy and plant similar shrubs, Sandra can allocate 20 × $50 = $1,000 to the shrubs.

Sidewalk. Sandra can estimate the value of the sidewalk in a manner similar to the method used to find the value of the parking lot. Therefore, if it would cost $10 per linear foot to replace the sidewalk, and the sidewalk had 10 years left in a 15-year usual life, Sandra could allocate $10 × 150 feet × 10/15 = $1,000 to the sidewalk.

ISSUE 5: TRADE-IN OF MACHINERY FOR A LEASING ARRANGEMENT

On February 15, 1998, Spencer McDonald traded his tractor (tractor A) for a five-year lease on a new tractor (tractor B). He had purchased tractor A for $50,000 on March 3, 1985 , and has fully depreciated it. The lease calls for a $17,500 payment each year for the five years. Spencer was given a credit of $15,000 against the first lease payment in exchange for tractor A and paid the remaining $2,500 in cash. Spencer is allowed to purchase tractor B at the end of the lease for a price determined by the market value of used tractors at the time of the purchase.

Question 5A

Is Spencer allowed to deduct the $15,000 lease payment made by trading in his old tractor?

Answer 5A

Yes, Spencer can claim a deduction for the value of the tractor he traded in as long as the arrangement is a true lease arrangement and not a disguised installment sale. The facts of this case appear to be a true lease.

Question 5B

Must Spencer report any income as a result of trading in his tractor?

Answer 5B

Yes, Spencer is treated as if he sold his tractor for $15,000 and paid that amount to the dealer in lease payments. Therefore, he must report his gain ($15,000 – 0 = $15,000) in part III of form 4797. Since the gain is less than the depreciation he has claimed on tractor A, all of the gain is recaptured as ordinary income under Code § 1245.

Question 5C

Assume Spencer's arrangement with his dealer was as follows. The lease payments for tractor B are set by subtracting the $15,000 trade-in value of tractor A from the $70,000 list price of tractor B and amortizing the remaining $55,000 over five years at a 7% interest rate. At the end of the lease, Spencer is allowed to keep the tractor. Does Spencer report the transaction in the same manner as described above?

Answer 5C

No. The arrangement is now a like-kind exchange and an installation purchase/sale. Therefore, Spencer's basis in Tractor B is $55,000, for which he can claim the Code § 179 expense election and depreciate the balance. Spencer can deduct his interest payments. He cannot claim any lease payment deductions.

ISSUE 6: PERSONAL PROPERTY CONVERTED TO RENTAL PROPERTY

Facts. Richard McNichols purchased a principal residence in 1990 for $75,000. Since that date he has made $22,000 in improvements to this residence. In June 1998, Richard purchased a new residence and decided to convert his previous residence to rental property. The fair market value of his old residence at the time of conversion in June 1998 was $125,000 as determined by an appraisal.

Issue 1. What is Richard's basis for depreciation for this rental property?

> **Treas. Reg.** §1.168-2(j) states:
>
> **Charges in use--(1) Conversion from personal use or use in tax-exempt activity.** If property which was previously used by the taxpayer for **personal purposes** in a tax-exempt activity is **converted** to use in a trade or business or **for the production of income** during the taxable year, the the recovery allowance for the taxable year (and subsequent taxable years) shall be determined as though the property were placed in service by the taxpayer as recovery property on the date on which the conversion occurs. Thus, the recovery allowance shall be determined by multiplying the **unadjusted basis** (as provided in subparagraph (6)(ii) of this paragraph) by the applicable percentage.

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Paragraph (6)(ii) states: "The **unadjusted basis** shall be the **lesser of the fair market value or the adjusted basis of the property . . . at the time of the conversion** to use in the taxpayer's trade or business (or the production of income)."

Richard's adjusted basis is $97,000 ($75,000 purchase price plus $22,000 improvements). His **unadjusted basis** for **depreciation only** is the **lower** of the adjusted basis ($97,000) of the fair market value ($125,000) **at the time of the conversion.** If we assume a land allocation of $20,000, the **building's depreciable basis is $77,000. Treas. Reg.** § 1.168-2(j) requires the use of MACRS.

MACRS Computation in Year of Disposition

When residental rental or nonresidential real property is disposed of, the cost recovery dedution for the year of disposition is based on the number of months in the year of disposal that the property was in service. Under the **mid-month convention,** property disposed of **anytime during a month** is treated as disposed of in the **middle of that month.** Count the month of disposition as **half a month** of service. The amount of the cost recovery deduction in the year of disposition is computed by using a fraction. The numerator of the fraction is the number of months (including partial months) in the tax year that the property is considered in service. The denominator is always 12.

Issue 2. The second part of this problem deals with the sale of the property in 1998. The computation of gain or loss is not just subtracting the adjusted basis from the sales price. Rather, the beginning adjusted basis (before cost recovery deductions) must be revisited, based on whether the sale results in a gain or loss.

Assume Richard sold the rental house on March 2, 1998, for $120,000. Expenses of sale were $15,000. Therefore, the "net sales price" of $105,000 will result in a taxable gain. In that case, the basis to be used is the basis to Richard at the **time of conversion** ($97,000) reduced by the allowable cost recovery deduction ($16,100). The computation of **gain** on this sale is illustrated below:

Selling price	$120,000
Less: Selling expenses	(15,000)
Net sale price	$105,000
Less: Adjusted basis ($97,000 -- $16,000)	(80,900)
Gain recognized	$ 24,000

Depreciation Worksheet For Client

Item Purchased	Date Purchased	Purchase Price	Item Traded (if any)	Adjusted Basis of Item Traded	Boot Paid

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VII. CURRENTLY DEDUCTIBLE REPAIRS AND MAINTENANCE COSTS VS. EXPENSES THAT MUST BE CAPITALIZED AND DEPRECIATED

TREASURY REGULATIONS

The regulations for I.R.C. §§ 162 and 263 provide the general rules for making this sometimes difficult determination.

1. Treas. Reg. 1.263 (a) and (b)

It is a **capital expense** if it:

- **Adds** to the value of the land, building, or machine
- **Substantially prolongs** the life of the property
- **Adapts** the property to a new or different use
- **Restores** the property

2. Treas. Reg. 1.162-4

It is a **repair** if it:

- Does not **materially** add to the value of the property
- Does not **appreciably** prolong its life
- Is an expense that keeps the property in an ordinarily efficient operating condition

Note: §1.162-4 also provides that a repair that is a **replacement** is a capital expense only if it arrests deterioration **and** appreciably prolongs the life of the equipment.

CASE LAW

Hundreds of cases have been decided that determine whether an expense is a currently deductible repair or a capital expense. They are helpful to the practitioner because they further define some of the phrases used in the regulations. The cases reviewed below have been chosen to assist the practitioner in making **common but difficult** determinations.

1. *Lanz v. United States*

Facts. The taxpayer purchased a used bulldozer for $5,500 and in the same year purchased new tracks for it for $1,532 to replace the worn-out original tracks. The court found that the expense had to be capitalized.

> Where. . . as here, in the very year of a used machine's purchase a set of parts is replaced at a cost of over 25% of the total cost of the entire machine, such replacement can in no way be categorized as an incidental repair which does not materially increase the value or life of the property. As the Internal Revenue agent who disallowed the claim so aptly put it, "if [plaintiffs' claim] were allowed, one could purchase an older used machine and in a few months replace all the parts, one by one, and have a completely new machine with the entire cost expensed out as tax deductions."

[*Lanz v. United States,* 22 AFTR 5579, 285 F.Supp. 796 (1965)]

Question 1A. What if the expense had been incurred in the year following the year of purchase?

Answer 1A. The result would be the same unless there was regular use of the machine by the taxpayer before the repairs.

Question 1B. What if the bulldozer had cost $100,000 and the repair cost before use by the taxpayer was $10,000 (10%)?

Answer 1B. The decision in Lanz would likely be the same.

2. *Jacks, Jerry v. Commissioner*

Facts

- The taxpayer's company owns two scrapers, a number of trucks, a backhoe, and a number of loaders, **including a 70-ton, 12-cylinder diesel CAT loader.** The taxpayer purchased the CAT loader from Cushman Equipment and Construction Company in 1979 for $40,000. At the time of purchase by Jacks, the CAT loader was five years old, and the $40,000 purchase price reflected its **used value.** In 1979, the cost of a comparable new CAT loader was $530,000.
- Over the course of the next six years, the taxpayer used the CAT loader in his business and depreciated it over a seven-year life. The adjusted tax basis of the loader as of January 1, 1985, was $3,271.
- In **June of 1985, the CAT loader's transmission gear malfunctioned.** The forward gears still worked, but the loader would not move when the reverse gear was engaged.
- To fix the transmission, the taxpayer purchased for $17,500 a **used transmission** for a CAT loader. The used transmission **was not** rebuilt or reconditioned. A rebuilt or reconditioned transmission would have cost **significantly more** than $17,500. The guarantee that went with the used transmission was only that it would function properly at the time of installation. The operation of the used transmission after its installation in the taxpayer's CAT loader was not covered by any guarantee or warranty.
- In a July 1985 incident unrelated to the transmission problem, the rod bearings on two of the engine cylinders of the taxpayer's CAT loader "went out." **In order to fix the engine,** Jacks did not purchase a new or rebuilt engine, because a rebuilt engine would have cost approximately $90,000, not including installation. Instead, he purchased two **rebuilt rod bearings and two rebuilt pistons, a rebuilt crankshaft, and new crankshaft bearings.** His company performed the labor to install these parts. While working on the engine, his company also decided to replace **the other 10 pistons and rings.** The total cost of the parts used in restoring the engine to operating condition was $15,437.62. Since 1985, the CAT loader has operated with routine maintenance.
- The taxpayer claimed the cost of the 1985 transmission and engine repairs as ordinary and necessary business expenses on Schedule C of his 1985 tax return.

Decision

- Expenditures incurred to replace mere parts of a whole, not to replace an entire structural unit are often regarded as repairs, not capital improvements. *Red Start Yeast & Products Co. v. Commissioner* [Dec. 21,351], 25 T.C. 321, 348-350 (1955).
- But the costs of purchasing new or rebuilt motors for trucks and heavy equipment generally are regarded as capital expenditures. *West Va. Steel Corp. v. Commissioner* [Dec. 24,307], 34 T.C. 851, 859 (1960).

- [See *LaSalle Trucking Co. v. Commissioner* [Dec. 26,345(M)], T.C. Memo 1963-274 (costs of replacing engines and tanks in a fleet of petroleum hauling trucks held to be capital improvements where the replacement engines and tanks extended the useful lives of the trucks).]

Decision. The $17,500 cost of the used transmission is a deductible repair expense. The $15,437.62 cost of the engine overhaul is a nondeductible capital expenditure.

Reasoning

Transmission

- Before the transmission broke down, the CAT loader had a working but **used** transmission. After the taxpayer incurred the expenses in question, the CAT loader still had a **used** transmission, **not a rebuilt or reconditioned transmission.**
- The transmission repair was not undertaken to improve the value of the CAT loader or to prolong its useful life. It was simply a repair to **restore the loader** to the operating condition it was in prior to the necessity of incurring the expense. The transmission repair also was unrelated to the overhaul of the engine.

Engine

- The expenditures relating to the overhaul of the engine are regarded as capital in nature. Those expenditures represented more than a repair of the existing defect in the engine. Rather than merely **repairing** the defect in the engine, the taxpayer gave the engine a major overhaul, replacing essentially all the major parts of the engine except the block.
- The rebuilt engine **materially extended** the useful life of the taxpayer's CAT loader. The benefits associated with the rebuilt engine would accrue over a number of years, and therefore it is appropriate that the related costs be recovered over a similar period.

[*Jacks, Jerry v. Commissioner,* T.C. Memo 1988-237, 55 TCM [CCH Dec. 44,810(M)], 1988]

Question 2A. What if a rebuilt transmission had been used?

Answer 2A. The Jacks decision would require capitalization, probably because it would increase the value of the machine. If the taxpayer could establish that a rebuilt transmission was no better than a used transmission and had no better warranty than a used transmission, the cost might be considered a repair.

Question 2B. What if Jacks only had the two broken cylinders fixed or replaced?

Answer 2B. If they had been fixed, it would be a deductible repair. If replacing the cylinders did not substantially improve the value of the CAT or **appreciably** prolong its life, then this cost would also be a deductible repair.

3. *Claussner Hosiery Co. v. Commissioner*

Facts. The taxpayer owned hosiery knitting machines.

- In the years 1945 and 1946, the machines had outlived their normal useful life and their cost had been fully recovered through depreciation. Under these conditions the machines would have been discarded by the taxpayer and sold for scrap, since they were **valueless** from the standpoint of producing salable merchandise.

- In the years 1945 and 1946, because of war conditions, it was impossible for the taxpayer to acquire new machines to replace these. Faced with these conditions, the taxpayer decided to have the machines **reconditioned and certain of the moving parts rebuilt.**
- After this reconditioning, these machines operated satisfactorily, produced first-class merchandise, and were still being used at the date of the hearing of this proceeding.

The reconditioning in question extended the economic life of the several machines for an additional period of four to six years.

Decision. **The costs had to be capitalized.** [Claussner Hosiery Co. v. Commissioner, 9 TCM 891 [CCH Dec. 17,909(M)], 1950.]

Question 3A. Why is the reconditioning not a repair since the reconditioning merely kept the machines in operating condition?

Answer 3A. Because the normal useful operating life of the machines had been exhausted. The reconditioning substantially prolonged the useful life.

Question 3B. If a property is depreciated out under MACRS, does that mean that the “normal useful operating life” is at an end?

Answer 3B. **No.** The life provided for tax depreciation purposes is not the same as the normal life of the property.

4. *Hudlow v. Commissioner*

Facts

- A cold storage room had floor dimensions of about 55 feet by 100 feet. It had a concrete floor that was higher around the edges of the room and sloped down toward the drains, which were built in. The drains were helpful when the room was being washed down and when the room was used for the storage of such items as ice-packed turkeys and certain types of produce that resulted in water getting on the floor. However, as a result of the way the concrete floor had been installed to accommodate the drains, the thickness of the concrete was not uniform; rather, the concrete was made much thicker (5 to 6 inches) around the outside walls of the room and thinner (about 1 inch) around the drains. Over a period of time, with heavy usage, the floor became cracked and broken in the vicinities of the drains. Also, a layer of foam glass insulation material beneath the concrete was damaged further whenever a forklift truck was operated on a spot where the concrete was broken. As a result, the room became unusable.
- To restore the floor to its original condition would have necessitated taking up all of the remaining concrete and insulation, as well as the “sub floor.” Such work would have cost $40,000. Instead of that, the taxpayer had workmen remove the bad spots of the floor and pour concrete over what remained. Such work enabled the taxpayer to resume use of that cold storage room.

Decision. **The pouring of the concrete over the pre-existing floor in the taxpayer’s leased facility was done for the purpose of restoring such facility to its previously useful condition, and not to bring about a material increase in the value of the facility, or to substantially prolong its life.** Such conclusion is consistent with those in *Oberman Manufacturing Co.*, with respect to work done to a roof, including a structural change, to prevent it from leaking; *Plainfield-Union Water Co.*, with respect to cleaning and installing a cement lining in the taxpayer’s water pipe; *Southern Ford Tractor Corporation*, with respect to filling and grading a lot; *Midland Empire Packing Co.* (Dec. 17,601), 14 T.C. 635 (1950), with respect to lining the walls and floor of the basement of the taxpayer’s building; and *American Bemberg Corporation* (Dec. 16,268), 10 T.C. 361 (1948), aff’d (49-2 USTC ¶9460) 177 F.2d

200 (C. A. 6, 1949), with respect to drilling and grouting expenditures to prevent a cave-in of the taxpayer's warehouse building after the wooden piles on which it rested were damaged by dry rot.

- In *Phillips & Easton Supply Co.* (Dec. 19,691), 20 T.C. 455 (1953), the expense of installing a new floor in the taxpayer's building was held to be a **capital expenditure.** There, however, the old floor was 46 years old, **and had so deteriorated that further repairs were not practical;** such old floor had been previously patched in various places. The new floor was a replacement of the old one, and we think that the facts in that case are akin to what would have been the situation had **Mr. Hudlow** chosen the more expensive route of bringing about a complete restoration of the floor in his storage room. **However, he did not do so,** and the court held that his action in pouring concrete over the old floor is factually distinguishable from what the taxpayer did in *Phillips & Easton Supply Co.*

[*Hudlow v. Commissioner,* T.C. Memo 1971-218 [CCH Dec. 30,959(M)], 1971]

Question 4A. The expense obviously improved the value of the property. Did the court overlook this?

Answer 4A. No. The court explained it as follows:

> Of course, any properly performed repair adds value to the property as compared to the situation immediately before the repair was done, but "the proper test is whether the expenditure **materially** enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."

Note: This is a useful quote in arguing close cases with the IRS.

5. *Nottingham v. Commissioner*

Facts

- The taxpayer owned, in connection with his businesses, many pieces of equipment, including, in 1945, a Caterpillar tractor, two Chevrolet trucks, a trailer, and a drill rig, none of which was new. The tractor, **after being rented** to another contractor, required complete cleaning, overhauling, and replacing of many parts in order to restore it to the condition that **it was in when rented.** The taxpayer made those repairs in 1945 at a cost of $1,088.03. The transmissions on the two Chevrolet trucks broke down and had to be replaced in 1945 at a cost of $621.67. The taxpayer, in order to put brakes on and thereby be permitted to continue using a trailer, had to replace its axles in 1945 with two other **used axles** at a cost of $410.

Decision

- The repairs were extensive and in two cases the new material had some advantages over that which it replaced. Nevertheless, the evidence shows that the equipment received rough use and the expenditures should be classified as ordinary and necessary expenses of the business.

[*Nottingham, Mark v. Commissioner*, 12 TCM [CCH Dec. 19,648(M)], 1945]

Question 5A. Wasn't this court more liberal than the Jacks court?

Answer 5A

1. Note that the **tractor** had been rented to another person, and these kinds of repairs could be expected in a rental situation.
2. The axles were replaced with **used** axles.

3. If the transmission were new or rebuilt, **Jacks** would require the cost to be capitalized. If the cost of a rebuilt transmission was about the same as a used transmission, the rebuilding might also be a repair expense.

6. *Jacobson v. Commissioner*

Facts

- In November 1977, the taxpayer purchased a four-unit house for rental purposes at a cost of $30,000. At the time of purchase, one of the units was being rented while the other three were vacant. The property as a whole was in disrepair.
- The taxpayer paid $6,247 to a contractor, who made various repairs to the property. The repairs included trimming limbs from the trees that had been rubbing the roof; repairing water damage in the units; patching holes in the walls; repairing damaged electrical wiring; cleaning the carpeting, floors, and the exterior of the property; repairing the front porch; replacing electrical fixtures; and installing new cabinet doors and a formica countertop in one of the kitchens.

Decision

- The taxpayer's testimony established that his purpose in having the work done to the house was to keep the property in an operating condition over its probable useful life for the uses for which it was purchased, **and not to prolong** the life of the property or **make it adaptable to a different use.**
- Although the property was in poor condition at the time of purchase, one of the units was in fact being rented at that time. The taxpayer simply wished to perform minor repairs on the property to make it more suitable for rental purposes.
- Indeed, the evidence indicates that most of the work consisted of "incidental repairs" necessary to keep the building in an "ordinarily efficient operating condition." We do not believe that the work performed on the property was part of a **general plan of renovation on a piece of property that had lost its commercial usefulness.**
- Nor did the work materially add to the value of the property. While the repairs properly performed may have added value as compared with the situation existing at the time the taxpayer purchased the building, it did not **materially** enhance the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditures.

[*Jacobson, Roger v. Commissioner,* T.C. Memo 1983-719 [CCH Dec. 40,640(M)], 1983]

Note: The repairs did not adapt the property to different use. There was no general plan of renovation.

Question 6A. Do building repairs such as painting, cleaning, patching, and so on ever have to be capitalized?

Answer 6A. Yes, in instances where they are a part of a general plan of renovation.

7. *Chesapeake Corporation of Virginia v. Commissioner*

Facts

- In 1945, the taxpayer owned a house which it rented to one of its officers for $50 a month. In that year, the taxpayer spent $2,879.02 for work done on the house and materials used in connection with such work. The work that was done consisted of painting the entire house, papering

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the rooms, repairing cracked bath tiles, patching outside woodwork, and scraping and painting floors. The work done on the house did not result in any additions of space or any structural changes. The house is located about 500 feet from the taxpayer's pulp mill, which emits acid fumes that have a tendency to make paint peel from wood. The taxpayer owns other houses that are occupied by officers and employees. In order to keep the wood in such houses in good condition, it is the practice to paint them at least once a year.

Decision

- The evidence establishes that these repairs are such as are customarily made to keep rental property in a tenantable condition. No structural changes and no additions were made.

[*Chesapeake Corp. of Virginia v. Commissioner*, 17 T.C. 668 (1951)]

Note: This expense was to keep the property in tenantable condition, not a general renovation.

8. *Pryor v. Commissioner*

Facts

- The taxpayers purchased a residence in the latter part of 1946 for $4,500. They planned to live in one side and rent the other. The building had been built around 1900 and was in a bad state of repair.
- The taxpayers spent $502.81 for repairs to the entire dwelling. The repairs consisted of plastering of two rooms, some patchwork, painting the outside of the house, and repairing the windows. They also spent $176.63 in wiring and installing a hot water heater. A portion of the house was rented during five months of 1947 at $25 per month for a total rental of $125.

Decision

- Expenditures were pursuant to a **general plan of reconditioning, improving, and altering** the property, and hence were capital expenditures.

[*Pryor v. Commissioner*, T.C. Memo 1954-60 [CCH Dec. 20,384(M)], 1954]

9. *G & R Corp. v. Commissioner*

Facts The taxpayer placed new oak floors over old pine floors in an 11-story building.

Decision Repairs to wooden floors **include** mending, replacement of loose or damaged boards, planing, sanding, polishing, and like work performed on the old floor surface. **They do not include** the **complete replacement** of old pine floors by new oak floors. Moreover, the fact that the old floors were not removed but were used as supports for the new **does not justify a conclusion** that the work consisted merely of repairing the old floors. The function of the old floors as floors ceased completely when they were covered from wall to wall by the new floors. The installation of the new floors resulted in a direct business advantage, the effect of which will be felt by petitioner in future years. They "rendered the building better suited to the purpose for which it was used."

[*G & R Corp. v. Commissioner,* 8 TCM 970 [CCH Dec. 17,264(M)], 1949]

10. *Farmers Creamery v. Commissioner*

Facts

- The general building was erected in 1914 and has since been in constant hard use. The cost of the building at the beginning of 1945 was $35,775.52. The building was then in **bad condition,** due to rotting of wood portions of floors and walls resulting from milk and water seepage. Repairs were required for sanitary, safety, and utility purposes in order to maintain and continue the efficient use of the building.

- Repairs were made from time to time as occasion arose during each of the taxable years, without discontinuing the use of the building. These were **not made in accordance with any overall plan.** They did not require a building permit.
- Typical separate repairs were replacing several joists where the old ones had rotted, permitting the floor to sag; replacing small portions of rotted flooring; and patching walls and ceilings. **The materials used were similar to those replaced.** The work was unusually expensive because of wartime costs and because much of it was done on an overtime basis, so as to interfere as little as possible with the operation of the plant.
- **The repairs never replaced as much as one-half of any wall, ceiling, or floor, and they did not in any way enlarge or change the design of the building.**
- The costs were all charged to a repair account.
- The repairs were solely to mend deteriorated parts of the old building in order to restore it to a sound condition.
- These repairs did not appreciably prolong the original useful life of the property.

Decision

- The repairs merely permitted the **continued use** of the building without substantially extending its former estimated useful life.

[*Farmers Creamery Company of Fredricksburg v. Commissioner,* 14 T.C. 879 (1950)]

11. SPECIAL ITEMS

Tires. If the taxpayer can establish that the average useful life is **about** one year or less, the cost is a repair. **Rev. Rul.** 59-249; **Rev. Rul.** 68-134; Rev. Rul. 69-560; **Rev. Rul.** 73-357

Tools. The taxpayer should be able to establish that they have a useful life of **about** one year or less. [*Clausman*, 57 TCM 17 (1989)] The IRS generally allows the current deduction of the cost of small tools if the annual cost of these tools does not materially distort income and it is not practical to require records for depreciating the item.

Practitioner Note: Consider using I.R.C. §179 on questionable items that qualify for §179 treatment.

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