

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 applies to the year of purchase, and there is 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.)

<u>In the Case of</u>	<u>Taxpayer Could Have Elected a Recovery Period of</u>
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

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.**

The **MACRS** recovery periods are 3-, 5-, 7-, 10-, 15-, 20-, 27.5- or 31.5- (now 39-) year.

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The class life of an item of property determines its recovery period and the method of depreciation used.

B. EXAMPLES OF PROPERTY INCLUDED IN RECOVERY PERIODS—MACRS

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

- Breeding hogs
- Over-the-road tractor (semi-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 in entertainment services. (Added to this category are assets that have no ADR midpoint and that are not classified.)

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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 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 [I.R.C. §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 5/13/93; 39-year recovery period for property placed in service on or after 5/13/93):

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

Election: A taxpayer may elect to apply the alternative depreciation system to any class of property for any taxable year. In the case of nonresidential real property or residential rental property, the election may be **made separately with respect to each property**.

2. The computation method under ADS is the straight-line method using the applicable convention over the specified recovery period (alternate MACRS life).
3. The recovery period (alternative MACRS life) is the mid-point of the asset depreciation range (ADR) if property has a class life. [I.R.C. §168(i)(1)(A)] Property with no class life has a recovery period of 12 years. Nonresidential real, residential rental, and Section 1245 property that is real property with no class life has a recovery period of 40 years.
4. The alternate MACRS life for selected assets is listed in Depreciation Practice Guides 2 and 3 below.

Practice Pointer. For alternative minimum tax purposes, depreciation for assets placed in service after 1986 and before 1999 is computed using the 150% declining balance 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 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

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.

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.

E. AMT DEPRECIATION OF PROPERTY

For property placed in service **after 1998**, a taxpayer is 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.)

Example 1. Rose Thorn acquires office furniture in July 2000, at a cost of \$12,000. Rose can elect to depreciate the office furniture over its normal recovery period of seven years using 150-percent declining balance depreciation rather than the 200-percent declining balance method generally available. By

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doing so, Rose will avoid an AMT adjustment in 2000 and future years for the office furniture. Such an election reduces Rose's 2000 depreciation on the office furniture as follows:

<u>Method</u>	<u>Rate</u>	<u>Depreciation Amount</u>
200 DB	14.29%	\$1,715
150 DB	10.71%	\$1,285
Decrease in 2000 depreciation deduction with election		<u>\$ 430</u>

Observation. Rose will claim exactly the same total depreciation over the 7-year recovery period whether she uses 150 DB or 200 DB depreciation. The difference in annual deductions is only a timing difference.

Result. Taxpayers can elect, for regular tax purposes, to compute depreciation on tangible personal property that is qualified for the 200-percent declining balance method by using the 150-percent declining balance method over the regular tax recovery period. This election eliminates the need for an AMT depreciation adjustment for assets placed in service after 1998.

For \$1250 property placed in service the 1999 tax year and thereafter, taxpayers can use the MACRS recovery period (27.5 years for residential rental real estate and 39 years for nonresidential real estate) using straight-line depreciation for both regular tax and AMT purposes. As a result, no depreciation adjustment is required for AMT purposes with regard to residential and nonresidential real estate placed in service after 1998.

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III. DEPRECIATION PRACTICE GUIDES

A. GUIDE 1: GENERAL DEPRECIATION SYSTEM

For personal property other than listed property the 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	Property placed in service prior to 1999: AMT requires 150% declining balance over alternate MACRS (ADS) (longer) life.	Half-year or midquarter (depreciation allowed in year of disposition)	Non-farm 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	Property placed in service after 1998: Regular life is used for AMT and regular depreciation purposes.		
	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	Property placed in service prior to 1999: AMT requires straight-line over alternate MACRS (ADS) (longer) life. (If straight-line is used for regular tax, it must be used for AMT)	Half-year or midquarter	Farm and non-farm Half-year—Table 8 Midquarter—Tables 9–12
		See Depreciation Practice Guides 2 and 3	Property placed in service after 1998: Regular life is used for both AMT and regular depreciation purposes.		
C. Alternate Depreciation System	Straight-line	Alternate MACRS life (ADS) See Depreciation Practice Guides 2 and 3	No	Half-year or midquarter	Farm and non-farm Half-year—Table 14 Midquarter—Tables 9–12

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Option	Method	Recovery Period	AMT Adjustment Required	Convention	Tables (IRS Pub. 946 Appendix A)
D. AMT Method	150% declining balance	<p>Property placed in service prior to 1999: Alternate MACRS life (ADS)</p> <p>See Depreciation Practice Guides 2 and 3.</p> <p>Property placed in service after 1998: Use regular life for AMT purposes.</p>	No	Half-year or midquarter	Farm and non-farm 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	<p>27.5 years—residential rental</p> <p>*39 years—nonresidential real</p>	<p>Property placed in service prior to 1999: AMT requires straight-line over 40 years.</p> <p>Property placed in service after 1998: Use regular life for AMT purposes.</p>	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	<p>Property placed in service prior to 1999: 40 years.</p> <p>Property placed in service after 1998: Use regular life of 27.5 or 39 years.</p>	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	Property Class and Recovery Period		
	ACRS	MACRS	Alternate MACRS Life
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-gin 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	5
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 lb.)	3	5	5
Typewriter	5	5	6
Vineyard	5	10 ²	20
Wind energy property	5	5	12

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

¹7 years if placed in service before 1989.

²Straight-line depreciation.

³31.5 years for property placed in service before 5/13/93.

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

Asset	MACRS Life	Alternate MACRS Life
Airplane	5	5
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 (business share)	5	5
Buses	5	9
Light general-purpose trucks (actual weight is less than 13,000 lb.)	5	5
Heavy general-purpose trucks (unloaded weight of 13,000 lb. 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 and television transmitting towers	15	20
Residential rental property	27.5	40
Nonresidential real property	39*	40
Mobile home (Pub. 534)	27.5	40

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

IV. I.R.C. §179

A. SMALL BUSINESS JOBS PROTECTION ACT OF 1996

The act **increases** the \$17,500 amount of qualified property allowed to be expensed under §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

The act provides that the following is added to the list of property **not** qualifying for the §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

Practitioner Note. Property used in connection with furnishing lodging can be a troublesome issue. Property used in the living quarters of a lodging facility, including furniture and appliances, is considered as used predominantly to furnish lodging. The term *lodging facility* includes an apartment house, hotel, motel, or any other facility where sleeping accommodations are provided.

However, property used by a hotel, motel, inn, or other similar establishment is not considered used in connection with the furnishing of lodging if more than half of the living quarters are used to accommodate tenants on a transient basis (**rental periods of 30 days or less**). See Code §50(b)(2)(B) and Treas. Reg. §1.48-1(h).

Result. Property used by a hotel or motel in connection with the business of furnishing lodging for transients is eligible for §174 expensing. Such property would include items such as television sets, radios, phones, clocks, hair dryers, and furniture.

Horses. Horses that meet the requirement of §179(d) are eligible for §179 expensing.

The committee report for §1111 of the Small Business Jobs Protection Act of 1996 states that the committee 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. PROPERTY QUALIFYING FOR §179

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 qualifies for the §179 election. Section 179(d)(1) defines “§179 property” as “any tangible property. . .which is §1245 property (as defined in §1245(a)(3). . . .” Section 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

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iii constituted a facility used in connection with any of the activities used 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)).

C. ASSETS QUALIFYING FOR §179 EXPENSING

The following tables list a number of assets and their eligibility for §179 expensing and the reason for qualifying or not qualifying.

§179 Eligibility of Selected Assets Used in All Business Activities

Asset	Depreciation		§§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Airplanes and helicopters (except commercial airlines)	5	Table B-1, Class 00.21	Yes	Personal property	§179(d)(1), §1245(a)(3)(A)
Automobiles	5	Table B-1, Class 00.22	Yes	Personal property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Calculators, copiers, typewriters, and duplicating equipment	5	Table B-2, Class 00.13	Yes	Personal property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Computers and peripheral equipment	5	Table B-1, Class 00.12	Yes	Personal property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Office furniture, desks, files, safes, telephones	7	Table B-1, Class 00.11	Yes	Personal property	§179(d)(1), §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)

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§179 Eligibility of Selected Assets Used in All Business Activities

Asset	Depreciation		§§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Office fixtures that are not structural components of a building, such as carpeting, vinyl floor coverings, vinyl wall coverings, and movable partitions	7	Table B-1, Class 00.11	Yes	Personal property	Rev. Rul. 67-349, 1967-2 C.B. 48, Rev. Rul. 75-17, 1975-1 C.B. 9, <i>Hospital Corporation of America</i> . 109 T.C 21 (1997)
Buses	5	Table B-1, Class 00.23	Yes	Personal property	§179(d)(1) §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Light general-purpose trucks (actual weight less than 13,000 lb.)	5	Table B-1, Class 00.241	Yes	Personal property	§179(d)(1) §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Heavy general-purpose trucks (unloaded weight 13,000 lb. or more)	5	Table B-1, Class 00.242	Yes	Personal property	§179(d)(1) §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Tractor units for over-the-road use	3	Table B-1, Class 00.26	Yes	Personal property	§179(d)(1) §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Trailers and trailer-mounted containers	5	Table B-1, Class 00.27	Yes	Personal property	§179(d)(1) §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Distributive trades and services—Assets used in wholesale and retail trade and personal and professional services	5	Table B-2, Class 57.0	Yes	Personal property	§179(d)(1) §1245(a)(3)(A), IRS Pub. 946, p. 12 (1999)
Distributive trades and services—Billboards (if installed to be easily moved)	15	Table B-2, Class 57.1	Yes	Personal property	<i>Alabama Displays, Inc.</i> , 75-1 USTC 9116 (Ct. Cls., 1974), Rev. Rul. 80-151, 1980-1 C.B. 7
Billboards (if extremely difficult to move)	15	Table B-2, Class 57.1	No	Real property	Rev. Rul. 80-151, 1980-1 C.B. 7

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§179 Eligibility of Selected Assets Used in All Business Activities

Asset	Depreciation		§§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Distributive trades and services—Service station buildings and car wash buildings	15	Table B-2, Class 57.1	No	Building	Rev. Rul. 79-406 1979-2 C.B. 18
Recreation—Assets used in entertainment services for a fee or admission charge, such as the operation of bowling alleys, pool establishments, theaters, miniature golf courses (excludes buildings)	7	Table B-2, Class 79.0	Yes	Personal property	§179(d)(1), §1245 (a)(3)(A)
Land improvements such as sidewalks, roads, bridges, fences, landscaping shrubbery	15	Table B-1, Class 00.3	No	Not Personal property	<i>Kenneth L. LaCroix</i> , 61 T.C. 471 (1974)
Movable trailers	7	Table B-2, Personal property with no class life	Yes	Personal property	<i>Joseph Henry Moore</i> , 58 T.C. 1045 (1972); Rev. Rul. 77-8, 1977-C.B. 3; and Rev. Rul. 77-291, 1977-2 C.B. 7.
Trailers that are not mobile—Wheels detached and permanent utilities attached	27.5 or 39	§168(c)	No	\$1250 Real property	Rev. Rul. 77-8, 1977-1 C.B.3 and Rev. Rul. 77-291, 1977-2 C.B. 7
Elevators and escalators	27.5 or 39	§168(c)	No	Structural component of a building; relating to operation or maintenance of building	Treas. Reg. §1.48-1(e)(2)
Oil and gas well equipment	7	Table B-2, Class 13.2	Yes	Tangible Personal property	Rev. Rul. 67-99, 1967-1 C.B. 68
Oil and gas drilling equipment	5	Table B-2, Class 13.1	Yes	Integral	Treas. Reg. 1.48-1(d)

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Section 179 Eligibility of Selected Farm Assets

Asset	Depreciation		RC §§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Apple storage	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 74-451, 1974-2 C.B. 10
Barns	20	Table B-2, Class 01.3	No	Building	Rev. Rul. 66-89, 1966-1 C.B. 7
Citrus trees	10	§168(e)(3)(D)(ii)	Yes	Integral	Rev. Rul. 69-249, 1969-1 C.B. 31
Drain tile	15	Pub. 225	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7
Fences	7	Table B-2, Class 01.1	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7
Fish raising facilities	20	Table B-2, Class 01.3	Yes	Integral	Rev. Rul. 80-341, 1980-2 C.B. 24
Fruit trees and orchards	10	§168(e)(3)(D)(ii)	Yes	Integral	Rev. Rul. 67-51, 1967-1 C.B. 68, Ltr. Rul. 8108007
Fruit cooling room	20	Table B-2, Class 01.3	Yes	Integral	<i>Giannini Packing Corp v. Commissioner</i> , 83 T.C. 526 (1984)
Gasoline storage tanks	20	Table B-2, Class 01.3	Yes	Personal property	Rev. Rul. 74-602, 1974-2 C.B. 12, revoking Rev. Rul. 74-152, 1974-1 C.B. 11
Grain storage	7	Table B-2, Class 01.1	Yes	Storage	<i>Schuyler Grain Co., Inc. v. Commissioner</i> , 50 T.C. 265 (1968)
Grain storage, flat	20	Table B-2, Class 01.3	No	Building	<i>Bundy v United States</i> , 87-1 USTC 87,084 (D. Neb. 1986)
Greenhouses	10	§168(e)(3)(D)(i)	Yes	Single purpose	Rev. Rul. 79-343, 1979-2 C.B. 18, modifying Rev. Rul. 66-89, 1966-1 C.B. 7
Hay storage and feeding facility	10	§168(e)(3)(D)(i)	Yes	Single purpose	<i>Leshner v. Commissioner</i> , 73 T.C. 340 (1979)
Hay and grain storage barn	20	Table B-2, Class 01.3	No	Building	<i>Sherwood v. Commissioner</i> , T.C. Memo 1988-544

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Section 179 Eligibility of Selected Farm Assets

Asset	Depreciation		RC §§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Dairy and breeding cattle	5	Table B-2, Class 01.21	Yes	Personal property	IRS Pub. 225, p. 42 (1999)
Breeding or milk goats	5	Table B-2, Class 01.24	Yes	Personal property	IRS Pub. 225, p. 42 (1999)
Horses:					IRS Pub. 225, p. 42 (1999); Treas. Reg §1.1245-3(a)(4); and Senate Report, Section 1111 of Small Business Jobs Protection Act of 1996
breeding or working (12 years old or less)	7	Table B-2, Class 01.221	Yes	Personal property	
breeding or working (more than 12 years old)	3	Table B-2, Class 01.222			
any race horse more than 2 years old	3	Table B-2, Class 01.223			
any horse more than 12 years old that is not a race horse or in Class 01.222	3	Table B-2, Class 01.224			
any horse not described above	7	Table B-2, Class 01.225			
Breeding sheep	5	Table B-2, Class 01.24	Yes	Personal property	IRS Pub. 225, p. 42 (1999)
Poultry	None		No	Not §1245 property; treated as expense	Rev. Rul. 60-191, 1960-1 C.B. 78
Ostriches, emus, rheas	7	Table B-2, Personal Property with No Class Life	Yes	Personal property	Ltr. Rul. 8817003, Ltr. Rul. 9615001
Exotic game animals	7	Table B-2, Personal Property with No Class Life	Yes	Personal property	Ltr. Rul. 9615001, Ltr. Rul. 8817003
Hog facility	10	I.R.C. §168(e)(3)(D)(i)	Yes	Single purpose	Rev. Rul. 66-329, 1966-2 C.B. 16, as modified by Rev. Rul. 79-343, 1979-2 C.B. 18

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Section 179 Eligibility of Selected Farm Assets

Asset	Depreciation		RC §§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Horse facilities	10	I.R.C. §168(e)(3)(D)(i)	Yes	Single purpose	Senate Report, §1111 of Small Business Jobs Protection Act of 1996; Treas. Reg. §1.1245-3(b)(4)
Kennel, dog and cat			No	Not livestock	<i>McKenzie v Commissioner</i> , 85 T.C. 875 (1985)
Macadamia trees	10	I.R.C. §168(e)(3)(D)(ii)	Yes	Integral	Rev. Rul. 71-488, 1971-2 C.B. 60
Machinery and equipment	7	Table B-2, Class 01.1	Yes	Personal property	IRS Pub. 225, p. 42 (1999); Rev. Rul. 72-573, 1972-2 C.B. 12
Manure storage facility	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 66-89, 1966-1 C.B. 7
Milk parlor	10	IRC §168(e)(3)(D)(i)	Yes	Single purpose	Ltr. Rul. 8324009, Ltr. Rul. 8323011
Mushroom beds and conveyors	7	Table B-2, Class 01.1	Yes	Personal property	Rev. Rul. 66-156, 1966-1 C.B. 11, as modified by Rev. Rul. 79-183, 1979-1 C.B. 44
Onion shed	20	Table B-2, Class 01.3	No	Building	<i>Tamura v. United States</i> , 734 F.2d 470 (9th Cir. 1984)
Paved barnyard	15	Table B-2, Class 01.3	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7
Peanut Storage	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 71-359, 1971-2 C.B. 61
Potato Storage	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 68-132, 1968-1 C.B. 14, as modified by Rev. Rul. 71-359, 1971-2 C.B. 61; Ltr. Rul. 7107221760A

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Section 179 Eligibility of Selected Farm Assets

Asset	Depreciation		RC §§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
Poultry facility—Broiler house	10	§168(e)(3)(D)(i)	Yes	Single purpose	<i>Satrum v. Commissioner</i> , 62 T.C. 413 (1974); Rev. Rul. 79-343, 1979-2 C.B. 18, modifying Rev. Rul. 66-89, 1966-1 C.B. 7; but see <i>Starr Farms v. U.S.</i> , 447 F.Supp. 580 (W.D. Ark. 1977)
Stable (with working space)	20	Table B-1, Class 01.3	No	Building	Rev. Rul. 66-89, 1966-1 C.B. 7
Storage Facility	20	Table B-2, Class 01.3	Yes	Storage	Rev. Rul. 66-89, 1966-1 C.B. 7
Tobacco storage shed	15	Table B-1, Class 00.3	Yes	Storage	<i>Brown and Williamson Tobacco Corp.</i> , 369 F. Supp. 1283 (W.D. Kent. 1973); Rev. Rul. 66-89, 1966-1 C.B. 7
Tobacco barn (used for storing, curing and processing tobacco)	20	Table B-2, Class 01.3	No	Working space more than incidental	<i>Gary G. Hart v. Commissioner</i> , T.C. Memo. 1999-236
Tractor	7	Table B-2, Class 01.1	Yes	Personal Property	Rev. Rul. 72-573, 1972-2 C.B. 12
Vineyard	10	§168(e)(3)(D)(ii)	Yes	Integral	Rev. Rul. 67-51, 1967-1 C.B. 68; Ltr. Rul. 8108007
Warehouse	20	Table B-2, Class 01.3	No	Building	Rev. Rul. 66-89, 1966-1 C.B. 7
Water wells	15	Table B-2, Class 00.3	Yes	Integral	Rev. Rul. 66-89, 1966-1 C.B. 7, clarified by Rev. Rul. 72-222, 1972-1 C.B. 17
Housetrailer for farm laborers—mobile, has wheels, history of being moved	7	Table B-2, Class 01.1	Yes	Personal property	IRS Pub. 225, p. 47 (1999) <i>Joseph Henry Moore</i> , 58 T.C. 1045 (1972); Rev. Rul. 77-8, 1977-1 C.B. 3

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Section 179 Eligibility of Selected Farm Assets

Asset	Depreciation		RC §§179 and 1245		
	MACRS Life	Authority	Qualifies?	Reason	Authority
House trailers for Farm Laborers—not mobile, wheels detached, permanent utilities attached	20	Table B-2, Class 01.3	No	§1250 Real property	IRS Pub. 225, p. 43 (1999); Rev. Rul. 77-8, 1977-1 C.B. 3, Rev. Rul. 77-291, 1977-2 C.B. 7

V. SHORT-YEAR DEPRECIATION

A. WHO IS SUBJECT TO SHORT-YEAR DEPRECIATION RULES?

Individuals. For depreciation purposes, the tax year of an individual placing depreciable property in service does not begin until the person engages in a trade or business or holds depreciable property for the production of income. However, if an individual is an employee, the tax year will include all of the period in which the individual is in the trade or business of being an employee, even if no depreciable assets have been placed in service in conjunction with the employment.

Example 2. In 2000, Terminator Corporation expanded its chemical sales staff and required all sales representatives to furnish a vehicle as a condition of employment. Steve has been an employee of Terminator for four years, while Mike and Larry are hired July 1, 2000. Mike has 6 years of experience with another company from which he recently resigned; Larry just graduated from college in June, and the Terminator position is his first job. The three sales representatives each placed a vehicle in service in early July.

In determining depreciation for the vehicle, Steve and Mike do not have a short tax year because they are treated as engaging in a trade or business for the entire year. However, Larry falls under the short-year rules and has a short tax year for depreciation beginning July 1. He was not engaged in the business of being an employee for the period January 1–June 30 [see Prop. Reg. §1.168-2(f)(6), Examples 4–6].

Even though an individual is in the trade or business of being an employee and can avoid short-year rules for business assets used in his employment, the employee is not considered to be engaged in a trade or business by virtue of employment for a second business activity as a sole proprietor [Prop. Reg. §1.168-2(f)(6), Example 4].

Example 3. Steve, from Example 2, has worked for Terminator Corporation for 4 years. In addition to the vehicle placed in service on July 1 for use as an employee, Steve also placed in service carpet-cleaning equipment for use in a part-time sole-proprietorship business of residential carpet-cleaning. The carpet-cleaning activity was initiated in August. As indicated above, the vehicle is not subject to short-year rules. However, in determining when a tax year begins for property not used in the trade or business of employment, the carpet-cleaning equipment is considered placed in service in a short tax year.

Practitioner Note. If Steve had been engaged in *any* trade or business (*other than that of being an employee*) during 2000 before his new business of carpet cleaning began, the short-year depreciation rules would not have applied (*McKnight v. Commissioner*, T.C. Memo 1990-69; TAM 89-35-002).

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Example 4. Assume that Steve from Example 3, in addition to his position as an employee of Terminator Corporation, had been engaged in a sole proprietorship of raising rare birds for several years prior to 2000. In this case, the carpet-cleaning equipment from Example 3 would not be subject to the short-year depreciation rules. This is because Steve was in a trade or business (other than being an employee) for all of 2000.

Business Entities. C corporations, S corporations, partnerships, limited liability companies, and estates and trusts can be subject to the short-year depreciation rules. A short tax year is any tax year of less than 12 full months. For example, in the case of a corporation, a short tax year can result from the incorporation of a business, a change in tax years, or the dissolution of a corporation.

Possible Attribution from Partnership to Partner. In the case of *Theodore G. Arens v. Commissioner* (T. C. Memo 1990-241), it was determined that a general partner in a partnership engaged in leasing commercial real estate could avoid the short-year depreciation rules for a newly formed sole proprietorship based on attribution of the partnership's trade or business activity to the partner.

Property Subject to Midmonth Convention. Since real property is treated as being placed in service or disposed of at the midpoint of the calendar month it is placed in service, there is no adjustment to make for a short tax year.

\$179 expensing. No proration of the \$179 expensing election is required for eligible property placed in service in a short tax year.

Example 5. Use the facts of Steve's carpet-cleaning activity from **Example 3**. Because his only other business activity was that of being an employee, the carpet-cleaning equipment of the new sole proprietorship is subject to the short-year depreciation rules. Assume Steve places in service \$20,000 of carpet-cleaning equipment in 2000 when he initiates the activity. Steve may elect to claim a \$20,000 \$179 expense deduction on the equipment (subject to the taxable income limitation) without any proration of cost for the number of days in 2000 during which the property was in service or the sole proprietorship was in existence.

B. CALCULATING SHORT-YEAR DEPRECIATION

If property is placed in service during a short taxable year, the standard depreciation rates for the first year of depreciation cannot be applied since they are based on a full taxable year. The tax years following the first short year also require special calculations since they include parts of two different years of the life of the asset.

The MACRS percentage tables cannot be used to compute the depreciation deduction for any taxable year for any property placed in service in a short taxable year.

BACKGROUND

To determine the amount of depreciation that is allowed in the short year, the length of the depreciation period for the applicable convention must be determined. If the half-year convention applies, the length of the half-year must be determined. If the mid-quarter convention applies, the length of the mid-quarter must be determined. Once the length of the depreciation period is determined, the portion of a full year's depreciation that is allowed for the short year can be determined.

DETERMINING THE DEPRECIATION CONVENTION FOR PROPERTY PLACED IN SERVICE IN A SHORT TAX YEAR

The half-year, mid-quarter, and mid-month conventions establish the date when property is treated as placed in service and depreciation starts. Depreciation is allowable only for that part of the tax year the

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property is treated as in service. The recovery period begins on the placed-in-service date. The recovery period at the beginning of the next tax year is the full recovery period less that part of the first tax year for which depreciation is allowable.

For the mid-month convention, property is always treated as placed in service at the midpoint of the month it is placed in service. The mid-month convention is applied without regard to the tax year.

Half-Year Convention. Under the half-year convention, property is treated as placed in service on the midpoint of the tax year. **For a short tax year that begins on the first day of a month or ends on the last day of a month, the tax year consists of the number of months in the tax year. If the short tax year includes part of a month, the full month is generally included in the number of months in the tax year.**

The midpoint of the tax year is determined by dividing the number of months in the tax year by 2. For the half-year convention, property is treated as placed in service on either the first day or the midpoint of a month. For example, a short tax year that begins on June 20 and ends on December 31 consists of 7 months. Because only full months are used for this determination, the tax year is treated as beginning on June 1 instead of June 20. The midpoint of the tax year is 3 1/2 months from the beginning of the tax year or the middle of September.

Example 6. Tara Corporation, a calendar-year taxpayer, was incorporated on March 15, 2000. It has a short tax year of 10 months, ending on December 31, 2000. During the 2000 tax year, Tara placed property in service for which it uses the half-year convention. This property is treated as placed in service on the first day of the fifth month of the tax year, or August 1, 2000.

Mid-Quarter Convention

To determine if the mid-quarter convention must be used instead of the half-year convention, **compare the basis of property placed in service in the last 3 months of the tax year to the basis of property placed in service during the full tax year.** The length of the tax year is immaterial. For a short tax year of 3 months or less, use the mid-quarter convention for all applicable property placed in service during that tax year.

Treat property under the mid-quarter convention as placed in service on the midpoint of the quarter of the tax year. **Divide a short tax year into 4 quarters and then determine the midpoint of each quarter.**

For a short tax year of 4 or 8 full calendar months, determine quarters on the basis of whole months. The midpoint of each quarter is either the first or the midpoint of a month.

For a short tax year of other than 4 or 8 calendar months, determine the number of days in the tax year. Divide the number of days in the tax year by 4 to determine the length of each quarter. Divide the number of days in each quarter by 2 to determine the midpoint of the quarter. If the midpoint of a quarter is other than the first or midpoint of a month, the property is treated as placed in service on the nearest preceding first or midpoint of that month.

Example 7. Tara Corporation, a calendar year taxpayer, was incorporated on March 15, 2000. It has a short tax year of 10 months, ending on December 31, 2000. During December 2000 it placed property in service for which it must use the mid-quarter convention. Because this is a short tax year of other than 4 or 8 full calendar months, it determines that the tax year consists of 292 days. It divides 292 by 4 to determine the length of each quarter, 73 days. It divides 73 by 2 to determine the midpoint of each quarter, or the thirty-seventh day. The following table shows the quarters of the tax year, the midpoint of each quarter, and the date in each quarter that property is treated as placed in service.

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<u>Quarter</u>	<u>Midpoint</u>	<u>Placed-in-Service Date</u>
March 15–May 25	April 20	Middle of April
May 27–August 7	July 2	Beginning of July
August 8–October 19	September 13	Beginning of September
October 20–December 31	November 25	Middle of November

The last quarter of the short tax year begins on October 20, which is 73 days from December 31, the end of the tax year. The thirty-seventh day of the last quarter is November 25. Because the midpoint of the quarter is not the first or the midpoint of November, the property is treated as placed in service in the middle of November.

DEPRECIATION FOR SHORT YEAR

As indicated earlier, the MACRS percentage tables cannot be used to determine depreciation for a short tax year. The first step is to determine the depreciation for the full tax year. Do this by multiplying the basis of the property by the applicable depreciation rate. Then determine the depreciation for the short tax year. Do this by multiplying the depreciation for a full tax year by a fraction. The numerator of the fraction is the number of months (including parts of a month) the property is treated as in service during the tax year (applying the applicable convention). The denominator is 12.

Example 8. Tara Corporation, with a short tax year beginning on March 15 and ending on December 31, 2000, placed in service on March 16 an item of 5-year property with a basis of \$100. This is the only property the corporation placed in service during the short tax year. The depreciation method for this property is the 200% declining balance method. The depreciation rate for a full year is 40%, and the half-year convention is used.

The property is treated as placed in service on August 1, 2000. Tara is entitled to 5 months of depreciation for the short tax year, which consists of 10 months. The corporation first multiplies the basis (\$100) by 40% to get \$40, the depreciation for a full tax year. This amount is then multiplied by 5, the number of months the property is treated as in service. The result is divided by 12 to arrive at \$16.67, the short-tax-year depreciation.

Example 9. Tara Corporation, with a short tax year beginning on March 15 and ending on December 31, 2000, placed in service on October 16 an item of 5-year property with a basis of \$100. This is the only property the corporation placed in service during the short tax year. The depreciation method for this property is the 200% declining balance method. The depreciation rate for a full year is 40%. The mid-quarter convention is used because the property was placed in service in the last 3 months of the tax year.

The property is treated as placed in service on September 1, 2000 (see table in Example 7). The corporation first multiplies the basis (\$100) by 40% to get \$40, the depreciation for a full tax year. This amount is then multiplied by 4, the number of months the property is treated as in service. The result is divided by 12 to arrive at \$13.33, the short-tax-year depreciation.

DEPRECIATION IN RECOVERY YEARS AFTER SHORT TAX YEAR

You may use either the “allocation method” or the “simplified method” to figure the depreciation for later tax years in the recovery period. **The method chosen must be used consistently until the year of change to the straight-line method.** Only the simplified method is discussed.

Simplified Method. In most cases, the allocation method and the simplified method result in the same depreciation allowances. However, if prior to the switch to the straight-line method (but

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after the first taxable year) the taxpayer has a short taxable year or disposes of the property, the depreciation allowance under the simplified method for that year will be less than under the allocation method.

The depreciation for subsequent tax years in the recovery period under this method is figured by multiplying the unrecovered basis of the property at the beginning of the tax year by the applicable depreciation rate.

Example 10. Tara Corporation has a short tax year of 10 months, ending on December 31, 2000. It placed in service an item of 5-year property with a basis of \$100. It claimed depreciation of \$16.67 using a depreciation rate of 40% and the half-year convention. The unrecovered basis on January 1, 2001 is \$83.33 (\$100 – \$16.67). Tara's depreciation for its 2001 tax year will be 40% of \$83.33, or \$33.33.

Computation of Depreciation Allowances under the Simplified Method—Declining Balance

Taxable Year	Depreciation Allowance
2000	$[40\% \times \$100,000 \times 5/12] = \16.67
2001	$40\% \times \$83.33 = \33.33
2002	$40\% \times \$50.00 = \20.00
2003	$40\% \times \$30.00 = \12.00
2004	$40\% \times \$18.00 = \$ 7.20$
2005	$[40\% \times \$10.80 \times 7/12] = \$ 2.52$

Tara Corporation would switch to the straight-line method for 2004 and 2005 and claim a depreciation allowance of \$11.37 and \$6.63, respectively, using the allocation method.

SHORT TAX YEAR AFTER PROPERTY IN SERVICE

If a subsequent tax year in the recovery period is a short tax year, the depreciation for that year is figured by multiplying the unrecovered basis of the property at the beginning of the tax year by the applicable depreciation rate, and then by a fraction. Its numerator is the number of months (including parts of a month) in the tax year. Its denominator is 12.

More Information. For more information on figuring depreciation in a short tax year, see Revenue Procedure 89-15, 1989-9 I.R.B. 39.

VI. CORRECTING ERRONEOUS DEPRECIATION

Depreciation is an area of the tax return where mistakes are common. Claiming an incorrect amount of depreciation can result from several mistakes:

1. Posting errors
2. Mathematical errors
2. Using the wrong recovery period or depreciation method
3. Deducting as an ordinary business expense an expenditure that should have been capitalized and depreciated.

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A. MATHEMATICAL AND POSTING ERRORS

The 1999 Publication 946, *How to Depreciate Property* (p. 10), states that if the taxpayer did not deduct the correct amount of depreciation, he or she can file an amended return to make any of the following three corrections:

1. To correct a mathematical error made in any year
2. To correct a posting error made in any year
3. To correct the amount of depreciation for property for which the taxpayer has not adopted a method of accounting

If the taxpayer used an incorrect method of depreciation for the property on two or more consecutively filed tax returns, he or she has adopted a method of accounting for that property. If the taxpayer has adopted a method of accounting, he or she cannot change the method by filing amended returns.

If an amended return is allowed, the taxpayer must file it by the later of

1. Three years from the date of filing the original return for the year in which the taxpayer did not deduct the correct amount, or
2. Two years from the time the taxpayer paid the tax for that year

Observation. Correction of mathematical or posting errors is not considered to be a change in accounting method [Treas. Reg. §1.446-1(e)(2)(ii)(b)]. Therefore, such corrections are made on an amended return.

Example 11. Dudley Dunce became aware, when preparing his depreciation schedule for 2000, that he had omitted \$15,000 of depreciation from his 1999 Form 4562 (and Schedule F) due to a posting error.

Question 11A. How should Dudley handle the correction of the error?

Answer 11A. Since this mistake would be classified as a mathematical or posting error, Dudley can file an amended return (Form 1040X) to claim the correct amount of depreciation. Therefore, Dudley would increase his depreciation deduction for 1999 by \$15,000 on the amended return.

Using the Wrong Recovery Period or Depreciation Method. Using a wrong recovery period or a wrong depreciation method is not an unusual occurrence on a tax return. For example, taxpayers may mistakenly use a 7-year life for a 5-year asset, or vice versa. Taxpayers may also be unaware of the requirement to use the 150% declining balance method for farm property rather than the 200% declining balance method. Other farm taxpayers may be subject to the rules of I.R.C. §263A and may have elected to expense preproductive costs. If so, these taxpayers are required to use straight-line depreciation over the alternative depreciable life [Treas. Reg. §1.263A-4T(d)(4)(ii)]. All of these special rules increase the probability of mistakes on the depreciation schedule.

If the taxpayer has used an incorrect depreciation method, the procedure may involve filing an amended return or, alternatively, requesting permission to change the depreciation method. Rev. Proc. 99-49 (I.R.B. 1999-52, Dec. 27, 1999) and Rev. Proc. 98-60 (I.R.B. 1998 51, Dec. 10, 1998) treat a change in depreciation method as a change in method of accounting and set out the procedure for getting permission to change a method of accounting. In general, the rules create an incentive for taxpayers to correct errors in their method of accounting before being subject to examination by the IRS. The incentives are created by giving the taxpayer more favorable terms of making the adjustments to the correct method of accounting.

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Example 12. Daisy Flowers paid \$118,500 for a combine for use in her farm business in 1998. She properly claimed an \$18,500 expense deduction under §179 but erroneously used the 200% declining balance method to depreciate the remaining \$100,000 basis. She used the 200% declining balance to depreciate the combine again in 1999.

In 1999, Daisy paid \$69,000 for a tractor for use in her farm business. She again properly claimed a \$19,000 expense deduction under §179 but erroneously claimed 200% declining balance depreciation on the remaining \$50,000 basis.

The depreciation Daisy claimed and the proper depreciation for 1998 and 1999 are as follows:

<u>Asset and Year</u>	<u>§179 Deduction</u>	<u>Depreciable Basis</u>	<u>Depreciation Claimed</u>	<u>Proper Depreciation</u>	<u>Difference</u>
Combine					
1998	\$18,500	\$100,000	\$14,290	\$10,710	\$3,580
1999	0	100,000	24,490	19,130	5,360
Tractor					
1999	19,000	50,000	7,145	5,355	1,790

Daisy purchased another \$76,000 of machinery in 2000 and wants to know how she should report depreciation in 2000.

The depreciation Daisy can claim in 2000 differs according to the year the property was placed in service.

- **Property placed in service in 2000—machinery (\$76,000).** Property placed in service in 2000 must be depreciated using the 150% declining balance method. The improper method claimed on property placed in service in prior years does not require and does not allow Daisy to use the improper method for property placed in service in 2000.

Therefore, she can claim \$20,000 as an expense deduction under §179. On the remaining \$56,000 of basis, she can claim $\$56,000 \times 10.71\% = \$5,998$ of depreciation.

- **Property placed in service in 1999—tractor (\$69,000).** The improper depreciation claimed on property placed in service in 1999 can be corrected by filing an amended return for 1999. Therefore, Daisy can file an amended return for 1999 showing \$5,355 instead of \$7,145 of depreciation. That increases her 1999 income by \$1,790.
- **Property placed in service in 1998—combine (\$118,500).** Daisy has established a method of accounting with respect to the depreciation claimed on the combine placed in service in 1998 since she has used that improper method for two or more years. See Appendix §2.01(2) of Rev. Proc. 99-49, I.R.B. 1999-52 (Dec. 27, 1999). Therefore, she is not allowed to correct the error by filing amended returns for 1998 and 1999. Instead, she must seek the permission of the Commissioner to change her method of accounting and follow the Commissioner's requirements for reporting the adjustment to income that results from changing the method of accounting.

Practitioner Note. Establishing a Method of Accounting. If the proper method of depreciation is used, only one year is needed to establish a method of accounting.

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Practitioner Note. When to File Form 3115. Revenue Procedure 99-49 requires the taxpayer to file Form 3115 in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change, and a copy of Form 3115 must be filed with the IRS national office no earlier than the first day of the year of change and no later than when the original Form 3115 is filed with the tax return for the year of change.

Relief for Late Application. An automatic extension of 6 months from the due date of the return for the year of change (including extensions) is granted to file Form 3115, provided the taxpayer

- a. timely filed (including extensions) its federal income tax return for the year of change,
- b. files an amended return within the 6-month extension period in a manner consistent with the new method,
- c. attaches the original Form 3115 to the amended return,
- d. files a copy of Form 3115 with the IRS national office no later than the filing of the amended return, and
- e. writes at the top of the application "Filed Pursuant to §301.9100-2."

§481(a) Adjustment Period. The general rule for a taxpayer-initiated change of accounting method is for the taxpayer to take into account both positive and negative §481(a) adjustments over 4 taxable years. However, a taxpayer may elect to use a 1-year adjustment period in lieu of the 4-year adjustment period if the entire adjustment is less than \$25,000 (either positive or negative). A taxpayer makes an election under the de minimis rule by so indicating on the application.

The adjustment Daisy will make as a result of correcting the depreciation rate on her combine is $\$3,580 + \$5,360 = \$8,940$. Since the total adjustment is less than \$25,000, she can elect to make the entire adjustment in the year of the change instead of the normal 4-year adjustment period. See §5.04(3) of Rev. Proc. 99-49. Daisy makes that election by checking the "yes" box on line 21a of Form 3115 as shown on the following form.

No User Fee Required. A user fee is not required for a change in accounting method filed under Revenue Procedure 99-49 [§6.02(6)]. The receipt of an application filed under this revenue procedure will not be acknowledged by the IRS.

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Form **3115**

(Rev. May 1999)

Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

OMB No. 1545-0152

▶ See page 1 of the instructions for the Automatic Change Procedures.

Name of applicant (If a joint return is filed, also give spouse's name.) Daisy Flowers	Identification number (See page 3 of the instructions.) 446 - 27 - 3115
Number, street, and room or suite no. (If a P.O. box, see page 3 of the instructions.) Route 2 Box 86	Tax year of change begins (mo., day, yr.) and ends (mo., day, yr.) 1 - 1 - 00 12 - 31 - 00
City or town, state, and ZIP code Farmtown WI 53497	District director's office having jurisdiction Milwaukee
Name of person to contact (If not the applicant, a power of attorney must be submitted.)	Contact person's telephone number/Fax number (414) 555 - 0700 ()

<p>Check the appropriate box to indicate who is filing this form.</p> <p><input checked="" type="checkbox"/> Individual</p> <p><input type="checkbox"/> Corporation</p> <p><input type="checkbox"/> Cooperative (Sec. 1381)</p> <p><input type="checkbox"/> Qualified Personal Service Corporation (Sec. 448(d)(2))</p> <p><input type="checkbox"/> Exempt organization. Enter code section ▶</p> <p style="text-align: right;"><input type="checkbox"/> Partnership</p> <p style="text-align: right;"><input type="checkbox"/> S Corporation</p> <p style="text-align: right;"><input type="checkbox"/> Insurance Co. (Sec. 816(a))</p> <p style="text-align: right;"><input type="checkbox"/> Insurance Co. (Sec. 831)</p> <p style="text-align: right;"><input type="checkbox"/> Other (specify) ▶</p>	<p>Check the appropriate box to indicate the type of accounting method change being requested. (See page 3 of the instructions.)</p> <p><input checked="" type="checkbox"/> Depreciation or Amortization</p> <p><input type="checkbox"/> Financial Products and/or Financial Activities of Financial Institutions</p> <p><input type="checkbox"/> Other (specify) ▶</p>
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Part I Eligibility To Request Change (All applicants complete Parts I through IV.) (See page 2 of the instructions.)

	Yes	No
1 Is the applicant changing its method of accounting under a revenue procedure or other published guidance that provides for an automatic change? (See page 1 of the instructions.)	X	
If "Yes," enter the citation of the revenue procedure or other published guidance ▶ Rev. Proc. 99 - 49		
2 Is the applicant changing its method of accounting under sections 263A, 447, 448, 460, or 585(c) for the first tax year the applicant is required to change?		X
If "Yes," the applicant is required to make the change in accounting method under the automatic change procedures set forth in the applicable regulations.		
3a Does the applicant have any Federal income tax returns under examination by the IRS? See section 3.07 of Rev. Proc. 97-27, 1997-1 C.B. 680		X
If "Yes," complete line 3b.		
b Is the method of accounting the applicant is requesting to change: (i) an issue under consideration or (ii) an issue placed in suspense by the examining agent(s)? See sections 3.08(1) and 6.01 of Rev. Proc. 97-27.		X
If "Yes," the applicant is not eligible to request the change in accounting method. If "No," complete lines 3c through 3e.		
c Indicate the "window period" the applicant is filing under or state if the change is being requested with the consent of the district director. ▶ _____ See section 6.01 of Rev. Proc. 97-27.		
d Has a copy of this Form 3115 been provided to the examining agent(s) for all examinations that are in process? See section 6.01 of Rev. Proc. 97-27.		
e Enter the name(s) and telephone number(s) of the examining agent(s). ▶ _____ See section 6.01 of Rev. Proc. 97-27.		
4a Is the applicant before an appeals office with respect to any Federal income tax return issue?		X
If "Yes," complete line 4b.		
b Is the method of accounting the applicant is requesting to change an issue under consideration by the appeals office? See sections 3.08(2) and 6.02 of Rev. Proc. 97-27		
If "Yes," the applicant is not eligible to request the change in accounting method. If "No," complete lines 4c and 4d.		
c Has a copy of this Form 3115 been provided to the appeals officer? See section 6.02 of Rev. Proc. 97-27		
d Enter the name and telephone number of the appeals officer. ▶ _____ See section 6.02 of Rev. Proc. 97-27.		

Signature—All Applicants (See page 3 of the instructions.)

Under penalties of perjury, I declare that I have examined this application, including accompanying documents, and, to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and such facts are true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

<p style="text-align: center;">Applicant</p> <p style="text-align: center;">Daisy Flowers</p> <p style="text-align: center;">-----</p> <p style="text-align: center;">Officer's signature and date</p> <p style="text-align: center;">Daisy Flowers</p> <p style="text-align: center;">-----</p> <p style="text-align: center;">Name and title (print or type)</p> <p style="text-align: center;">Joe Preparer</p> <p style="text-align: center;">-----</p> <p style="text-align: center;">Signature(s) of individual or firm preparing the application and date</p>	<p style="text-align: center;">Parent corporation (if applicable)</p> <p style="text-align: center;">-----</p> <p style="text-align: center;">Parent officer's signature and date</p> <p style="text-align: center;">-----</p> <p style="text-align: center;">Name and title (print or type)</p> <p style="text-align: center;">Joe Preparer</p> <p style="text-align: center;">-----</p> <p style="text-align: center;">Name of firm preparing the application</p>
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Part I Eligibility To Request Change (continued)

	Yes	No
5a Is the applicant before a Federal court with respect to any Federal income tax issue? If "Yes," complete line 5b.		X
b Is the method of accounting the applicant is requesting to change an issue under consideration by the Federal court? See sections 3.08(3) and 6.03 of Rev. Proc. 97-27 If "Yes," the applicant is not eligible to request the change in accounting method. If "No," complete lines 5c and 5d.		
c Has a copy of this Form 3115 been provided to the counsel for the government? See section 6.03 of Rev. Proc. 97-27.		
d Enter the name and telephone number of the counsel for the government. ► _____ See section 6.03 of Rev. Proc. 97-27.		
6a Is the applicant a member of an affiliated group filing a consolidated return for the year of change?		X
b If "Yes," attach a statement listing the parent corporation's (1) name, (2) identification number, (3) address, and (4) tax year.		
c Has the applicant ever been a member of a consolidated group other than the current group? If "Yes," complete line 6b for each group of which the applicant was formerly a member.		
d If the applicant is (or was formerly) a member of a consolidated group, is any consolidated group under examination, before an appeals office, or before a Federal court for a tax year(s) that the applicant was a member of the group? See sections 3.07(1) and 4.02(5) of Rev. Proc. 97-27 If "Yes," complete lines 3b through 3e, 4b through 4d, or 5b through 5d (whichever are applicable).		
7 If the applicant is an entity (including a limited liability company) treated as a partnership or an S corporation for Federal income tax purposes, is the method of accounting the applicant is requesting to change an issue under consideration in an examination of a partner, member, or shareholder's Federal income tax return or an issue under consideration by an appeals office or by a Federal court with respect to a partner, member, or shareholder's Federal income tax return? See sections 3.08 and 4.02(6) of Rev. Proc. 97-27 If "Yes," the applicant is not eligible to request the change in accounting method.		

Part II Description of Change

8 Is the applicant requesting to change its overall method of accounting? If "Yes," check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also complete Schedule A on page 4 of the form. Present method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Hybrid (attach description) Proposed method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Hybrid (attach description)		X								
9 If the applicant is not changing its overall method of accounting, attach a description of each of the following: a The item being changed. b The applicant's present method for the item being changed. c The applicant's proposed method for the item being changed. d The applicant's present overall method of accounting (cash, accrual, or hybrid).										
10 Attach an explanation of the legal basis supporting the proposed method for the item being changed. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. The applicant is encouraged to include a discussion of any authorities that may be contrary to the proposed method.										
11 Attach a description of the applicant's trade or business, including the goods and services it provides and any other types of activities it engages in that generate gross income.										
12 Attach a copy of all documents directly related to the proposed change. (See page 3 of the instructions.)										
13 Attach a statement of the applicant's reasons for the proposed change.										
14a Attach an explanation of whether the proposed method of accounting will be used for the taxpayer's books and records and financial statements. (Insurance companies, see page 3 of the instructions.) b Attach an explanation of whether the proposed method of accounting conforms to generally accepted accounting principles (GAAP) and to the best accounting practice in the applicant's trade or business.										
15a Does the applicant have more than one trade or business as defined in Regulations section 1.446-1(d)?		X								
b If "Yes," is each trade or business accounted for separately? If "Yes," for each trade or business, attach a description of the type of business, the overall method of accounting, whether the business has changed any accounting method in the past 4 years, and whether the business is changing any accounting method as part of this application or as a separate application.										
16 If the applicant is a member of an affiliated group filing a consolidated return for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? If "No," attach an explanation.										
17 If the applicant is changing to the cash method, or to the inventory price index computation (IPIC) method under Regulations section 1.472-8(e)(3), or is changing its method of accounting under sections 263A, 448, or 460, enter the gross receipts for the 4 tax years preceding the year of change. (See page 3 of the instructions.)										
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 25%;">1st preceding year ended: mo. yr.</th> <th style="width: 25%;">2nd preceding year ended: mo. yr.</th> <th style="width: 25%;">3rd preceding year ended: mo. yr.</th> <th style="width: 25%;">4th preceding year ended: mo. yr.</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> </tbody> </table>	1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.	4th preceding year ended: mo. yr.	\$	\$	\$	\$		
1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.	4th preceding year ended: mo. yr.							
\$	\$	\$	\$							

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Part II Description of Change (continued)

18 Attach a statement addressing whether the applicant has entered (or is considering entering) into a transaction to which section 381(c)(4) or (c)(5) applies (e.g., a reorganization or merger) during the tax year of change determined without regard to any (potential) closing of the year under section 381(b)(1). Also include in the statement an explanation of any changes in method of accounting that resulted (or will result) from the transaction(s).

Part III Section 481(a) Adjustment

	Yes	No
19 Enter the net section 481(a) adjustment for the year of change. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ \$ _____	<input type="checkbox"/>	<input type="checkbox"/>
20 Has the section 481(a) adjustment been reduced by a pre-1954 amount?	<input type="checkbox"/>	<input checked="" type="checkbox"/>
21a If the section 481(a) adjustment is less than \$25,000 (positive or negative), does the applicant elect to take the entire amount of the adjustment into account in the year of change?	<input checked="" type="checkbox"/>	<input type="checkbox"/>
b If "No," (or if the applicant declines to elect to take the entire amount of the adjustment into account in the year of change), enter the applicable period over which the applicant proposes to take the adjustment into account. ▶ _____	<input type="checkbox"/>	<input type="checkbox"/>
22 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a controlled group, or other related parties? If "Yes," attach an explanation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

Part IV Additional Information

	Yes	No
23 Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in accounting method or accounting period in the past 4 years? If "Yes," attach a description of each change and the year of change. If the application was withdrawn, not perfected, or denied, or if a Consent Agreement was sent to the taxpayer but was not signed and returned to the IRS, or if the change was not made, include an explanation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
24 Does the applicant, its predecessor, or a related party currently have pending any request for a private letter ruling, a request for change in accounting method or accounting period, or a request for technical advice? If "Yes," for each request, indicate the name(s) of the taxpayer, the type of request (private letter ruling, request for change in accounting method or accounting period, or request for technical advice), and the specific issue in the request.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
25 Has the applicant attached Form 2848 , Power of Attorney and Declaration of Representative? (See the instructions for line 25 and "Person To Contact" on page 3 of the instructions.)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
26 Does the applicant request a conference of right at the IRS National Office if the IRS proposes an adverse response?	<input checked="" type="checkbox"/>	<input type="checkbox"/>
27 Enter the amount of user fee attached to this application. ▶ \$ _____ (See page 2 of the instructions.)	<input type="checkbox"/>	<input type="checkbox"/>
28 If the applicant qualifies for a reduced user fee for identical accounting method changes, has the information required by section 15.07 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, been attached?	<input type="checkbox"/>	<input type="checkbox"/>

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Schedule D—Change in Reporting Advance Payments and Depreciation/Amortization

Part I Change in Reporting Advance Payments (See page 4 of the instructions.)

- 1 If the applicant is requesting to defer advance payment for services under Rev. Proc. 71-21, 1971-2 C.B. 549, attach the following information.
 - a Sample copies of all service agreements used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the service agreement that require the taxpayer to perform services.
 - b If any parts or materials are provided, explain how the parts or materials relate to the services provided and provide the cost of such parts or materials as an absolute number and a percentage of the contract price.
 - c If the change relates to contingent service contracts, explain how the contracts relate to merchandise that is sold, leased, installed, or constructed by the applicant and whether the applicant offers to sell, lease, install, or construct without the service agreement.
 - d A description of the method the applicant will use to determine the amount of income earned each year on contingent contracts and why that method clearly reflects income earned and related expenses in each year.
- 2 If the applicant is requesting a deferral of advance payments for goods under Regulations section 1.451-5, attach the following information.
 - a Sample copies of all agreements for goods or items requiring advance payments used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the agreement that require the applicant to provide goods or items.
 - b A statement providing that the entire advance payment is for goods or items. If not entirely for goods or items, a statement that an amount equal to 95% of the total contract price is properly allocable to the obligation to provide activities described in Regulations section 1.451-5(a)(1)(i) or (ii) (including services as an integral part of those activities).

Part II Change in Depreciation or Amortization (See page 4 of the instructions.)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants must provide this information for each item or class of property for which a change is requested.

Note: If the property has been disposed of before the beginning of the year of change, a method change is not permitted for that property. See **Automatic Change Procedures** on page 1 of the instructions for information regarding automatic changes under sections 167, 168, and 197. Also see **When Not To File Form 3115** on page 4 of the instructions for information concerning retroactive elections and election revocations.

- 1 Is depreciation for the property figured under Regulations section 1.167(a)-11 (CLADR)? Yes No
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).
- 2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? Yes No
If "Yes," enter the applicable section ►
- 3 Has a depreciation or amortization election been made for the property (e.g., the election under section 168(f)(1))? Yes No
If "Yes," state the election made ►
- 4a To the extent not already provided, attach a statement describing the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.
 - b If the property is residential rental property, did the applicant live in the property before renting it? Yes No
 - c Is the property public utility property? Yes No
- 5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).
- 6 If the property is not currently treated as depreciable or amortizable property, provide the facts supporting the proposed change to depreciate or amortize the property.
- 7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods.
 - a The Code section under which the property is depreciated or amortized (e.g., section 168(g)).
 - b If the property is depreciated under section 168, identify the applicable asset class in Rev. Proc. 87-56, 1987-2 C.B. 674. (If none, state so and explain why.) Also provide the facts supporting the asset class under the proposed method.
 - c The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)).
 - d The useful life, recovery period, or amortization period of the property.
 - e The applicable convention of the property.

ATTACHMENT FOR FORM 3115

Daisy Flowers SS#446-27-3115

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Line 9 Information

- a. The items being changed are the depreciation claimed in 1998 and 1999 on a combine placed in service in 1998 for use in a farm business.
- b. The applicant's present method of depreciating the combine is 200% declining balance over 7 years using the half-year convention.
- c. The proposed method is the 150% declining balance method over a 7-year period using the half-year convention.
- d. The applicant uses the cash-basis method of accounting.

Line 10 Information

I.R.C. §168(b)(2)(B) requires the applicant to use the 150% declining balance method since she is using the asset in the business of farming.

Line 11 Information

Applicant's business is a grain and livestock farm.

Line 13 Information

Applicant's reason for making this change is to change from an improper to a proper method of accounting.

Line 14 Information

The proposed method conforms to generally accepted methods of accounting and will be used by applicant for all financial accounting purposes.

Line 18 information

Applicant has not and is not considering entering into a transaction to which §381(c)(4) or (5) applies.

Schedule D, Part II, Line 7 Information

	<u>Present Method</u>	<u>Proposed Method</u>
a. Code section	168(a)	168(a)
b. Asset class in Rev. Proc. 87-56	01.1	01.1
c. Method	200% DB; §168(b)(1)(A)	150% DB; §168(b)(2)(B)
d. Recovery period	7-year	7-year
e. Applicable convention	Half-year	Half-year

Observation. If Daisy had not made the election to make the entire adjustment in the year of the change, she would have spread the \$8,940 change evenly over 2000, 2001, 2002, and 2003.

Example 13. Barley Fields purchased a herd of beef cows in 1998 for \$118,500. He properly claimed \$18,500 of §179 expense deduction and used the 150% declining balance rate, but he erroneously used the 10-year recovery period to claim depreciation in 1998 and 1999.

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In 1999, he paid \$69,000 for a herd of sheep and claimed a \$19,000 §179 deduction. He claimed the 150% declining balance rate on the remaining \$50,000, but he again erroneously used the 10-year recovery period.

The depreciation Barley claimed and the proper depreciation for 1998 and 1999 are as follows:

<u>Asset and Year</u>	<u>§179 Deduction</u>	<u>Depreciable Basis</u>	<u>Depreciation Claimed</u>	<u>Proper Depreciation</u>	<u>Difference</u>
Beef Cows					
1998	\$18,500	\$100,000	\$ 7,500	\$15,000	\$(7,500)
1999	0	100,000	13,880	25,500	(11,620)
Sheep					
1999	19,000	50,000	3,750	7,500	(3,750)

Barley purchased another \$76,000 of beef cows in 2000 and wants to know how he should report depreciation in 2000.

The depreciation Barley can claim in 2000 differs according to the year the property was placed in service.

- **Property placed in service in 2000—beef cows (\$76,000).** Property placed in service in 2000 must be depreciated using the 150% declining balance method. The improper recovery period claimed on property placed in service in prior years does not require and does not allow Barley to use the improper method for property placed in 2000.

Therefore, he can claim \$20,000 as an expense deduction under §179. On the remaining \$56,000 of basis, he can claim $\$56,000 \times 15.00\% = \$8,400$ of depreciation.

- **Property placed in service in 1999—sheep (\$69,000).** The improper depreciation claimed on property placed in service in 1999 can be corrected by filing an amended return for 1999. Therefore, Barley can file an amended return for 1999 showing \$7,500 instead of \$3,750 of depreciation. That decreases his 1999 income by \$3,750.
- **Property placed in service in 1998—beef cows \$118,500.** Like Daisy in the previous example, Barley has established a method of accounting with respect to the depreciation claimed on the beef cows placed in service in 1998 since he has used that improper method for two or more years. See Appendix §2.01(2) of Rev. Proc. 99-49, I.R.B. 1998-52 (Dec. 27, 1999). Therefore, he is not allowed to correct the error by filing amended returns for 1998 and 1999. Instead he must change his method of accounting.

Unlike Daisy in the previous example, Barley has claimed less than the allowable depreciation. The automatic consent procedure is permitted for property for which either too much or too little depreciation has been claimed. Thus, Barley follows the same procedure as Daisy.

Practitioner Note. Conflict Between Rev. Proc. 98-60 and Form 3115 Instructions.

Revenue Procedures 99-49 and 98-60 state in §4 and in Appendix §2 that the automatic consent procedures apply to a change from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation, as long as the taxpayer has used the impermissible method in at least two taxable years. The revenue procedure applies whether the taxpayer has claimed less than, **or more than**, the depreciation allowable. The instructions for Form 3115 (May 1999), however, state that the automatic change procedure of Rev. Proc. 98-60 applies only if the taxpayer has used an impermissible method of accounting for depreciation and **has claimed less depreciation than allowable**. Thus, these two authorities appear to conflict. Since the revenue procedure is stronger authority than the form instructions, the practitioner should rely on the revenue procedure until clarification is issued by the IRS. The instructions to Form 3115 state that the taxpayer should determine if the IRS has published guidance after May 1999 on the accounting method being changed.

Deduction of Expenditure Subject to Capitalization. The taxpayer may erroneously treat as an ordinary and necessary business expense an expenditure that is subject to capitalization. This is not a mathematical or posting error. Therefore, it would appear that if the item in question was improperly expensed two or more years ago, the taxpayer has adopted an incorrect method of accounting and must file Form 3115 to rectify the mistake. If only one incorrect tax return has been filed, the taxpayer can file an amended return to correct the mistake.

Example 14. Rose Budd purchased a computer in 1999 for \$2,450. She incorrectly deducted the purchase price as “office expense” on Schedule C. In December 2000, Rose engages an accountant to review her 1999 tax return and to prepare her 2000 return. The accountant questions the large amount of “Office Expense” on the 1999 return. Rose informs the accountant that the amount is the purchase price of a computer.

Question 14A. How should the mistake be rectified?

Answer 14A. Rose should file an amended return for 1999, eliminate the “office expense” of \$2,450, and depreciate the computer over the required 5-year recovery period (using the 200% declining balance method for nonfarm property). Therefore, Rose will reduce “office expense” by \$2,450, and increase depreciation by \$490 ($\$2,450 \times 20\%$) when completing the Form 1040X).

Question 14B. Can Rose elect to expense (under §179) the \$2,450 cost of the computer and thereby avoid any increase in her tax liability on the amended return?

Answer 14B. No, §179 must be elected on the taxpayer’s **first** income tax return for the taxable year to which the election applies (whether or not the return is timely) or on an amended return filed by the due date (including extensions) of the return for that year [Treas. Reg. §1.179-5(a)]. The election is normally made by completing Part I of Form 4562, in which the specific items to be deducted under §179 must be listed. Since Rose did not make an election within the time prescribed, she is not eligible to make the election on an amended return filed after the required date. (See *Robert C. Fors*, T.C. Memo 1998-158.)

IRS Initiated Change. The IRS has issued Notice 98-31 (1998-22 I.R.B. 10), in which it proposed to issue a revenue procedure to cover accounting method changes it initiates. The proposed procedure’s terms and conditions are less favorable than those available for changes initiated under the voluntary

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request procedures of Rev. Proc. 99-49 and Rev. Proc. 98-60. This encourages taxpayers to voluntarily request to change from incorrect accounting methods before being contacted for examination.

An examining agent changing a taxpayer's method of accounting is required to impose the I.R.C. §481(a) adjustment in the earliest tax year under examination (or, if later, the first tax year the method is considered impermissible). **The adjustment will normally be imposed in a one-year adjustment period.** An appeals officer or government counsel may, however, agree to terms more favorable to the taxpayer, but the result will likely be less favorable than a taxpayer-initiated change.

The proposed procedure would be effective for the examiner's report issued, and for Forms 870 AD and closing agreements executed 90 or more days after the revenue procedure is published in the IRB. Taxpayers and the IRS, however, could agree to apply the procedure to closing agreements executed on or after August 30, 1998.

VII. DEPRECIATION OF PROPERTY RECEIVED IN A LIKE-KIND EXCHANGE

Notice 2000-4 changed the procedure for claiming depreciation on property received in a like-kind exchange or in an involuntary conversion. Under prior law, the basis carried over from the relinquished property was added to any new basis in the acquired property, and the total was depreciated over the life of the acquired property.

Example 15. Miles Aparte paid \$100,000 for a tractor in 1995 and depreciated it using MACRS 150% declining balance rates for 7-year property. In 1998 he traded the tractor for a chopper and paid \$40,000 of cash. His \$89,005 basis in the chopper is calculated as follows:

Unadjusted basis of tractor		\$100,000
Less depreciation:		
1995: $\$100,000 \times 10.71\% =$	\$10,710	
1996: $\$100,000 \times 19.13\% =$	19,130	
1997: $\$100,000 \times 15.03\% =$	15,030	
1998: $\$100,000 \times 12.25\% \times 0.5 =$	6,125	- 50,995
Sub-total		49,005
Plus boot (cash)		40,000
Basis in chopper		\$89,005

Miles depreciates the \$89,005 over 7 years beginning in 1998. Therefore, his total depreciation on the chopper and tractor for the year of the trade (1998) is

Depreciation on tractor		
$\$100,000 \times 12.25\% \times 0.5 =$	\$ 6,125	
Depreciation on chopper		
$\$89,005 \times 0.1071 =$	9,532	
Total		\$15,657

Notice 2000-4 requires taxpayers to continue depreciating the carried-over basis over the remaining life of the relinquished property using the depreciation rate that was used for the relinquished property. Any new basis in the acquired property is depreciated over the life of the acquired property at a rate allowed for the acquired property.

Example 16. If Miles Aparte (from Example 15) had bought the tractor in 1997 and made the trade in 2000, he would continue to depreciate the basis of the tractor over the useful life of the tractor and

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would depreciate the \$40,000 of new basis the same as any other new purchases of equipment in 2000. His 1998 depreciation for the tractor and the chopper is calculated as follows:

Fourth year depreciation on \$100,000	
$\$100,000 \times 0.1225 =$	\$12,250
First year depreciation on \$40,000	
$\$40,000 \times .1071 =$	4,284
Total	\$16,534

Observation. Notice 2000-4 does not require any particular record-keeping system. One way to keep a record of depreciation on the acquired property is to leave the relinquished property on the depreciation schedule with a note that it was traded for the acquired property. The new basis can be entered on a new line of the depreciation schedule with a note that there is additional basis on the line for the relinquished property. If a taxpayer makes frequent trades, there can be more than two lines that reflect the depreciation and basis in the most recently acquired property.

EFFECTIVE DATE

The new method of depreciating property received in a trade is mandatory for property placed in service on or after January 3, 2000. Taxpayers have the option of using the old method or the new method for property placed in service before January 3, 2000.

If property placed in service before January 3, 2000, has been reported on a tax return using the old method, the taxpayer can elect to use the new method of depreciation for that property. The change is treated as change in method of accounting, so Form 3115 must be filed. Notice 2000-4 says this change has automatic consent and the procedures of Rev. Proc. 99-49 must be followed. Revenue Procedure 99-49 requires the adjustment resulting from the change in method of accounting to be spread over the 4-year period beginning with the year of change. However, there is a **de minimis rule** that allows the taxpayer to elect to make the full adjustment in the year of change if the adjustment is less than \$25,000, positive or negative.

Example 17. Assume that Miles Aparte from Example 15 (1998 trade) wants to elect the new method of depreciating the chopper he acquired in 1998. He made this decision after he had filed his 1999 return and before he filed his 2000 return. His adjustment resulting from the change in method of accounting is the net difference between the depreciation he claimed on the chopper and tractor in 1998 and the chopper in 1999, and the amount he would claim using the new method. It is calculated as follows:

Year	Depreciation claimed under old method	Depreciation claimed under new method	Net difference
1998	\$15,657	\$16,534	\$ 877
1999	17,027	19,902	2,875
Total	\$32,684	\$36,436	\$3,752

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Since the total change is less than \$25,000, Miles can elect to make the full change on his 2000 income tax return.

He also claims \$18,262 of depreciation for the chopper in 2000, calculated as follows:

Sixth-year depreciation on \$100,000	
$\$200,000 \times 0.1225 =$	\$12,250
Third-year depreciation on \$40,000	
$\$50,000 \times 0.1503 =$	6,012
Total	\$18,262

Practitioner Note. Taxpayers who want to change to the new method on property reported under the old method must make the change in method of accounting in the first or second tax year ending after January 3, 2000. For calendar-year taxpayers, that is 2000 or 2001.

VIII. REDUCED RECOVERY PERIOD FOR CERTAIN ASSETS USED IN A RENTAL ACTIVITY

Problem. In 1999 the IRS in 1999 issued Announcement 99-82 (I.R.B. 1999-32), which corrects the 1998 (and earlier years) instructions for Form 4562 regarding the classification of certain personal property used in rental real estate activities (*such as appliances, carpeting, and furniture*). The correct classification should have been 5-year property rather than 7-year property.

According to IRS guidelines, personal property used in a rental real estate activity is included in asset class 57.0 (Distributive Trades and Services) of Rev. Proc. 87-56 (1987-2 C.B. 674). As a result, such property has a 5-year MACRS life. Most taxpayers have used a 7-year MACRS life for such assets in the past and, as a result, have underdepreciated personal property used in a rental activity.

Solution. The action to be taken is based on when the property was placed in service.

- For prior-year returns, the taxpayer can:
 1. Do nothing and continue to depreciate the property over a 7-year recovery period for regular tax purposes and a 12-year recovery period for AMT.
 2. File an amended return for the most recent tax year (1999) if the property was placed in service that year.
 3. File Form 3115 (Application for Change in Accounting Methods) if the property was placed in service prior to 1999.

Practitioner Note. If Form 3115 is filed, the change is automatic. In accordance with Rev. Proc. 99-49, no user fee is required.

Example 18. Wiley Landlord owns a large apartment complex in Collegetown, USA. In July 1998, substantial improvements were made to several apartments, including \$38,000 for new carpeting. Wiley depreciated the carpeting using a 7-year life and the half-year convention. In June 1999, addi-

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tional improvements were made, including \$34,000 for new appliances. Again Wiley depreciated the appliances using a 7-year life and the half-year convention.

In December 2000, Wiley asks you to prepare his 2000 tax return and review his 1998 and 1999 returns. You advise Wiley that he can continue to depreciate these assets using a 7-year life or he can opt to change to a 5-year life. Wiley wants to change to the 5-year life. Therefore, you make the following calculations:

Year	Asset	Depreciable Basis	Depreciation Claimed	Proper Depreciation	Difference
1998	Carpeting	\$38,000	\$5,430	\$7,600	\$(2,170)
1999	Carpeting	38,000	9,306	12,160	(2,854)
1999	Appliances	34,000	4,859	6,800	(1,941)

Action to Be Taken

- **Property placed in service in 1999.** The improper depreciation claimed on the appliances placed in service in 1999 can be corrected by filing an amended return for 1999. This will decrease Wiley's 1999 income by \$1,941.
- **Property placed in service in 1998.** Wiley has established a method of accounting for the depreciation claimed on the carpeting placed in service in 1998, because he has used an incorrect method for two or more years. He cannot file an amended return. Instead, he must change his method of accounting by filing Form 3115. This will provide Wiley an additional deduction of \$5,024 on his 2000 tax return (Schedule E), if he uses the de minimis 1-year adjustment period. No user fee is required, and the change is automatic. Wiley files one copy of Form 3115 with his 2000 tax return and sends one copy to the IRS national office (per the instructions to Form 3115).

DEFINING THE SCOPE OF FASTER DEDUCTION FOR SOME DEPRECIABLE ASSETS

The Tax Court's decision in *Hospital Corporation of America v. Commissioner* (109 T. C. 2, 1997) provides guidance on more rapid write-off of some property.

Hospital Corporation of America (HCA) classified as tangible personal property certain assets constructed in 1985, 1986, and 1987. HCA used a 5-year recovery period to depreciate these items, which included

1. Primary and secondary electrical distribution systems allocable to the hospital's equipment
2. Branch electrical wiring and connections
3. Carpeting
4. Vinyl wall coverings
5. Vinyl floor coverings (vinyl tiles)
6. Kitchen hoods and exhaust systems
7. Accordion-style room partitions

The IRS determined that these assets were **structural components** of the related buildings and **were not personal property, and that they must be depreciated over the same recovery period as the buildings.**

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The Tax Court disagreed with the IRS position. Neither the statute [I.R.C. §168(f)(1)] nor its legislative history reveals an intent by Congress to redefine I.R.C. §1250(c) to include property that was considered under long-standing precedent to constitute §1245 property.

The Tax Court in *Whiteco Industries Inc.*, 65 T.C. 664 (1975), examined certain essential factors to see if property is inherently permanent:

1. Is the property capable of being moved, and has it in fact been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that tend to show the expected or intended length of affixation (i.e., are there circumstances that show the property may or will have to be moved)?
4. How substantial a job is removal of the property, and how time-consuming is it? Is it “readily removable”?
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

The Court concluded that the tests developed to ascertain whether property constitutes tangible personal property for purposes of the Investment Tax Credit (old I.R.C. §38, which was repealed by the TRA of 1986) are equally applicable in determining whether the property constitutes tangible personal property for purposes of MACRS.

The general explanation of the Economic Recovery Tax Act of 1981 (ERTA) prepared by the staff of the Joint Committee on Taxation specifically states, “**The distinction between a structural component of a building, which is §1250 property, and an item of personal property that is §1245 property remains the same as under prior law.**”

Therefore, practitioners can rely on the guidance under the former ITC rules when determining whether property is depreciated as real property (generally 39-year or 27.5-year recovery period) or personal property (generally 5-year or 7-year recovery period). Thus, the types of disputed property listed above that were previously depreciated under MACRS using either a 27.5- or 39-year recovery period are now eligible for the shorter 5-year or 7-year MACRS recovery period classification. Remember that, generally, §1245 property that has not been assigned a specific class life has a 7-year recovery period [§168(d)(3)(c)]. In addition, some of the disputed assets could qualify for §179 expensing.

Observation. The IRS chief counsel’s office has released instructions to auditors to follow the *HCA* decision in Chief Counsel Advice 199921045. Thus, tax practitioners can follow cases such as *HCA* in determining what assets will qualify as tangible personal property or as other tangible property used as an integral part of manufacturing, processing, or extraction.

Several court cases have concluded that other assets also qualified for §38 eligibility and were therefore *not* structural components of a building. Included in these assets are the following:

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Asset	Authority
Outdoor advertising signs	<i>Whitco Industries, Inc., et al., v. Commissioner</i> [65 T.C. 664 (1975)]
Grain storage tanks of an elevator	<i>Illinois Cereal Mills, Inc. v. Commissioner</i> [T.C. Memo 1983-469 (1983)]
Special foundations, pads, and footings for machinery	<i>Illinois Cereal Mills, Inc. v. Commissioner</i> [T.C. Memo 1983-469 (1983)]
Word processing structures	<i>Scott Paper Company v. Commissioner</i> [74 T.C. 137 (1980)]
Portion of primary electrical distribution system (based on percentage of electricity supplied to equipment)	<i>Scott Paper Company v. Commissioner</i> [74 T.C. 137 (1980)] and <i>Morrison, Inc., et al. v. Commissioner</i> [90-1 U.S.T.C. 50,034, CA-11 (1990) affirming T.C. Memo 1986-129]

IX. FLUCTUATING BUSINESS USE OF LISTED PROPERTY

There are two separate limits that may affect the depreciation of automobiles and light trucks:

- 1. Passenger Automobile Limitation.** The annual ceiling on depreciation of passenger automobiles under I.R.C. §280F(a)(1)(A).
- 2. Listed Property Limitation.** The limit on depreciation of listed property under I.R.C. §280F(b) when the business use percentage does not exceed 50%.

Passenger Automobile Limitations

I.R.C. §280F(a)(1)(A) limits the depreciation and §179 deduction for passenger automobiles placed in service in 2000 to \$3,060 in 2000, \$4,900 in 2001, \$2,950 in 2002, and \$1,775 in 2003 and later years.

Note. Because the automobile portion of the consumer price index actually dropped slightly last year, the limit in the second year has decreased by \$100 for automobiles placed in service in 2000.

The limits for vehicles placed in service in years 1995 through 2000 follow.

	Year Vehicle Placed in Service				
	1995/96	1997	1998	1999	2000
First year	\$3,060	\$3,160	\$2,160	\$3,060	\$3,060
Second year	\$4,900	\$5,000	\$5,000	\$5,000	\$4,900
Third year	\$2,950	\$3,050	\$2,950	\$2,950	\$2,950
Later years	\$1,775	\$1,775	\$1,775	\$1,775	\$1,775

The category of passenger automobiles includes trucks and vans rated with a gross vehicle weight of 6,000 pounds or less. Gross vehicle weight (GVW) is the manufacturer's rated weight as listed on the vehicle. It is the weight of the vehicle as the vehicle is equipped when it comes off the dealer's lot. For trucks and vans, the 6,000-pound test is applied to loaded gross vehicle weight. (For all other vehicles the test is applied to unloaded gross vehicle weight.)

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Example 19. Hy Roller purchased a 1998 Cadillac, for use in his Schedule C manufacturer's representative business, in September 1998 for \$36,000. There was no trade-in involved, and it was the only business asset he purchased in 1998. Hy used the vehicle 70% for business in 1998, 65% in 1999, and 48% in 2000.

Question 19A. What are the tax consequences for Hy in 2000? (The \$179 deduction was not elected!)

Answer 19A. The auto is listed property as defined in I.R.C. §280F(d)(4)(i)—“any passenger automobile.” Accordingly, MACRS depreciation (accelerated) and I.R.C. §179 expensing deductions are not available unless the vehicle is used more than 50% for business purposes. The business use was more than 50% in the year the car was placed in service (1998), and the luxury automobile limitations apply [I.R.C. §280F(a)(1)(A)].

Recapture rules apply if MACRS depreciation is used and the business use percentage falls to 50% or less during the second, third, fourth, fifth, or sixth year of use. The recapture amount is the difference between the MACRS deductions and ADS depreciation method [I.R.C. §280F(b)(1) and (2)].

The MACRS deductions for 1998 and 1999 are computed as follows:

1998		
Cost	\$36,000	
Business use	× .70	
	\$25,200	
First-year MACRS deduction	× .20	(MACRS Table A-1)
(assume half-year)	\$ 5,040	
or §280F(a)(1)(A) limitation		
1998 limit	\$ 3,160	Whichever is less: <u>\$2,212</u>
Business use	× .70	
	\$ 2,212	
1999		
Cost	\$36,000	
Business use	× .65	
	\$23,400	
Second-year MACRS	× .32	(MACRS Table A-1)
	\$ 7,488	
or §280F(a)(1)(A) limitation		
1999 limit	\$ 5,000	Whichever is less: <u>\$3,250</u>
Business use	× .65	
	\$3,250	

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In 2000, the business use of the auto fell to 50% or less (48%). As a result, the recapture rules apply. The recapture applies to the extent that the MACRS deductions for the earlier years (1998 and 1999) **exceed** the depreciation that would have been allowed under the alternative MACRS (ADS) method (straight-line depreciation over the alternative MACRS recovery period). The alternative MACRS recovery period for automobiles is 5 years.

Recomputation

Total MACRS deductions claimed in 1998 and 1999 (\$2,212 + \$3,250): \$5,462

Total ADS cost recovery allowable in 1998 and 1999

(recomputed using straight-line with a 5-year life—MACRS Table A-8)

1998:	\$36,000	× .70	× .10	= \$2,520,	limited to	\$2,212
1999:	\$36,000	× .65	× .20	= \$4,680,	limited to	\$3,250
				\$7,200,	limited to	\$5,462

Note. The slower ADS depreciation method provides for the same amount of depreciation as the faster MACRS depreciation method. In this example, the “luxury car” depreciation limitations affect the depreciation allowed under both methods.

However, since the business use is **only 48% in 2000**, Hy **must** use the straight-line method (MACRS Table A-8) to calculate his 2000 cost recovery deductions.

Cost	\$36,000				
× 2000 business use	.48				
	\$17,280				
Third-year rate	× .20	(MACRS Table A-8)			
	\$3,456				
or §280F(A)(1)(A) limitation 2000 limit	\$2,950				
	× .48				
	\$1,416				

Hy can claim \$1,416 as a cost recovery deduction for the vehicle in 2000.

Once the business use of an item of listed property falls to 50% or less, the ADS method **must** be used for the **remainder of its life**. This is true even if the business use rises above 50% in any later year [I.R.C. §280F(b)(1)].

Example 20. In June 1997, Will B. Wealthy purchased a Buick for exclusive use in his Schedule C business. Will paid \$18,000 for the vehicle in 1997 and used it 100% for business in 1997, 1998, and 1999. In 2000, he used the vehicle 50% for business and 50% for personal purposes. Will’s MACRS cost recovery deductions as claimed for years prior to 2000 are as follows:

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1997	
Cost	\$18,000
× Business use	<u>100%</u>
	\$18,000
First-year MACRS	<u>.20</u> (MACRS Table A-1)
(1/2 yr.)	\$3,600
or §280F(a)(1)(A) limitation	
1997 limit	\$3,160
	× 100%
	<u>\$3,160</u>
	Whichever is less: <u>\$3,160</u>
	\$3,160
1998	
	\$18,000
	× .32 (MACRS Table A-1)
	<u>\$5,120</u>
or §280F(a)(1)(A) limitation	
1998 limit	\$5,000
	× 100%
	<u>\$5,000</u>
	Whichever is less: <u>\$5,000</u>
	\$5,000
1999	
	\$18,000
	× .192 (MACRS Table A-1)
	<u>\$ 3,456</u>
or §280F(a)(1)(A) limitation	
1999 limit	\$3,050
	× 100%
	<u>\$3,050</u>
	Whichever is less: <u>\$3,050</u>
	\$3,050
Total MACRS deductions claimed in 1997–99	\$11,210
Less: Total ADS deductions allowed in 1997–99	
(Recomputed using straight-line with a 5-year life—Table A-8)	
1997: \$18,000 × 10% = \$1,800	
1998: \$18,000 × 20% = \$3,600	
1999: \$18,000 × 20% = <u>\$3,600</u> (limited to \$3,050)	
	(\$8,450)
Excess depreciation (recapture)	<u>\$2,760</u>

In 2000, the excess depreciation of \$2,760 must be shown in Part IV, Form 4797 **and** included as “Other income” on line 6 on Will’s 2000 Schedule C. The \$2,760 recapture amount is subject to **both** income and self-employment taxes. In addition, the adjusted basis of the vehicle is increased by the \$2,760 recapture amount.

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The 2000 cost recovery deduction for Will's auto is calculated as follows:

	\$18,000	(Unadjusted basis)
	× .50	(Business use percentage in 2000)
	\$9,000	
	.20	(MACRS Tables A-8, 4th year rate)
	\$1,800	
	or	§280F(a)(1)(A) limitation
Whichever is less	\$1,775	(2000 limit)
	× .50	
	\$ 888	

Will's allowable 2000 cost recovery deduction is \$888. He must also use the straight-line method (MACRS Table A-8) to compute allowable deductions in later years for this vehicle.

Observation: Potential Problem

The tax preparer will usually assume, if he or she enters the data above correctly into the software program, that Form 4562, Part V, will be calculated as follows:

Form 4562 (1999)

Page 2

Part V Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See page 7 of the instructions for limits for passenger automobiles.)

23a Do you have evidence to support the business/investment use claimed? Yes No **23b** If "Yes," is the evidence written? Yes No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost
24 Property used more than 50% in a qualified business use (See page 6 of the instructions.):								
Buick Auto	6 - 97	50 %	18,000	9,000	5	SL - HY	888	
		%						
		%						
25 Property used 50% or less in a qualified business use (See page 6 of the instructions.):								
		%				S/L -		

This is the correct answer and is determined by the following procedure:

Year	(a) 100% Business-Use MACRS ADS Depreciation	(b) Luxury Car Limit	(c) Overall Limit (%Bus. Use × Lesser) of (a) or (b)	(d) §280F Unrecovered Basis*
1997	\$1,800	\$3,160	\$1,800	\$16,200
1998	3,600	5,000	3,600	12,600
1999	3,600	3,050	3,050	9,550
2000	3,600	1,775	888	8,662

*Unrecovered basis: Basis at beginning of year less the lesser of col. (a) or col. (b).

Unrecovered Basis. In determining how much recovery period basis remains available for deduction, the basis of a passenger automobile is reduced by the maximum allowable deduction as if the automobile were used 100% for business/investment use (I.R.C. §280F(d)(8)). Thus, the term "unrecovered basis" means the adjusted basis of the passenger automobile after reduction by the lesser of the amount

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of the full luxury-car-specific dollar limit or the depreciation deduction (assuming 100% business use even where, because of personal use, a smaller deduction was actually allowed).

The §280F unrecovered basis (col. (d)) for each year is the original cost of the vehicle (\$18,000) reduced by the accumulated depreciation that could have been claimed if business use for each year had been 100% (i.e., for each year, the lesser of col. (a) or col. (b)). For example, 1999 unrecovered basis is \$9,550 (\$18,000 – \$1,800 – \$3,600 – \$3,050).

Practitioner Note. Publication 946, *How to Depreciate Property* (1999), contains a worksheet on page 53 that can be used to calculate the depreciation deduction allowed. A complete form for Will B. Wealthy for 2000 indicates the following result:

Worksheet for Passenger Automobiles (Subject to Special Limits)

Part I

1. Description of property	<u>Buick Auto</u>
2. Date placed in service	<u>6-97</u>
3. MACRS method (GDS or ADS)	<u>ADS</u>
4. Property class and recovery period	<u>5-year</u>
5. Convention	<u>Half-year</u>
6. Depreciation rate (from tables)	<u>.20</u>
7. Deduction limit for this year from the <i>Maximum Depreciation Deduction for Passenger Automobiles</i> table	<u>1775</u>
8. Business/investment use percentage	<u>50%</u>
9. Multiply line 7 by line 8. This is your adjusted deduction limit	<u>888</u>
10. Section 179 deduction claimed this year (not more than line 9). Enter -0- if this is not the year you placed the car in service.	<u>0</u>

Note.

- 1) If line 10 is equal to line 9, stop here. Your combined section 179 and depreciation deduction is limited to line 9.
- 2) If line 10 is less than line 9, complete Part II.

Part II

11. Subtract line 10 from line 9. This is the maximum amount you can deduct for depreciation	<u>888</u>
12. Cost or other basis (reduced by any section 179A deduction* or credit for electric vehicles**)	<u>18,000</u>
13. Multiply line 12 by line 8. This is your business/investment cost	<u>9,000</u>
14. Section 179 deduction claimed in year you placed the car in service	<u>0</u>
15. Subtract line 14 from line 13. This is your unadjusted basis for depreciation	<u>9,000</u>
16. Multiply line 15 by line 6. This is your maximum depreciation deduction	<u>3,600</u>
17. Enter the lesser of line 11 or line 16. This is your depreciation deduction	<u><u>888</u></u>

*The section 179A deduction is for clean-fuel vehicles or clean-fuel vehicle refueling property. When figuring the amount to enter on line 12, do not reduce your cost or other basis by any section 179 deduction you claimed for your car.

**Reduce the basis by the lesser of \$4,000 or 10% of the cost of the vehicle even if the credit is less than that amount.

The result agrees with the depreciation deduction calculated earlier under I.R.C. §280F(d)(8).

However, some software packages may calculate the depreciation deduction on Form 4562, Part V, as follows:

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Part V Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See page 7 of the instructions for limits for passenger automobiles.)

23a Do you have evidence to support the business/investment use claimed? Yes No **23b** If "Yes," is the evidence written? Yes No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost
24 Property used more than 50% in a qualified business use (See page 6 of the instructions.):								
Buick Auto	6 - 97	50 %	18,000	9,000	5	SL - HY	550	
		%						
		%						
25 Property used 50% or less in a qualified business use (See page 6 of the instructions.):								
		%				S/L -		

Reason. The depreciation schedule of the Buick auto will show prior depreciation claimed of \$8,450 (1997–1999). The software package may first reduce the business depreciable basis of \$9,000 by the \$8,450 of prior depreciation before the current-year deduction is calculated. If the prior depreciation of \$8,450 is compared to the business basis of \$9,000 (rather than the cost basis of \$18,000), current-year depreciation of only \$550 will be allowed, since only \$550 of depreciable basis remains.

Solution. The tax preparer will have to override the computer calculation and simply force the depreciation deduction of \$888.

Example 21. Paige Turner operates a Schedule C swimming pool supply business. In 1998 she purchased an F-150 pickup truck with a GVWR of 6,100 pounds. Paige paid \$20,000 for this vehicle and used it 90% for business in 1998 and 1999. In 2000, she allowed her 18-year-old son to use the truck, which reduced her business use to 40%. Paige had claimed \$179 on this vehicle in 1998. The cost recovery calculations are shown below:

1998	
\$20,000	(Total cost—unadjusted basis)
× .90	(Business use percentage)
\$18,000	(Business basis)
-(18,000)	Less: \$179 deduction
-0-	Remaining basis

Practitioner Note. This vehicle is not a “passenger automobile” as defined in I.R.C. §280F(d)(4)(A)(i). It is classified under I.R.C. §280F(d)(4)(A)(ii) as “any other property used as a means of transportation.” This classification permits maximum \$179 expensing and significantly higher MACRS cost recovery deductions as long as the business use exceeds 50%. Since the business use fell to 50% or below during the recovery period, the recapture rules apply. The recapture calculations are shown below.

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Total cost recovery deductions claimed (§179)	\$18,000
Less: Total ADS cost recovery allowable (Recomputed using straight-line with 5-year life—MACRS Table A-8)	
1998: $\$20,000 \times .90 \times .10 = \$1,800$	
1999: $\$20,000 \times .90 \times .20 = \underline{\$3,600}$	
	(5,400)
Excess depreciation	<u>\$12,600</u>

The \$12,600 of excess depreciation must be shown in Part IV, Form 4797 and included as “Other income” on line 6 of Paige’s 2000 Schedule C. The \$12,600 should also be added back to the adjusted basis of the truck. The cost recovery deduction for 2000 will be

\$20,000	(Unadjusted basis)
<u>× .40</u>	(Business use percentage in 2000)
\$8,000	
<u>× .20</u>	(MACRS Table A-8, third-year rate)
<u>\$1,600</u>	

X. SECTIONS 1245, 179, AND 1250 RECAPTURE

A. SECTION 1245 DEPRECIATION RECAPTURE

I.R.C. §1245 requires the **lesser** of the gain realized or the depreciation previously claimed to be reported as ordinary income upon sale or other transfer of an asset that is defined as §1245 property. In general, this includes personal property for which depreciation was allowed and certain real property, such as single-purpose agricultural and horticultural structures and property used as an integral part of production.

Since the gain is subject to §1245 recapture, the transaction is reported in Part III of Form 4797. Since all of the gain is ordinary income, it is all reported on line 13 of Form 4797.

For purposes of this provision, the following (in addition to regular depreciation) are treated as depreciation:

1. Any amount claimed as a deduction under §179
2. Any basis reduction as a result of discharge of indebtedness under §108
3. The basis reduction from claiming the investment credit [§50(c)(4)(A)]
4. The deduction for qualified clean-fuel vehicle property or refueling property
5. Deductions claimed under §190 (removal of architectural and transportation barriers to the handicapped and elderly), §193 (deduction for tertiary injectant expenses), or §1253(d)(2) or (3) (transfers of franchises, trademarks, and trade names) (as in effect before the Omnibus Budget Reconciliation Act of 1993)

Example 22. Recapture of Depreciation on the Sale of a §1245 Asset. In 1997 Dusty Diggers purchased a heavy-duty dump truck for use in his dirt hauling business. He claimed MACRS, 5-year, half-year convention on this truck. The original cost was \$58,000. In September 2000 Dusty sold the truck for \$32,000. The computation of the §1231 and §1245 gain, with completed forms, follows:

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Adjusted Basis Computation

Cost	\$58,000	
Depreciation claimed:		
1997	20%	\$11,600
1998	32%	18,560
1999	19.2%	11,136
2000	11.52% × 1/2	3,341
Accumulated depreciation		\$44,637
Selling price	32,000	
Less adjusted basis	(13,363)	(\$58,000 – \$44,637)
Realized gain	\$18,637	(\$1231)

Pursuant to §1245, the amount of the \$1231 gain that is taxed as ordinary income is the lesser of depreciation taken (\$44,637) or the realized gain (\$18,637). The entire gain in this problem is taxed as ordinary income.

Form 4797 (1999)

Page 2

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)		
A Dump Truck	7 - 1 - 97	9 - 3 - 00		
B				
C				
D				
These columns relate to the properties on lines 19A through 19D. ▶	Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 before completing)	20 32,000			
21 Cost or other basis plus expense of sale	21 58,000			
22 Depreciation (or depletion) allowed or allowable	22 44,637			
23 Adjusted basis. Subtract line 22 from line 21	23 13,363			
24 Total gain. Subtract line 23 from line 20	24 18,637			
25 If section 1245 property:				
a Depreciation allowed or allowable from line 22	25a 44,637			
b Enter the smaller of line 24 or 25a	25b 18,637			
26 If section 1250 property: If straight line depreciation was used, enter				
Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.				
30 Total gains for all properties. Add property columns A through D, line 24		30 18,637		
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13		31 18,637		
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6		32		

Example 23. Sale Price of §1245 Asset Exceeds Purchase Price. If in Example 22 the dump truck had been sold for \$65,000, the gain would have included both ordinary gain under §1245 and gain treated as capital gain under I.R.C. §1231.

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Selling price	\$65,000
Less adjusted basis	(13,363)
Realized gain	51,637 (\$1231)

Pursuant to I.R.C. §1245, the amount of the I.R.C. §1231 gain that is taxed as ordinary income is the lesser of depreciation taken (\$44,637) or the realized gain (\$51,637). Of the \$51,637 realized gain, \$44,637 is taxed as ordinary income under I.R.C. §1245 and \$7,000 is taxed as capital gain under I.R.C. §1231.

Form 4797 Department of the Treasury Internal Revenue Service (99)	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0184 2000 Attachment Sequence No. 27
Name(s) shown on return Dusty Diggers (Example 27 B)		Identifying number 626 - 77 - 4193
1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20		1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2						
3 Gain, if any, from Form 4684, line 39						3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37						4
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6 Gain, if any, from line 32, from other than casualty or theft						6 7,000
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						7 7,000

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11 Loss, if any, from line 7						11 ()
12 Gain, if any, from line 7 or amount from line 8, if applicable						12
13 Gain, if any, from line 31						13 44,637
14 Net gain or (loss) from Form 4684, lines 31 and 38a						14

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Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Dump Truck	7 - 1 - 97	9 - 3 - 00
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1 before completing)	20	65,000		
21	Cost or other basis plus expense of sale	21	58,000		
22	Depreciation (or depletion) allowed or allowable	22	44,637		
23	Adjusted basis. Subtract line 22 from line 21	23	13,363		
24	Total gain. Subtract line 23 from line 20	24	51,637		
25 If section 1245 property:					
a	Depreciation allowed or allowable from line 22	25a	44,637		
b	Enter the smaller of line 24 or 25a	25b	44,637		

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	51,637
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	44,637
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	7,000

A. DEPRECIATION RECAPTURE FROM A LIKE-KIND EXCHANGE

Gain that is recognized from a like-kind exchange of property is subject to the same recapture rules as gain recognized from the sale of the property.

Gain that is recognized from the exchange of §1245 property is ordinary income to the extent of depreciation claimed on the property. Gain in excess of the depreciation claimed is §1231 gain.

Gain that is recognized from the exchange of §1250 property is ordinary income to the extent that depreciation claimed on the property exceeds straight-line depreciation. The remaining gain is §1231 gain.

Practitioner Note. If the §1231 gain from the §1250 property is treated as long-term capital gain, the gain due to straight-line depreciation is subject to the 25% maximum capital gains rate. The gain in excess of depreciation claimed is subject to the 20% maximum capital gain rate.

Example 24. In 1998, Daisy Flowers traded a combine with an adjusted basis of \$36,755 and FMV of \$50,000 for planting equipment with a FMV of \$40,000, and she received \$10,000 in boot. The trade qualifies as a like-kind exchange since the combine and planting equipment are both included in SIC product class 3523, Farm Machinery and Equipment.

Daisy had originally acquired the combine in 1994 for \$100,000 and had claimed \$63,245 in depreciation deductions for the corn planter as of the date of the trade-in (including one half-year depreciation of \$6,125 for 1998).

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Trade-in value of combine	\$50,000
Adjusted basis of combine	<u>36,755</u>
Gain realized	\$13,245
Gain recognized (boot)	\$10,000

Practitioner Note. Gain recognized is limited to the lesser of gain realized or boot received. In this case \$10,000 boot was received; therefore, the deferred gain is \$3,245 (\$13,245 – \$10,000), which is recognized upon disposition of the planting equipment. The gain that is recognized is treated as ordinary income, since the gain recognized (\$10,000) is less than the prior depreciated claimed on the combine (\$63,245).

Daisy reported the exchange on Form 8824 and Form 4797 as shown below.

Form	8824	Like-Kind Exchanges (and nonrecognition of gain from conflict-of-interest sales) ▶ Attach to your tax return.	OMB No. 1545-1190 1999 Attachment Sequence No. 109
Department of the Treasury Internal Revenue Service		Name(s) shown on tax return Daisy Flowers (Example 28)	
		Identifying number 882 - 46 - 1031	

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 ▶ **combine**
- 2 Description of like-kind property received ▶ **planting equipment**

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	10,000	
16 FMV of like-kind property you received		16	40,000	
17 Add lines 15 and 16		17	50,000	
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		18	36,755	
19 Realized gain or (loss). Subtract line 18 from line 17		19	13,245	
20 Enter the smaller of line 15 or line 19, but not less than zero		20	10,000	
21 Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions		21	10,000	
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	10,000	
24 Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions		24	3,245	
25 Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23		25	36,755	

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Form **4797**
 Department of the Treasury
 Internal Revenue Service (99)
 Name(s) shown on return

Sales of Business Property
 (Also Involuntary Conversions and Recapture Amounts
 Under Sections 179 and 280F(b)(2))
 ▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184
2000
 Attachment
 Sequence No. **27**

Daisy Flowers (Example 28)

Identifying number
882 - 46 - 1031

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11 Loss, if any, from line 7	11	()
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	
13 Gain, if any, from line 31	13	
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	

Daisy used the planting equipment in 1998, 1999, and 2000 and then sold it for \$39,000. The depreciation procedure for exchanged property in 1998 required that the basis of property carried over from relinquished property (the combine) be added to the new basis of the acquired property (the planting equipment) and the total basis then depreciated over the life of the acquired property. Using this procedure, Daisy calculated depreciation on the planting equipment as follows:

7-year Property, 150% D.B.

Year	Basis	Rate (%)	Amount
1998	\$36,755	10.71	\$ 3,936
1999	36,755	19.13	7,031
2000	36,755	15.03	2,762(1/2 Year)
			\$13,729

Daisy must report the following gain:

Planting Equipment

Amount realized	\$39,000
Less adjusted basis:	
Unadjusted basis	\$36,755
Depreciation	13,729
Adjusted basis	23,026
Gain realized	\$15,974

Of the gain realized on the planting equipment, \$13,729 must be reported as recapture of depreciation on the planting equipment. **The remaining \$2,245 of gain realized must also be reported as depreciation recapture** since it is included in the \$3,245 of gain rolled over from the combine and would have been reported as depreciation recapture if the gain had been recognized.

The taxpayer is required to include the depreciation claimed on property transferred in a like-kind exchange for the property that is currently being sold. However, the depreciation that must be

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included from the transferred asset is limited to the gain that is rolled over into the asset acquired—in this case, \$3,245. The depreciation reported on line 22 of Form 4797 is

Depreciation on planter	\$13,729
Deferred gain from combine	3,245
Total	\$16,974

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Planting equipment	3 - 10 - 98	6 - 20 - 00
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 before completing.)	20	39,000			
21 Cost or other basis plus expense of sale	21	40,000			
22 Depreciation (or depletion) allowed or allowable	22	16,974			
23 Adjusted basis. Subtract line 22 from line 21	23	23,026			
24 Total gain. Subtract line 23 from line 20	24	15,974			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a	16,974			
b Enter the smaller of line 24 or 25a	25b	15,974			
26 If section 1250 property: If straight line depreciation was used, enter					

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	15,974
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	15,974
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	- 0 -

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less
(See instructions.)

		(a) Section 179		(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33			
34 Recomputed depreciation. See instructions	34			
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35			



Daisy is also allowed to increase the basis she reports on line 21 of Form 4797 (\$36,755 + \$3,245 of deferred gain from the combine). The adjustment is necessary to arrive at the appropriate gain on line 24 of Form 4797 of \$15,974.

New Rules. As discussed in Section VII, “Depreciation of Property Received in a Like-Kind Exchange,” Notice 2000-4 now requires taxpayers to continue depreciating the carried-over basis from the relinquished property over the remaining life of the relinquished property using the depreciation rate used for the old property. The new method of depreciating property received in a trade is mandatory for property placed in service on or after January 3, 2000. **Taxpayers have the option of using the old method or the new method for property placed in service prior to January 3, 2000.**

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Therefore, Daisy could elect to use the new method for the planting equipment acquired in 1998 by filing Form 3115 under the procedures of *Rev. Proc. 99-49*. However, in this example, Daisy chooses to stay with the old method, since she disposes of the planting equipment in 2000. In this example, a change in depreciation method would not alter the outcome in the year of disposition.

Observation. If Daisy had continued to hold the planting equipment, she would likely have elected to apply the new rules and, by doing so, could accelerate this depreciation deductions for the planting equipment.

B. RECAPTURE OF §179 DEDUCTIONS

A §179 recapture is triggered when the **business use** of property placed in service in an earlier year is **reduced to 50% or less** during the recapture period. The recapture period of the expense election is the entire recovery period of the qualifying §179 property [§179(d)(10)].

The **recapture amount** (reported on Form 4797) equals the §179 expense deduction taken minus the MACRS depreciation amount that would have been allowed on the expense amount from the time the property was placed in service up to and including the year of recapture [Treas. Reg. §1.179-1(e)(1)].

Listed Property

If a §179 deduction is claimed on listed property, and the business use of the property later falls to 50% or less, the §179 recapture is included with the recapture of the excess depreciation [§280F(d)]. The §280F(b)(2) recapture rule requires the taxpayer to report as income the difference between

1. The depreciation and §179 deduction that has been claimed, and
2. The depreciation that would have been allowed using the alternative MACRS depreciation rules.

Listed property is any of the following:

1. Any passenger automobile.
2. Any other property used for transportation.
3. Any property of a type generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment).
4. Any computer and related peripheral equipment, unless it is used only at a regular business establishment and is owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit if and only if that portion is used both regularly and exclusively for business.
5. Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

Example 25. Sandy Marsh paid \$5,000 for a computer in 1997. She used the computer 80% in her business and 20% for personal use. Therefore, her basis in the portion used for business was \$4,000. Sandy used the computer in a room of her home that was not used exclusively for the business. She claimed a \$3,000 §179 deduction for the computer on her 1997 income tax return. She depreciated the remaining \$1,000 business basis using MACRS. She deducted the following depreciation:

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Year	Depreciation Rate	Depreciation Basis	Depreciation Amt.
1997	15.00%	\$1,000	\$150
1998	25.50%	1,000	255
1999	17.85%	1,000	179
			\$584

The total depreciation deducted through 1999 is \$3,584.

In 2000 Sandy used the computer only 40% for business. Therefore, she must recapture the §179 deduction and depreciation claimed to the extent they exceed the depreciation that is allowed under alternative MACRS. The recapture is calculated as follows:

Alternative MACRS Depreciation Allowable (Straight-Line Method)

Year	Depreciation Rate	Depreciation Basis	Depreciation Amt.
1997	10.00%	\$4,000	\$ 400
1998	20.00%	4,000	800
1999	20.00%	4,000	800
			\$2,000
Total taken		\$3,584	
Total allowable		(2,000)	
Excess depreciation recapture		\$1,584	

Sandy reports the recapture on Form 4797. She carries the \$1,584 recapture amount to her 2000 Schedule C, line 6 (Other Income). The \$3,584 originally taken reduced her self-employment income in 1997–1999; likewise, the \$1,584 recapture amount in 2000 is subject to self-employment tax.

Sandy Marsh (Example 28) 111 22 1234

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (See instructions.)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		3,584
34 Recomputed depreciation. See instructions	34		2,000
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		1,584

Form 4797 (1999)



Practitioner Note. Sandy's depreciation for 2000 is zero. The \$5,000 cost × 40% business use gives a \$2,000 business basis. When the \$2,000 of depreciation claimed in prior years is subtracted, there is no remaining business basis to be depreciated.

Property Other than Listed Property

If the business use of property other than listed property falls to 50% or below, the taxpayer must report as ordinary income the difference between the §179 expense claimed and the depreciation that would have been allowed on that amount had it not been expensed.

Example 26. In 1998 E. Z. Rider bought a livestock trailer that cost \$10,000. In 1998 and 1999 he used the trailer 100% for hauling cattle for his farm business. He claimed \$2,000 of his \$10,000 business

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basis as a \$179 deduction in 1998 and depreciated the remaining \$8,000 business basis using 150% declining balance.

In 2000 E. Z. reduced his business use of the trailer to 40% and used it 60% for his hobby, participating in cutting horse events. That reduction in business use requires E. Z. to report his excess \$179 deduction as other income on line 10 of his 2000 Schedule F. The amount of the excess \$179 deduction is calculated as follows:

Year	Depreciation Rate	Depreciation Basis	Allowable Depreciation Amt.
1998	10.71%	\$2,000	\$214.20
1999	19.13%	2,000	382.60
2000	15.03%	2,000	120.24 (\$300.60 × 40%)
Total allowable			\$717.04

The excess recapture amount is \$1,282.96 (\$2,000 – \$717.04).

E. Z. reports the recapture amount on Form 4797. He also reports \$1,282.96 as other income on his 2000 Schedule F, line 10 (Other Income), and adds that amount to the basis of the trailer at the beginning of 2000.

Easy Rider Example 29 123 45 6799

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (See instructions.)

		(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33 2,000	
34	Recomputed depreciation. See instructions	34 717	
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35 1,283	

Form 4797 (1999)



C. §1250 DEPRECIATION RECAPTURE

Section 1250 requires gain realized on the sale of property to be reported as ordinary income to the extent that depreciation claimed on the property exceeded straight-line depreciation.

Example 27. Lotta Bucks purchased a strip shopping mall (nonresidential real property) on January 1, 1974, and is claiming double declining balance depreciation based on a 35-year useful life. Her accountant switched the double declining balance to straight-line when the accelerated method started to produce lower depreciation deductions. Lotta paid \$380,000 for the strip mall, of which \$30,000 was allocated to the land. Lotta sold the property on July 1, 2000, for \$550,000. The computation of depreciation claimed, adjusted basis, realized gain, and §1231 and §1250 gain follows:

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Depreciation Claimed (35-year Life DDB, Converting to S/L): Cost \$250,000

Tax year	DDB	S/L	Difference
1974	\$ 20,000	\$ 10,000	\$10,000
1975	18,857	10,000	8,857
1976	17,780	10,000	7,780
1977	16,764	10,000	6,764
1978	15,806	10,000	5,806
1979	14,902	10,000	4,902
1980	14,051	10,000	4,051
1981	13,248	10,000	3,248
1982	12,491	10,000	2,491
1983	11,777	10,000	1,777
1984	11,104	10,000	1,104
1985	10,470	10,000	470
1986	9,871	10,000	(129)
1987	9,307	10,000	(693)
1988	8,776	10,000	(1,224)
1989	8,274	10,000	(1,726)
1990	7,801	10,000	(2,199)
1991	7,355	10,000	(2,645)
1992 (converts to S/L)	7,139	10,000	(2,861)
1993	7,139	10,000	(2,861)
1994	7,139	10,000	(2,861)
1995	7,139	10,000	(2,861)
1996	7,139	10,000	(2,861)
1997	7,139	10,000	(2,861)
1998	7,139	10,000	(2,861)
1999	7,139	10,000	(2,861)
2000	3,570	5,000	(1,430)
	<u>\$289,316</u>	<u>\$265,000</u>	<u>\$24,316</u>
Selling price			\$550,000
Cost	\$380,000		
Less: Depreciation	(289,316)		
Adjusted basis			<u>(90,684)</u>
Realized gain			\$459,316

Lotta reports the sale of the shopping mall on Part III of Form 4797. Her original purchase price is reported on line 20. The depreciation claimed is the depreciation claimed through 1999 plus the depreciation she claims in 2000. She calculates her 2000 depreciation on the shopping mall by prorating the \$7,139 of depreciation she would have claimed for the whole year based on the number of days she actually held the property.

Observation. Before 1981 taxpayers had the option of using the mid-month convention or using a daily method for depreciating property placed in service during the tax year.

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Because the shopping mall is §1250 property and Lotta did not use straight-line depreciation, she is required to calculate her depreciation recapture on line 26. That is done by entering the depreciation she claimed in excess of straight-line depreciation for the period **after 1975** on line 26a. **For that period, Lotta has \$5,459 of additional depreciation.** This is calculated by starting with the total difference in DDB and S/L depreciation (\$24,316) and subtracting the difference for 1974 and 1975 (\$10,000 + \$8,857). The result is \$5,459 (\$24,316 – \$10,000 – \$8,857). That is, accelerated depreciation claimed for that period exceeds straight-line depreciation by \$5,459. Consequently, she enters \$5,459 on line 26a. She enters \$5,459 on line 26b since the applicable percentage is 100%.

Lotta enters \$453,857 on line 26c (\$459,316 total gain less the \$5,459 on line 26b). The excess depreciation for the period after 1969 and before 1976 is \$18,857. This is entered on line 26d.

Observation. If straight-line depreciation claimed after 1975 had been greater than the accelerated depreciation after 1975, Lotta could reduce the amount on line 26d by the deficit for the period after 1975 [Treas. Reg. §1.1250-2(b)(6)]. On line 26e she enters the lesser of \$453,857 and \$18,857. Lotta enters \$24,316 on line 28g as the sum of line 26b (\$5,459) and line 26c (\$18,857).

Observation. The §1250 recapture gain is reported on line 31 (\$24,316) and is then carried to Part II of Form 4797 (on line 13). Thus, this gain will be taxed at ordinary income tax rates. The remaining gain of \$435,000 (line 32 of Part III) is then carried to Part I of Form 4797 (line 6), and is therefore treated as §1231 gain. Assuming there are no §1231 losses, this gain carries over to Schedule D. However, to the extent of prior straight-line depreciation claimed [\$265,000, or (\$289,316 – \$24,316)], this §1231 gain will be taxed at a maximum rate of 25%. The remaining gain of \$170,000 will be eligible for the 20% capital gain rate.

Type of Gain	Amount	Maximum Tax Rate
§1250 ordinary income recapture	\$ 24,316	Ordinary income tax rate
§1231 (to extent of prior S/L depreciation)	265,000	25%
§1231 (in excess of prior depreciation)	170,000	20%

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Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Shopping Mall	1 - 1 - 74	7 - 1 - 00
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1 before completing)	20 550,000			
21	Cost or other basis plus expense of sale	21 380,000			
22	Depreciation (or depletion) allowed or allowable	22 289,316			
23	Adjusted basis. Subtract line 22 from line 21	23 90,684			
24	Total gain. Subtract line 23 from line 20	24 459,316			
25 If section 1245 property:					
a	Depreciation allowed or allowable from line 22	25a			
b	Enter the smaller of line 24 or 25a	25b			
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a 5,459			
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b 5,459			
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c 453,857			
d	Additional depreciation after 1969 and before 1976	26d 18,857			
e	Enter the smaller of line 26c or 26d	26e 18,857			
f	Section 291 amount (corporations only)	26f			
g	Add lines 26b, 26e, and 26f	26g 24,316			
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a	Soil, water, and land clearing expenses	27a			
b	Line 27a multiplied by applicable percentage (see instructions)	27b			
c	Enter the smaller of line 24 or 27b	27c			
28 If section 1254 property:					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a			
b	Enter the smaller of line 24 or 28a	28b			
29 If section 1255 property:					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a			
b	Enter the smaller of line 24 or 29a (see instructions)	29b			

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	459,316
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	24,316
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	435,000

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (See instructions.)

		(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33	
34	Recaptured depreciation. See instructions	34	
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	



2000 Workbook

Form **4797**
 Department of the Treasury
 Internal Revenue Service (99)

Sales of Business Property
 (Also Involuntary Conversions and Recapture Amounts
 Under Sections 179 and 280F(b)(2))
 ▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184
1999
 Attachment
 Sequence No. 27

Name(s) shown on return **Lotta Bucks (Example 30)** Identifying number **111 - 22 - 5091**

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 **1 550,000**

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2						
3	Gain, if any, from Form 4684, line 39					3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37					4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824					5
6	Gain, if any, from line 32, from other than casualty or theft					6 435,000

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11	Loss, if any, from line 7	11 ()
12	Gain, if any, from line 7 or amount from line 8, if applicable	12
13	Gain, if any, from line 31	13 24,316
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14

XI. DEATH OF THE TAXPAYER

When property is transferred as a result of death of the owner, the transfer is not treated as a disposition [Prop. Reg. §1.168-2(l)(1)]. Therefore, no gain or loss has to be reported and there is no depreciation recapture. However, the depreciation that can be claimed on the decedent's last return is limited to the depreciation allocable to the portion of the tax year before the date of death.

The decedent's estate and beneficiaries calculate depreciation using their own basis in the property. Since the anti-throwing rules do not apply to transfers by death [I.R.C. §168(f)(5)(A)(I) and former I.R.C. §168(e)(4)(H)], the MACRS rules apply to inherited property.

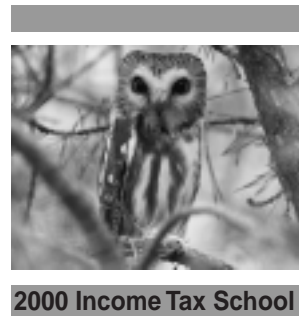
Example 28. At the time of her death on September 1, 2000, Gwen owned 5-year property that she had placed in service in 1998. Her unadjusted basis in the property was \$10,000. Therefore, Gwen would have claimed $19.2\% \times \$10,000 = \$1,920$ of depreciation expense if she had lived. The property had an FMV of \$15,000 on the date of her death. Gwen's estate continues to hold the property for use in a trade or business and elects a 12-month tax year for its first year.

Since she lived for only 8 months of that tax year, $8/12 \times \$1,920 = \$1,280$ can be claimed as depreciation on Gwen's final return.

Gwen's estate can claim $\$15,000 \times 20\% = \$3,000$ of depreciation for its first year.

2000 Workbook

Observation. If an estate's first year is less than a full year, the estate must use the short-year depreciation rules discussed earlier.



2000 Income Tax School

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