Chapter 13: Depreciation

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

EXPENSES THAT MUST BE CAPITALIZED

"Should the repair be expensed or capitalized?" is a question that every tax practitioner faces each tax season on a significant number of clients' returns.

The issue of whether an expense is currently deductible as a repair or is capitalized and subsequently depreciated is usually resolved based on opinion. The purpose of this chapter is to address this problematic area by providing an in-depth review of the statutory and regulatory authorities. It will also summarize recent court case findings and IRS documents in an attempt to provide guidance to tax practitioners.

Capital improvements are generally viewed as an **expenditure** that will:

- Last for **more than one year,**
- **Do more than restore** the property/asset to its previous condition,
- **Change the use** of the property, or
- Substantially **increase the value** of the property/asset.

STATUTORY AND REGULATORY AUTHORITIES

IRC §161, Allowance of Deductions

In computing taxable income under IRC §63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (IRC §261 and following, relating to the items not deductible).

13

IRC §263, Capital Expenditures

A. General Rule

No deduction shall be allowed for—

1. *Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.*

Treas. Reg. §1.162-4, Repairs.

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the *cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with §167 or charged against the depreciation reserve if such account is kept.*

Discussion

The Code citations are fairly broad, with IRC §161 allowing deductions, but only within the specific constraints of IRC §261 and IRC §263.

The final regulations under IRC §162 (Trade or Business Expenses), in this instance Treas. Reg. §1.162.4, provide significant guidance regarding what constitutes a repair and what constitutes a capital expenditure. Breaking this short regulatory paragraph into its components results in the following:

The following **key words** are more indicative to **repairs:**

- Incidental
- Not adding value
- Not appreciably prolonging its life
- Keeps in an ordinary operating condition
- Cost not added to basis

On the other hand, these **key words** are an indication the expenditure is a **capital improvement:**

- In nature of replacements
- Arrest deterioration
- Appreciably prolong the life of the property

However, even given these characteristics, a specific expenditure can be classified as either a repair or a capital improvement. There are numerous court cases on this subject, and the more relevant cases have been reported annually in the Rulings and Cases Chapter of this annual publication.

Significant Court Cases and IRS Documents

ILM 199924044. The IRS plans to scrutinize faster write-offs of tangible personal property in real estate properties. This focuses on the "component method" of allocating costs to the personal property within a real estate property versus the costs associated with the structure, land, building improvements, and so on.

FSA 199949003. Cost of cleaning exteriors of buildings currently deductible.

The costs of sandblasting, cleaning, and tuck-pointing are held to be deductible.

PLR 200152016. Costs incurred with general renovation must be capitalized.

The IRS reaffirms the otherwise deductible repairs incurred in a general renovation must be capitalized and recovered through depreciation deductions.

***Michael A. and Frances Y. McGrath v. Commr., TC Memo 2002-231*, 84 TCM 310, September 18, 2002.**

Taxpayers entered into a lease wherein they were required to make substantial improvements to the leasehold property. Taxpayers deducted over $111,000 in construction costs, but the court held for the IRS that these costs were capital improvements and recoverable through depreciation (cost recovery) deductions. Taxpayers also argued that if they were not sustained by the court on the deductibility of these costs, that some of the costs should be eligible for IRC §179. The court held that a timely IRC §179 deduction had not been made, and therefore was not allowable.

***Nevia Campbell v. Commr., TC Summary Opinion 2002-117*, September 6, 2002.**

A residential rental house owner was entitled to deduct the cost of removing and replacing the roof-covering material on the house as a trade or business expense. By not replacing or substituting the roof, the taxpayer did not prolong the life of her property, increase its value, or make it adaptable to another use. Rather, she repaired the roof to prevent leakage and keep her rental house in operating condition. Thus, the expense was not a capital expenditure.

Facts. Nevia Campbell lived in Long Beach, CA, and owned a one-story residential rental house. The roof began leaking and moisture began seeping through the walls into the main bedroom of the house. Ms. Campbell could not continue to rent the house while the roof leaked.

Contractors removed the existing top layers of the roof and recovered it with fiberglass sheets and hot asphalt. They made no structural changes to the roof. Removing and replacing of the roof-covering material on the roof of the rental house cost $8,000.

Court Summary. The issue in this case was previously considered by the Court in *Oberman*.[1] In that case, the Court held that the cost of removing and replacing roof-covering material (as well as the cost of inserting an expansion joint in the roof) was a deductible expense. The Court observed that "it is necessary to take into consideration the purpose for which an expenditure is made in order to determine whether such expenditure is capital in nature or constitutes a current expense."[2] The Court in *Oberman Manufacturing Co*. observed that the taxpayer's only purpose was to prevent leakage and keep the leased property in an operating condition over its probable useful life and not to prolong the life of the property, increase its value, or make it adaptable to another use. There was no replacement or substitution of the roof. As in *Oberman Manufacturing Co*., Campbell's expenditure merely restored her rental house to one with a roof free of leaks. The Tax Court held that Campbell was entitled to deduct the expenditure in issue.

> **Note.** This case was argued by the taxpayer pro se in the small tax court. The author used this case in a major IRS audit in the Minneapolis, MN, area and the represented taxpayer was allowed to deduct over $30,000 in asphalt roof reshingling of three residential apartment buildings. It appears the court believes a "roof" is far more than just the top covering, and although not stated specifically, would include the trusses, sheathing, paper, and shingles (or flat roof materials as in this case). The author believes this case will allow more taxpayers to challenge the IRS on the deductibility of the most common types of roof repair. It is important to keep in mind that "substantial authority" transgresses district boundaries. Tax practitioners nationwide can rely on this case without fear of the substantial understatement penalty assessment. However, the IRS may continue to pursue positions contrary to this case.

DEPRECIATION COMPUTATIONS: IRC §1031 EXCHANGE OR IRC §1033 INVOLUNTARY CONVERSION

The basis of property acquired in a transaction to which IRC §§1031 or 1033 applies, generally is the same as the property surrendered, less any cash received, plus any gain recognized. However, prior to Cumulative Bulletin Notice 2000-4, 2000-1 CB 313 (January 4, 2000), there was little guidance and much confusion about how to depreciate the basis of the acquired property.

Under ACRS (1981–1986), the replacement property was treated as two separate assets. The extent to which the replacement property's basis did not exceed the basis of the relinquished property, the relinquished property's depreciation method and depreciable life continued. The extent to which the replacement property's basis exceeded the relinquished property's basis, the excess was treated as new property, subject to the depreciation methods and useful-lives in place at that time of the exchange. Obviously, for an ACRS property exchanged after 1986 where the depreciable basis increased significantly, this outcome was a disadvantage for the owner due to the difference between ACRS and MACRS methods and use-lives.

Prop. Reg. §1.168-5, dated February 16, 1984, followed the ACRS theory of "two separate assets." However, these regulations were never finalized, and with the use of MACRS for post-1986 acquisitions, these regulations left many tax professionals unsure as to its application. As a result, prior to Notice 2000-4, many professionals followed these proposed regulations using the "two separate assets" theory, while others simply depreciated the replacement asset basis as a new property using the depreciation methods and use-lives in effect in the acquisition year.

Notice 2000-4 resolves all doubts and specifies how the basis of the replacement property is to be allocated for depreciation purposes. These rules are effective for MACRS property acquired on or after January 3, 2000.

Notice 2000-4 states:

For acquired MACRS property placed in service on or after January 3, 2000, in a like-kind exchange of MACRS property under IRC 1031 or as a result of an involuntary conversion of MACRS property under IRC 1033, a taxpayer must follow the principles set out in this notice.

For purposes of determining the depreciation allowable for MACRS property acquired in an exchange of MACRS property for like-kind property to which IRC 1031 applies, or acquired in replacement of involuntarily converted MACRS property to which IRC 1033 applies, the acquired MACRS property should be treated in the same manner as the exchanged or involuntary converted MACRS property with respect to so much converted MACRS property. Thus, the acquired MACRS property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, the exchanged or involuntarily converted MACRS property. Any excess of the basis in the acquired MACRS property over the adjusted basis in the exchanged or involuntarily converted MACRS property is treated as newly purchased MACRS property.

Note. This means the exchanged or converted property continues to be depreciated under the existing method and life. The basis of the newly acquired asset is depreciated using methods and lives available on the date of acquisition. This results in two different line items on a depreciation detail schedule for the same asset.

For acquired MACRS property placed in service before January 3, 2000, in a like-kind exchange of, or as a result of an involuntary conversion of, MACRS property, the IRS is aware that that taxpayers are depreciating this acquired property under either the 1984 regulations or, as newly purchased MACRS property. The IRS will allow a taxpayer to continue to use its present method of depreciating the acquired property and will treat these methods as allowable methods of depreciation. However, a taxpayer presently treating the acquired property as newly purchased MACRS property may change to treating the property under the principles in this notice, provided the property has been treated by the taxpayer as acquired in an IRC 1031 like-kind exchange or IRC 1033 involuntary conversion and the change is made for the first or second taxable year ending after January 3, 2000.

The following example illustrates the basis computation of the replacement property which then provides the user with numbers to be used in calculating the depreciation deductions for years following the IRC §1031 exchange.

Example 1. Terri purchased a single-family rental in 1989 for $70,000. At the time of purchase, she allocated $15,000 of the purchase price to land and the remaining $55,000 to the structure. She used MACRS 27½ for depreciating the structure. For the period she owned the property, through December 31, 2002, she claimed a total of $28,000 of depreciation using the straight-line method. On January 1, 2003, Terri sold the property through an IRC §1031 exchange, and on January 2, 2003, closed on the purchase of the replacement property. (Assume that all IRC §1031 requirements were met, including like-kind, identification rules and timing, and closing rules)

Information on Property Sold	Total	Land	Building
Selling Price	$160,000	$20,000	$140,000
Selling Expenses*	14,000	1,750	12,250
Adjusted Basis	42,000	15,000	27,000
IRC §1031 Fees*	400	50	350
Debt on property at closing*	36,000	4,500	31,500

*Allocated based on FMV of land and building

Information on Property Acquired	Total	Land	Building
Purchase Price	$262,000	$42,000	$220,000
Acquisition Expenses*	2,000	320	1,680
IRC §1031 Fees*	400	64	336
Debt on property at closing*	130,000	20,800	109,200

*Allocated based on FMV of land and building

The following computations reflect the basis of the replacement land and the replacement building. It is the basis in the replacement building, $121,544, that must be compared to the basis in the relinquished building, $27,000, for purposes of computing depreciation deduction for 2003 and later years. The following worksheets are courtesy of CFS Tax Tools and are part of a software program that provides many useful computations and worksheets for tax practitioners.

Equity Balancing Worksheet — Total

(For use in determining Cash Given or Received)

1. FMV of like-kind property given up	$160,000
2. FMV of unlike property/services given up (Pt III Ln 9)	
3. Total FMV of like and unlike property given up (Ln 1 + Ln 2)	160,000
4. Liabilities given up with property (Pt III Ln 7)	36,000
5. Equity in like/unlike property given up (Ln 3 − Ln 4)	124,000
6. FMV of like-kind property received (Pt IV Ln 1)	262,000
7. FMV of unlike property/services received (Pt III Ln 12+ 13)	0
8. Total FMV of like and unlike property received (Ln 6 + Ln 7)	262,000
9. Liabilities received/assumed with property (Pt III Ln 8)	130,000
10. Equity in like/unlike property received (Ln 8 − Ln 9)	132,000
11. Cash Given/(Received) (Ln 10 − Ln 5)	8,000

(Neg. amount is cash received, and should equal amount on Line 1 of Part III)

(Pos. amount is cash given, and should equal amount on Line 2 of Part III)

13

Tax Deferred Exchange Worksheet — Total

Part I — Adjusted Basis Of Property Given Up: Like-Kind

Description of property given up: Single Family Rental

1.	Original cost or other basis		$ 70,000	
2.	Improvements			
3.	Total (Ln 1 + Ln 2)			$ 70,000
4.	Depreciation/ACRS/MACRS allowed or allowable		28,000	
5.	Casualty losses deducted			
6.	Investment/energy credits claimed			
7.	Deferred gain			
8.	Total (Sum, Lns 4 through 7)			28,000
9.	Adjusted Basis (Ln 3 − Ln 8)			42,000

Part II — Adjusted Basis of Property Given Up: Unlike

Description of property given up:

1.	Original cost or other basis			
2.	Improvements			
3.	Total (Ln 1 + Ln 2)			0
4.	Depreciation/ACRS/MACRS allowed or allowable			
5.	Casualty losses deducted			
6.	Investment/energy credits claimed			
7.	Deferred gain			
8.	Total (Sum, Lns 4 through 7)			0
9.	Adjusted basis (Ln 3 − Ln 8)			0

Part III — Boot Received

1.	Cash received			
2.	Cash paid	$ 8,000		
3.	Expenses incurred for exchange	16,800		
4.	Total (Ln 2 + Ln 3)		24,800	
5.	Net cash paid (Ln 1 − Ln 4) or			0
6.	Net cash paid (Ln 4 − Ln 1)	24,800		
7.	Liabilities given up		36,000	
8.	Liabilities received	130,000		
9.	FMV of unlike property/services given			
10.	Total (Sum, Lns 6, 8, 9)		154,800	
11.	Net liabilities (Ln 7 − Ln 10, must > 0)			0
12.	FMV of unlike property received			
13.	FMV of services received			
14.	Total boot received (Sum, Lns 5, 11, 12, 13)			0

Tax Deferred Exchange Worksheet — Total (continued)

Part IV — Realized Gain or Loss			
1. FMV of like-kind property received		$262,000	
2. FMV of unlike property received			
3. FMV of services received			
4. Cash received			
5. Liabilities given up		36,000	
6. Exchange price (Sum, Lns 1 through 5)			$298,000
7. Adjusted basis of like-kind property given up		42,000	
8. Adjusted basis of unlike property given up		0	
9. Cash paid		8,000	
10. Expenses incurred for exchange		16,800	
11. Liabilities received		130,000	
12. Basis of property given up (Sum, Lns 7 through 11)			196,800
13. Realized gain or loss (Ln 6 − Ln 12)			101,200
Part V — Recognized Gain or Loss			
Recognized gain or loss in unlike property given up:			
1. FMV of unlike property/services given up			
2. Adjusted basis of unlike property given up		0	
3. Recognized gain/loss on unlike property (Ln 1 − Ln 2			0
Recognized gain on the exchange of like-kind property			
4. Total boot received (Pt III Ln 14)		0	
5. Realized gain/loss (Pt IV Ln 13)	$101,200		
6. Gain/loss (Pt V Ln 3, gain entered as negative, loss as positive)	0		
7. Total (Ln 5 + Ln 6)		101,200	
8. Recognized gain on like-kind property (lesser of Ln 4 or Ln 7)			0
Part VI — Basis of Property Received			
1. Adjusted basis of like-kind property given up		42,000	
2. Adjusted basis of unlike property given up		0	
3. Cash paid		8,000	
4. Expenses incurred for exchange		16,800	
5. Liabilities received		130,000	
6. Gain recognized on exchange		0	
7. Total (Sum, Lns 1 through 6)			196,800
8. Cash received			
9. Liabilities given up		36,000	
10. Loss recognized on exchange		0	
11. Total (Sum, Lns 8 through 10)			36,000
12. Basis of all property acquired (Ln 7 − Ln 11)			160,800
13. FMV of unlike property received			
14. FMV of services received			
15. Total (Ln 13 + Ln 14)			0
16. Basis of like-kind property received (Ln 12 − Ln 15)			160,800

Equity Balancing Worksheet — Land

(For use in determining Cash Given or Received)

1.	FMV of like-kind property given up	$20,000
2.	FMV of unlike property/services given up (Pt III Ln 9)	
3.	Total FMV of like and unlike property given up (Ln 1 + Ln 2)	20,000
4.	Liabilities given up with property (Pt III Ln 7)	4,680
5.	Equity in like/unlike property given up (Ln 3 − Ln 4)	15,320
6.	FMV of like-kind property received (Pt IV Ln 1)	42,000
7.	FMV of unlike property/services received (Pt III Ln 12+ 13)	0
8.	Total FMV of like and unlike property received (Ln 6 + Ln 7)	42,000
9.	Liabilities received/assumed with property (Pt III Ln 8)	20,800
10.	Equity in like/unlike property received (Ln 8 − Ln 9)	21,200
11.	Cash Given/(Received) (Ln 10 − Ln 5)	5,880

(Neg. amount is cash received, and should equal amount on Line 1 of Part III)

(Pos. amount is cash given, and should equal amount on Line 2 of Part III)

Tax Deferred Exchange Worksheet — Land

Part I — Adjusted Basis Of Property Given Up: Like-Kind

Description of property given up: Land

1. Original cost or other basis		$15,000	
2. Improvements			
3. Total (Ln 1 + Ln 2)			$15,000
4. Depreciation/ACRS/MACRS allowed or allowable			
5. Casualty losses deducted			
6. Investment/energy credits claimed			
7. Deferred gain			
8. Total (Sum, Lns 4 through 7)			0
9. Adjusted Basis (Ln 3 − Ln 8)			15,000

Part II — Adjusted Basis of Property Given Up: Unlike

Description of property given up:

1. Original cost or other basis			
2. Improvements			
3. Total (Ln 1 + Ln 2)			0
4. Depreciation/ACRS/MACRS allowed or allowable			
5. Casualty losses deducted			
6. Investment/energy credits claimed			
7. Deferred gain			
8. Total (Sum, Lns 4 through 7)			0
9. Adjusted basis (Ln 3 − Ln 8)			0

Part III — Boot Received

1. Cash received			
2. Cash paid	$ 5,880		
3. Expenses incurred for exchange	2,256		
4. Total (Ln 2 + Ln 3)		8,136	
5. Net cash paid (Ln 1 − Ln 4) or			0
6. Net cash paid (Ln 4 − Ln 1)	8,136		
7. Liabilities given up		4,680	
8. Liabilities received	20,800		
9. FMV of unlike property/services given			
10. Total (Sum, Lns 6, 8, 9)		28,936	
11. Net liabilities (Ln 7 − Ln 10, must > 0)			0
12. FMV of unlike property received			
13. FMV of services received			
14. Total boot received (Sum, Lns 5, 11, 12, 13)			0

13

Tax Deferred Exchange Worksheet — Land (continued)

Part IV — Realized Gain or Loss

1. FMV of like-kind property received		$42,000	
2. FMV of unlike property received			
3. FMV of services received			
4. Cash received			
5. Liabilities given up		4,680	
6. Exchange price (Sum, Lns 1 through 5)			$46,680
7. Adjusted basis of like-kind property given up		15,000	
8. Adjusted basis of unlike property given up		0	
9. Cash paid		5,880	
10. Expenses incurred for exchange		2,256	
11. Liabilities received		20,800	
12. Basis of property given up (Sum, Lns 7 through 11)			43,936
13. Realized gain or loss (Ln 6 − Ln 12)			2,744

Part V — Recognized Gain or Loss

Recognized gain or loss in unlike property given up:

1. FMV of unlike property/services given up			
2. Adjusted basis of unlike property given up		0	
3. Recognized gain/loss on unlike property (Ln 1 − Ln 2			0

Recognized gain on the exchange of like-kind property

4. Total boot received (Pt III Ln 14)		0	
5. Realized gain/loss (Pt IV Ln 13)	$2,744		
6. Gain/loss (Pt V Ln 3, gain entered as negative, loss as positive)	0		
7. Total (Ln 5 + Ln 6)		2,744	
8. Recognized gain on like-kind property (lesser of Ln 4 or Ln 7)			0

Part VI — Basis of Property Received

1. Adjusted basis of like-kind property given up		15,000	
2. Adjusted basis of unlike property given up		0	
3. Cash paid		5,880	
4. Expenses incurred for exchange		2,256	
5. Liabilities received		20,800	
6. Gain recognized on exchange		0	
7. Total (Sum, Lns 1 through 6)			43,936
8. Cash received			
9. Liabilities given up		4,680	
10. Loss recognized on exchange		0	
11. Total (Sum, Lns 8 through 10)			4,680
12. Basis of all property acquired (Ln 7 − Ln 11)			39,256
13. FMV of unlike property received			
14. FMV of services received			
15. Total (Ln 13 + Ln 14)			0
16. Basis of like-kind property received (Ln 12 − Ln 15)			39,256

Equity Balancing Worksheet — Building

(For use in determining Cash Given or Received)

1.	FMV of like-kind property given up	$140,000
2.	FMV of unlike property/services given up (Pt III Ln 9)	
3.	Total FMV of like and unlike property given up (Ln 1 + Ln 2)	140,000
4.	Liabilities given up with property (Pt III Ln 7)	31,320
5.	Equity in like/unlike property given up (Ln 3 − Ln 4)	108,680
6.	FMV of like-kind property received (Pt IV Ln 1)	220,000
7.	FMV of unlike property/services received (Pt III Ln 12+ 13)	0
8.	Total FMV of like and unlike property received (Ln 6 + Ln 7)	220,000
9.	Liabilities received/assumed with property (Pt III Ln 8)	109,200
10.	Equity in like/unlike property received (Ln 8 − Ln 9)	110,800
11.	Cash Given/(Received) (Ln 10 − Ln 5)	2,120

(Neg. amount is cash received, and should equal amount on Line 1 of Part III)

(Pos. amount is cash given, and should equal amount on Line 2 of Part III)

Tax Deferred Exchange Worksheet — Building

Part I — Adjusted Basis Of Property Given Up: Like-Kind

Description of property given up: Building

1. Original cost or other basis		$ 55,000	
2. Improvements			
3. Total (Ln 1 + Ln 2)			$55,000
4. Depreciation/ACRS/MACRS allowed or allowable		28,000	
5. Casualty losses deducted			
6. Investment/energy credits claimed			
7. Deferred gain			
8. Total (Sum, Lns 4 through 7)			28,000
9. Adjusted Basis (Ln 3 − Ln 8)			27,000

Part II — Adjusted Basis of Property Given Up: Unlike

Description of property given up:

1. Original cost or other basis			
2. Improvements			
3. Total (Ln 1 + Ln 2)			0
4. Depreciation/ACRS/MACRS allowed or allowable			
5. Casualty losses deducted			
6. Investment/energy credits claimed			
7. Deferred gain			
8. Total (Sum, Lns 4 through 7)			0
9. Adjusted basis (Ln 3 − Ln 8)			0

Part III — Boot Received

1. Cash received			
2. Cash paid	$ 2,120		
3. Expenses incurred for exchange	14,544		
4. Total (Ln 2 + Ln 3)		16,664	
5. Net cash paid (Ln 1 − Ln 4) or			0
6. Net cash paid (Ln 4 − Ln 1)	16,664		
7. Liabilities given up		31,320	
8. Liabilities received	109,200		
9. FMV of unlike property/services given	0		
10. Total (Sum, Lns 6, 8, 9)		125,864	
11. Net liabilities (Ln 7 − Ln 10, must > 0)			0
12. FMV of unlike property received			
13. FMV of services received			
14. Total boot received (Sum, Lns 5, 11, 12, 13)			0

Tax Deferred Exchange Worksheet — Building (continued)

Part IV — Realized Gain or Loss

1. FMV of like-kind property received		$220,000	
2. FMV of unlike property received			
3. FMV of services received			
4. Cash received			
5. Liabilities given up		31,320	
6. Exchange price (Sum, Lns 1 through 5)			$251,320
7. Adjusted basis of like-kind property given up		27,000	
8. Adjusted basis of unlike property given up		0	
9. Cash paid		2,120	
10. Expenses incurred for exchange		14,544	
11. Liabilities received		109,200	
12. Basis of property given up (Sum, Lns 7 through 11)			152,864
13. Realized gain or loss (Ln 6 − Ln 12)			98,456

Part V — Recognized Gain or Loss

Recognized gain or loss in unlike property given up:			
1. FMV of unlike property/services given up			
2. Adjusted basis of unlike property given up		0	
3. Recognized gain/loss on unlike property (Ln 1 − Ln 2			0
Recognized gain on the exchange of like-kind property			
4. Total boot received (Pt III Ln 14)		0	
5. Realized gain/loss (Pt IV Ln 13)	$98,456		
6. Gain/loss (Pt V Ln 3, gain entered as negative, loss as positive)	0		
7. Total (Ln 5 + Ln 6)		98,456	
8. Recognized gain on like-kind property (lesser of Ln 4 or Ln 7)			0

Part VI — Basis of Property Received

1. Adjusted basis of like-kind property given up		27,000	
2. Adjusted basis of unlike property given up		0	
3. Cash paid		2,120	
4. Expenses incurred for exchange		14,544	
5. Liabilities received		109,200	
6. Gain recognized on exchange		0	
7. Total (Sum, Lns 1 through 6)			152,864
8. Cash received			
9. Liabilities given up		31,320	
10. Loss recognized on exchange		0	
11. Total (Sum, Lns 8 through 10)			31,320
12. Basis of all property acquired (Ln 7 − Ln 11)			121,544
13. FMV of unlike property received			
14. FMV of services received			
15. Total (Ln 13 + Ln 14)			0
16. Basis of like-kind property received (Ln 12 − Ln 15)			121,544

Accordingly, the remaining basis of $27,000 must be depreciated as if the property were still owned by Terri, and the balance depreciated over the remainder of the 27$^1/_2$-year life as established when the property was placed in service in 1989. The annual depreciation deduction of $2,000 will continue until that part of the basis in the new property is used up. (13$^1/_2$ years). The balance of the replacement building basis must be set up as newly acquired MACRS property, in this case 27$^1/_2$-year property, and depreciation deductions calculated starting January 3, 2003. The calculations follow:

Replacement building basis	$121,544
Less: original basis	(27,000)
Excess basis	$ 94,544
× depreciation %	× .03485
Depreciation on excess basis for 2003	$ 3,295

Note. Notice 2000-4 provides a simplified method for depreciation of properties acquired through either IRC §1031 exchanges or IRC §1033 involuntary conversions. To the extent that the taxpayer has remaining basis in the relinquished property that transfers over to the replacement property, the taxpayer will generally benefit by higher depreciation deductions. This is illustrated by the previous example. The remaining basis of $27,000 in the relinquished building continues over the remaining original life, resulting in a $2,000 annual deduction. If the $27,000 were added in to the basis of the replacement building with depreciation starting over again, the same $27,000 basis would have resulted in a depreciation deduction of less than $1,000.

Example 2. Hoff Enterprises, Inc. purchased a used over-the-road tractor unit (three-year property) for $90,000 in 2001. The company traded this unit for a new tractor unit on January 1, 2003. The cost of the new tractor unit was $155,000. Hoff Enterprises was allowed a trade-in value of $55,000, and paid the $100,000 difference through a bank loan. Hoff Enterprises' basis in the new truck is $119,998. This consists of the adjusted basis in the old tractor unit, $19,998, plus the $100,000 cash paid for the new tractor unit. Hoff Enterprises is treated as:

1. Continuing to own the old tractor unit and continuing to claim the remainder of the depreciation for years 2003 and 2004. This will result in the original $90,000 basis being written down to zero.
2. Purchasing a new tractor unit on January 1, 2003 for $100,000 ($119,998 basis for the new tractor unit minus the $19,998 remaining basis in the old tractor unit) which it may depreciate the new unit as three-year property under MACRS for the tax years 2003–2006.

RELINQUISHED PROPERTY UNDER T.D. 9091

On September 5, 2003, the IRS released T.D. 9091 for guidance on the additional depreciation allowance. This guidance contains final and temporary regulations. One of the regulations deals with like-kind exchanges and involuntary conversions. The House Committee Report for JGTRRA of 2003 said, "The Committee wishes to clarify that the adjusted basis of qualified property acquired by a taxpayer in a like-kind exchange or involuntary conversion is eligible for the additional first year depreciation deduction."

Following IRS Notice 2000-4, this means that the 30%/50% bonus depreciation will also be allowed on the unrecovered cost of property relinquished in a like-kind exchange. Consequently, taxpayers who take the additional 30%/50% depreciation will no longer be able to use the existing MACRS tables to calculate depreciation by multiplying the table percentage by the original cost. They will need to multiply the table percentage by the original cost less the 50% bonus claimed.

Under the Temporary Regulations, the IRS notes that the only prohibition against claiming the bonus depreciation on a trade occurs when a taxpayer acquires an asset and disposes of it in the same year. That is consistent with prior regulations disallowing regular depreciation on assets acquired and disposed of in the same year. But, the Temporary Regulations do allow a 50% bonus depreciation allowance for property acquired and placed in service after May 5, 2003, that had been acquired in a 2002 trade where the property qualified for the 30% depreciation allowance.

CALCULATING 200% MACRS DEPRECIATION WITHOUT USING OPTIONAL TABLES

For some tax practitioners, it may be easier to calculate depreciation without using the MACRS optional tables. The following steps are required:

1. The depreciable life of the asset must be determined.
2. The unrecovered basis of the asset is divided by its useful life and then multiplied by two.
3. The result of step 2 is multiplied by the applicable convention to adjust for the first year.
4. If the resulting depreciation is less than what would be computed using straight line depreciation, then switch to the straight line method for the remaining life of the asset.

The following table shows the applicable year to switch to the straight line method:

Class of Property	Year of Switch
3-year	3
5-year	4
7-year	5
10-year	7
15-year	7
20-year	9

Example 3. Grady acquired a $100,000 7-year property on July 1, 2003. The yearly depreciation amount, without using the optional tables or the 50% special depreciation allowance, is computed as follows:

Year	Depreciation	Remaining Basis	Calculation
1	$14,285.71	$85,714.29	$((100,000 \div 7) \times 2) \div 2$
2	24,489.80	61,224.49	$(85,714.29 \div 7) \times 2$
3	17,492.71	43,731.78	$(61,224.49 \div 7) \times 2$
4	12,494.79	31,236.98	$(43,731.78 \div 7) \times 2$
5	8,924.85	22,312.13	$(31,236.98 \div 3.5)$
6	8,924.85	13,387.28	$(31,236.98 \div 3.5)$
7	8,924.85	4,462.43	$(31,236.98 \div 3.5)$
8	4,462.43	0	
Total	$100,000.00		

The final year's depreciation allowance should equal 50% of the prior years allowance because of the half-year convention. The total depreciation over the life of the asset should equal the original cost of the asset.

13

Understanding this computation is important if the purchase is part of a like-kind exchange and the taxpayer uses the 30%/50% special depreciation allowance. The adjusted basis of the exchanged asset will be eligible for a 30%/50% depreciation deduction in the year of the exchange.

Example 4. Jens purchases a new combine on May 20, 2000 for $100,000. He trades the combine each year for a new combine and pays $25,000 "boot" plus the old combine. Jens claims the 50% depreciation on the 2003 trade and consequently also claims 50% of the remaining basis on each of the prior combines that is still being depreciated. Jens' 2003 depreciation is calculated as follows:

Combine
Acquired: May 20, 2000
Cost: $100,000.00

Year	Depreciation	Remaining Basis
		$100,000.00
2000	$ 14,285.71	85,714.29
2001	24,489.80	61,224.49
2002	17,492.71	43,731.78
2003 — 50%	21,865.89	21,865.89
2003	6,247.40	15,618.49
2004	4,462.43	11,156.06
2005	4,462.43	6,693.63
2006	4,462.43	2,231.20
2007	2,231.20	0
Total	$100,000.00	

Traded: May 20, 2001
Boot Paid: $25,000.00

Year	Depreciation	Remaining Basis
		$25,000.00
2001	$ 3,571.43	21,428.57
2002	6,122.45	15,306.12
2003 — 50%	7,653.06	7,653.06
2003	2,186.59	5,466.47
2004	1,561.85	3,904.62
2005	1,115.61	2,789.02
2006	1,115.61	1,673.41
2007	1,115.61	557.80
2008	557.80	0
Total	$25,000.00	

Traded: May 20, 2002
Boot Paid: $25,000.00

Year	Depreciation	Remaining Basis
		$25,000.00
2002	$ 3,571.43	21,428.57
2003 — 50%	10,714.29	10,714.29
2003	3,061.22	7,653.06
2004	2,186.59	5,466.47
2005	1,561.85	3,904.62
2006	1,115.61	2,789.02
2007	1,115.61	1,673.41
2008	1,115.61	557.80
2009	557.80	0
Total	$25,000.00	

Traded: May 20, 2003
Boot Paid: $25,000.00

Year	Depreciation	Remaining Basis
		$12,500.00
2003	1,785.71	10,714.29
2004	1,530.61	9,183.67
2005	1,311.95	7,871.72
2006	1,124.53	6,747.19
2007	1,927.77	4,819.42
2008	1,927.77	2,891.65
2009	1,927.77	963.88
2010	963.88	0
Total	$25,000.00	

Summary 2003 Depreciation

2000 — 50%	$21,865.89
2000 — Regular	6,247.40
2001 — 50%	7,653.06
2001 — Regular	2,186.59
2002 — 50%	10,714.29
2002 — Regular	3,061.22
2003 — 50%	12,500.00
2003 — Regular	1,785.71
Total	$66,014.16

If the House Committee had not allowed the 50% depreciation on the adjusted basis of the exchange property, Jens' total 2003 depreciation would have been $46,647.23 or $19,366.93 less.

CORRECTING PAST DEPRECIATION DEDUCTION ERRORS (CATCH-UP DEPRECIATION)

Example 5. On June 8, 2003, Ralph meets with a new client, Sandy. Sandy wants Ralph to assume the bookkeeping and tax preparation related work for her small machine tool business. The business started in 1970. As part of the interview process, Ralph reviews the business' extensive depreciation schedule. Ralph discovers the following errors:

13

1. A lathe acquired in June 2000 was never entered on the depreciation schedule. It cost $42,000. This lathe is 7-year MACRS property.

2. Building improvements, consisting of carpeting (office section), moveable drywall partitions, and other nonstructural changes were made. These items cost $46,000. These items were placed in service in June 1998. These items were improperly established as 39-year MACRS property instead of 7-year MACRS property.

Questions. What can be done? How are these obvious errors corrected? Are the years closed by the statute of limitations beyond the reach of the taxpayer? What happens to the basis of the property?

In a legal memorandum in 1999,[3] the IRS indicated that any change in the method of computing depreciation for a particular asset would be considered to be a change in the method of accounting requiring the IRS's advance approval. However, in contrast to that memorandum are Revenue Procedures 96-31, 97-37, 98-60, 99-49, and the most recent, Rev. Proc. 2002-9.

Revenue Procedure 2002-9, Section 2 (selected parts only)

Depreciation or amortization

.01 Impermissible to permissible method of accounting for depreciation or amortization

1. Description of change

a. This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization under which the taxpayer did not claim the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable.

b. A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required.

2. Scope

a. Applicability. This change applies to any taxpayer that used an impermissible method of accounting for depreciation in at least two taxable years immediately preceding the year of change, and is changing that accounting method to a permissible method of accounting for depreciation, for any item of property.

i. for which, under the taxpayer's impermissible method of accounting, the taxpayer has not taken into account any depreciation allowance or has taken into account some depreciation but less than or more than the depreciation allowable (claimed less than or more than the depreciation allowable).

4. Section 481(a) adjustment

Because the adjusted basis of the property is changed as a result of a method change,... items are duplicated or omitted. Accordingly, this change is made with an IRC 481(a) adjustment. This adjustment may result in either a negative IRC 481(a) adjustment (a decrease in taxable income) or a positive IRC 481(a) adjustment (an increase in taxable income), ... This IRC 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's former method of accounting, and the total amount of depreciation allowable for the property under the taxpayer's new method of accounting for, for open and closed years prior to the change.

5. Basis adjustment

As of the beginning of the year of change, the basis of depreciable property, ... must reflect the reductions required by IRC §1016(a)(2) for the depreciation allowable for the property

For accounting method changes applied for on Form 3115, *Application for Change in Accounting Method*, a number of different IRC §481 adjustment periods apply. Different adjustment periods apply based on whether the taxpayer is or is not under IRS examination. This discussion will focus only on the taxpayer **not** under IRS examination.

If a taxpayer is not under IRS examination, a taxpayer must generally take a **net positive** adjustment (net increase to taxable income) into account ratably over **four** years in computing taxable income, beginning with the year of change. The adjustment period for a **net negative** adjustment is also **four** years. (Originally, Rev. Proc. 96-31 allowed a negative adjustment to be taken in **one** year; however, all subsequent Revenue Procedures listed previously did not include that language.)

A de minimis exception is provided where the entire net adjustment (positive or negative) is **less than $25,000**. In this case, the taxpayer **may elect** to use a one-year adjustment period in place of the normal adjustment period.

> **Note.** The author believes most depreciation "catch-up" adjustments would be **negative** (decrease in taxable income). Depending on the amount of the overall net adjustment, the adjustment period would be either **one** year or ratably over **four** years.

Applying the results of these rules for **Example 5** follows:

Computation of Incorrect Deprecation
Claimed Versus Correct Depreciation

Tax Year	Depreciation Claimed	Correct Depreciation
Lathe		
2000	$ 0	$ 6,002
2001	0	10,286
2002	0	7,346
Total	$ 0	$23,634
Building Improvements		
1998	$ 640	$ 6,573
1999	1,179	11,265
2000	1,179	8,045
2001	1,179	5,745
2002	1,179	4,108
Total	$5,356	$35,736
Net Adjustment Computation		
Lathe		($23,634)
Building Improvements ($35,736 – $5,356)		(30,380)
Net negative IRC §481(a) Adjustment		($54,014)

This adjustment would decrease taxable income by $13,504 each year for four years, starting in 2003. The basis of each property would be adjusted to reflect the depreciation deductions that should have been claimed, as of January 1, 2003, even though the correction of the prior years "under deduction" is taken into account over tax years 2003, 2004, 2005, and 2006.

TABLE OF ASSET CLASSES AND USE-LIVES

EXAMPLES OF PROPERTY INCLUDED IN RECOVERY PERIODS

3-Year Property (ADR Class Life of Four Years or Less):

- Breeding hogs
- Over-the-road tractor (semi-tractor)
- Horses assigned to three-year class under prior law (race horse more than 2 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)

5-Year Property (ADR 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 (not in the airline sense)
- Trailers (semi-trailers and other 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 sub-dividers and developers, and others, except railroads
- Logging machinery and equipment
- Research and experimentation property
- Solar and wind energy properties
- Personal property within residential real estate (carpeting, drapes, etc.)

7-Year Property (ADR Class Life of 10 Years or More but Less Than 16 Years):

- Personal property within nonresidential real estate (carpeting, movable drywall partitions, and much more).
- 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 stadiums, 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.)

10-Year Property (ADR 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 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

15-Year Property (ADR 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 IRC §1245 property or IRC §1250 property, provided such improvements are depreciable. Examples of such assets 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 IRC §1250 assets, including service station buildings and depreciable land improvements, whether IRC §1245 or IRC §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 IRC §1245 property or IRC §1250 property. Excludes all other land improvements.

20-Year Property (ADR Class Life of 25 Years or More Other Than IRC §1250 Property with Class Life of 27½ Years or More):

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

Residential Rental Property (27½-Year Recovery Period)

- Building or structure if 80% or more of the gross rental income is rental income from dwelling units.[4] 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.

Nonresidential Real Property (39-Year Recovery Period for Property Placed in Service on or after May 13, 1993):

- IRC §1250 class property that is not residential rental property and does not have an ADR midpoint of less than 27½ years, and includes properties such as office buildings, stores, and warehouses

IRC §179 DEDUCTION

The IRC §179 deduction is perhaps one of the most significant tax planning considerations used to reduce current tax liabilities. While the overall limit has increased each year, the $100,000 limit enacted with JGTRRA will result in more attention being given to this deduction over the next several years. Critics of this deduction argue that the taxes saved with this deduction will only have to be repaid upon sale of the asset(s). Proponents argue that taxes saved today outweigh the cost of the depreciation recapture taxes due at sale. In either case, the Schedule C or F taxpayer will reduce both income and social security taxes via the IRC §179 deduction. Also, the recapture due upon sale will not be subject to social security taxation. The only exception is the recapture of the IRC §179 deduction when the business use of the asset falls to 50% or less.

From a tax-planning standpoint, many variables have to be taken into account to determine if the election of the IRC §179 deduction is appropriate to a specific taxpayer.

Some of the more common planning considerations are:

- Marginal tax bracket of the taxpayer.
- Profitability of the business and availability of other income to satisfy the taxable income limitation.
- Future marginal tax rates of the client.
- Other asset acquisitions during the year.
- Status of estimated tax payments made for the current year.
- Does the client need the asset for the business, or is the acquisition more tax motivated?
- Will the subject asset(s) be **sold or traded** in later years?
- Did the taxpayer purchase both shorter use-life and longer use-life assets?
- IRC §179 deduction used as an effective means to reduce possible vulnerability to repair versus capital improvement issues with the IRS.
- Allocation of IRC §179 from other entities.
- Use of IRC §179 and its impact on social security benefits.

QUALIFYING PROPERTY

The following property qualifies for the IRC §179 deduction:

1. Tangible personal property
2. Other tangible property (except buildings and their structural components) used as:
   - An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   - A research facility used in connection with any of the activities listed previously, or
   - A facility used in connection with any of those activities for the bulk storage of fungible commodities.
3. Single purpose agricultural (livestock) or horticultural structures
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum

Tangible Personal Property

Tangible personal property is any tangible property that is not real property. It includes the following property:

1. Machinery and equipment
2. Property contained in or attached to a building (other than structural components), such as refrigerators, grocery store counters, office equipment, printing presses, testing equipment, and signs
3. Gasoline storage tanks and pumps at retail service stations
4. Breeding livestock, including horses, cattle, hogs, sheep, goats, mink, and other furbearing animals

> **Note.** Land and land improvements, such as buildings and other permanent structures and their components, are real property, not personal property. Land improvements include swimming pools, paved parking areas, wharves, docks, bridges, and fences. However, agricultural fences do qualify for IRC §179.[5]

NONQUALIFYING PROPERTY

1. Certain Property Leased to Others

This rule applies only to **noncorporate** lessors, which means corporations can elect the IRC §179 deduction for property leased to others. However, even noncorporate lessors can elect the IRC §179 deduction for the cost of the following property:

A. Property that is manufactured or produced by the taxpayer and leased to others

B. Property that the taxpayer purchases and leases to others if both of the following tests are met:

- The term of the lease (including option to renew) is less than half of the property's class life.
- For the first 12 months after the property is transferred to the lessee, the total business deductions that the taxpayer is allowed on the property (other than rents and reimbursed amounts) are more than 15% of the rental income from the property.

2. Certain Property Used Predominantly to Furnish Lodging or in Connection with the Furnishing of Lodging

This rule basically eliminates the IRC §179 deduction on tangible personal property located within residential rental property with a uselife of 27$^1/_2$ years. For example, 5-year property such as carpeting, drapes, and appliances that are located within a residential apartment building are eligible for a faster depreciation write-off period (5 versus 27$^1/_2$) but are not eligible for the IRC §179 expensing election. However, the following types of property specifically do qualify for the IRC §179 election:

A. Nonlodging commercial facilities that are available to those not using the lodging facilities on the same basis as they are available to those using the lodging facilities

B. Property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients

C. Any certified historic structure to the extent its basis is due to qualified rehabilitation expenditures

D. Any energy property

3. Air Conditioning or Heating Units

4. Property Used Predominantly Outside the United States (except property described in IRC §168(g)(4) — commercial airliners, ships, containers, etc.)

5. Property Used by Certain Tax-Exempt Organizations (except property used in connection with the production of income subject to the tax on unrelated trade or business income)

6. Property Used by Governmental Units

7. Property Used by Foreign Persons or Entities

LIMITATION ON IRC §179 EXPENSING

The total cost that can be deducted under IRC §179, after application of the dollar limitation, is limited to the **taxable income** from the active conduct of any trade or business during the year. Generally, a taxpayer is considered to actively conduct a trade or business if they meaningfully participate in the management or operations of the trade or business.

Any costs not deductible in the current year under IRC §179 because of this limit can be carried over to the next year. There is no limit on the number of years to which the unused IRC §179 deduction can be carried.

Note. This is the only limitation that provides the carryover of unused IRC §179 from one year to another.

Definition of Taxable Income for Purposes of the Limitation on IRC §179

Taxable income is computed by totaling the net income and losses from all trades and businesses that the taxpayer actively conducted during the year. Net income or loss includes the following items:

- IRC §1231 gains (or losses)
- Interest from working capital from the trade or business
- Wages, salaries, tips, or other pay earned as an employee (including the spouse if married and filing a joint return)

In addition, **taxable income** is computed **without regard** to the following:

- The IRC §179 deduction
- The self-employment tax deduction
- Any net operating loss carryback or carryforward
- Any unreimbursed employee business expenses

Annual Limit on the IRC §179 Deduction

Prior to JGTRRA, the maximum amount of asset cost that could be expensed each year after 2002 was $25,000, with higher amounts for enterprise zones, qualified renewal property, and the special Liberty Zone property. In addition, the maximum annual expensing amount was subject to a $200,000 investment ceiling limitation and a taxable income limitation**.**

JGTRRA increased the maximum dollar amount that may be deducted to $100,000 for qualifying property placed in service in tax years beginning after 2002 and before 2006, with the $100,000 maximum adjusted for inflation after 2003. The new bill increases the previous $200,000 annual investment limit to $400,000 for qualifying property placed in service in tax years beginning after 2002 and before 2006.

Reduced Dollar Limit for Cost Exceeding $400,000

If the cost of qualifying IRC §179 property placed in service in a year exceeds $400,000, the annual limit on the IRC §179 deduction must be reduced (but not below zero) by the amount of cost over $400,000. If the cost of the IRC §179 property placed in service during 2003 is $500,000 or more, then no IRC §179 deduction can be claimed in the current year, and no carryover of the unused IRC §179 deduction can be claimed. Prior to JGTRRA, the annual investment limit was $200,000, but due to the substantial increase in the IRC §179 deduction, Congress felt that the $200,000 limit would have too much of an adverse impact on capital investment decisions.

Partners and Partnerships

The IRC §179 deduction limitations apply at the partnership level and each partner's individual level. There are **three IRC §179 limitations** that must be applied.

1. The maximum qualified property is $400,000.
2. The maximum expense election for 2003 is $100,000.
3. The expense election is limited to the taxpayer's business income.

Note. The IRC §179 expenses from a pass-through entity to an individual must be considered when applying the $100,000 expense limitation. If the combined IRC §179 expense exceeds $100,000, the amounts in excess will be lost completely. In addition, although the individual did not receive the tax benefit of the expense, her basis in the flow-through is still reduced.

Example 6. In 2003, Kay acquired qualifying property for less than $400,000 and has adequate business income to allow the full $100,000 IRC §179 expense election. Kay elects to expense $60,000 of qualified property.

In addition, Kay has ownership interest in a partnership. The partnership issues a K-1 reporting a flow-through IRC §179 expense of $50,000. The combination of both of Kay's expense elections totals $110,000.

The $10,000 in excess of $100,000 limitation is permanently lost. In addition, Kay's basis in the partnership is still reduced by the full $50,000.

Note. Kay may want to elect to expense only $50,000 of the property from her business, preventing the $10,000 excess loss.

The partnership determines its IRC §179 deduction subject to the limits. It then allocates the deduction among the partners. Each partner adds the amount allocated from partnerships to his nonpartnership IRC §179 costs.

After the dollar limit (and any reduction in the dollar limit due to nonpartnership IRC §179 costs) is applied, any remaining cost of the partnership and nonpartnership IRC §179 property is subject to the business income limit at the partner level.

Example 7. In 2003, Kobelhoff Partnership placed in service qualified IRC §179 property with a total cost of $408,000. The partnership must reduce its expense dollar limit by $8,000. Its maximum IRC §179 deduction is $92,000 and it elects to expense that amount.

The partnership's taxable income from the active conduct of all its trades or businesses for the year was $124,000. Consequently, it can deduct/allocate the full $92,000.

Note. If the partnership's taxable income was only $60,000, the partnership could only deduct/allocate $60,000 of the $92,000, with carryover of the $32,000 balance.

The partnership allocates $46,000 of its IRC §179 and $62,000 of its taxable income to partners Kobel and Hoff, respectively.

Taxable income	$124,000
Property acquired	$408,000
Limitation	(400,000)
Excess property acquired	$ 8,000
IRC §179 limit	$100,000
Amount in excess of limit	(8,000)
IRC §179 deduction	$ 92,000
IRC §179 allocation to Kobel	$ 46,000
Income allocation to Kobel	$ 62,000

In addition to being a partner in Kobelhoff Partnership, Kobel is also a partner in JPKC Ventures Partnership. In 2003, she was allocated a $36,000 IRC §179 deduction and $39,000 of its taxable income from the active conduct of its trade or business.

She also conducts a business as a writer and reports her income and expenses as a sole proprietor. In 2003, she placed in service an integrated computer/processing/printing machine at a cost of $16,000. Kobel's weakness is writing and she had a net loss of $25,000 before taking into account the cost of the machine.

Kobel does not have to include IRC §179 partnership costs to compute any reduction in her dollar limit, therefore her total IRC §179 costs for the year are not more than $400,000 and her dollar limit of $100,000 is not reduced. Her maximum IRC §179 deduction is $76,000.

She elects to expense all of the $82,000 ($46,000 from Kobelhoff and $36,000 from JPKC) in IRC §179 deductions, plus $16,000 of her sole proprietorship's IRC §179 costs. However, her deduction is limited to her business taxable income of $76,000 ($62,000 from Kobelhoff Partnership, $39,000 from JPKC Ventures Partnership, minus $25,000 loss from her sole proprietorship). She carries over $22,000 ($98,000 – $76,000) of the elected IRC §179 costs to 2004.

IRC §179 from Kobelhoff	$46,000
IRC §179 from JPKC Ventures	36,000
IRC §179 from sole proprietorship	16,000
Total available IRC §179	$98,000
Income limit Kobelhoff	$62,000
Income limit JPKC Ventures	39,000
Income limit sole proprietorship	(25,000)
Total income limit	$76,000
IRC §179 available	98,000
IRC §179 carryover to 2004	$22,000

S Corporations and Shareholders

Generally, the rules that apply to a partnership and its partners also apply to an S corporation and its shareholders. The deduction limits apply to an S corporation and to each shareholder. The S corporation allocates its deduction to each shareholder who in turn take their IRC §179 deduction subject to the limits at their individual levels.

TIMING OF THE IRC §179 ELECTION

The timing of making the IRC §179 election has been the subject of much controversy in past years. Examples of timing problems may be:

- Attempting to make the election when IRS examiners are capitalizing improperly deducted repair expenses and
- Filing of an amended return to make the election when the election was not previously made.

The Internal Revenue Code leaves the manner and timing of the election to the regulations, which state:

Treas. Reg. §1.179-5 Time and manner of making election

(a) Election.—The election under section 179 and Regs. 1.179-1 to claim a section 179 expense deduction for section 179 property shall be made 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 within the time prescribed by law (including extensions) for filing the return for such taxable year.—

The instructions on Form 4562, *Depreciation and Amortization*, read:

You must make the election with either:

The original return you file for the tax year the property was placed in service (whether or not you file your return on time) or

An amended return filed no later than the due date (including extensions) for your return for the tax year the property was placed in service.

Note. If the taxpayer timely files his return without making the election, he can still make the election by filing an amended return within six months of the due date of the return (excluding extensions) Write **"Filed pursuant to section 301.9100-2"** on the amended return.

Note. The regulations and these specific instructions make the filing of an amended return inappropriate where the election was not made on the previously filed return, and the six-month period mentioned above has expired. The inconsistency of these rules is apparent because a delinquent return filing can include the election under IRC §179, regardless of the timing of the filing of the delinquent return. These regulations and Form 4562 instructions are not affected by JGTRRA.

However, it is interesting to note that the Conference Committee Report of the JGTRRA included the language "may make or revoke" the IRC §179 election on an **amended return** without the consent of the IRS. Practitioners will want to watch for technical corrections on this.

OFF-THE-SHELF COMPUTER SOFTWARE — A MAJOR CHANGE

JGTRRA includes a special provision that includes off-the-shelf computer software in the definition of property qualifying for the IRC §179 deduction. However, only property placed in service in tax years beginning after 2002 and before 2006 qualifies. Qualifying computer software is defined as software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. Prior to this change, this type of computer software was not allowed to be depreciated under MACRS, was not eligible for the IRC §179 deduction, and was generally required to be amortized over a 36-month, straight line method.

REVOCATION OF THE IRC §179 ELECTION

JGTRRA includes a provision impacting the prior law irrevocable status of the IRC §179 election. For taxable years beginning after 2002 and before 2006, any election or specification under IRC §179 may be revoked by the taxpayer with respect to any property, and such revocation, once made, shall be irrevocable.

HEAVY PICK-UP TRUCKS AND SUVS

JGTRRA provides an opportunity to purchase large SUV and pick-up trucks (GVWR > 6,000 lbs.) and elect the IRC §179 deduction up to $100,000 of the business basis. Whether intentional or not, JGTRRA does not exclude these expensive vehicles.

Example 8. Mitchell purchased a new H2 SUV. This vehicle will be used for Mitchell's Macho Weightlifting Equipment business 92% of the time. His IRC §179 deduction is calculated as follows:

Purchase price H2 SUV	$55,000
Business use percentage	92%
Business basis	$50,600
IRC §179 deduction	($50,600)
Remaining business basis	$ 0

Following is a list of large SUVs and pick-up trucks that weigh more than 6,000 lbs. This list is ever-expanding. The most effective method to determine whether a specific vehicle qualifies is to look at the production plate located on the driver's side door jam or the door itself. Generally, the top number on this production plate provides the GVWR of the vehicle. Be careful to look for the **total gross vehicle weight**, and not the gross vehicle weight of each axle.

2003 Model Vehicles With Gross Vehicle Weight (Partial List) Ratings (GVWRs) Of More Than 6,000 Pounds*

BMW
X5 SUV

Cadillac
Escalade SUV
Escalade EXT

Chevrolet
Astro Passenger Van AWD
Avalanche Pickup
Express Van
Silverado Pickup
Suburban SUV
Tahoe SUV
TrailBlazer EXT LT

Dodge
Durango SUV
Ram Van
Ram Wagon
Ram 1500 Pickup
Ram 2500 Pickup
Ram 3500 Pickup

Ford
Excursion SUV
Expedition SUV
Econoline (E150, E250, and E350) Van
Econoline Wagon
F150 Pickup**
F250 Pickup
F350 Pickup

GMC
Safari Passenger Van AWD
Savana Van
Sierra Pickup
Sierra Denali
Yukon (including XL and Denali) SUV
Hummer
H2 SUV
Land Rover
Discovery SUV
Range Rover SUV

Lexus
LX470 SUV

Lincoln
Blackwood Pickup (2002 model)
Navigator SUV

Mercedes
M-class SUV (ML 350, ML 500, ML55 AMG)

Toyota
Land Cruiser SUV
Sequoia SUV
Tundra Pickup (Limited models)

*Warning: This is not necessarily a complete list. Other vehicles may meet these requirements. Taxpayers should always verify the GVWR before making a buying decision. The GVWR can normally be found on the label attached to the inside edge of the driver's side door.

**4 WD Extended Cab version

Sources: http://www.intellichoice.com, http://www.carsdirect.com/research/new_cars and http://www.packerthomas.com/Automotive/2003_model_vehicles_with_gross_v.htm

Note. Additional listings can be found at Kiplinger's website, http://kiplinger.com/php/tools/trucktax.

TAX TREATMENT OF "NONPERSONAL USE" VANS AND LIGHT TRUCKS

On July 3, 2003, the IRS issued T.D. 9069, which contains temporary regulations relating to the definition of passenger automobiles for purposes of IRC §280F(a). These temporary regulations affect certain taxpayers that use vans and light trucks in their trade or business, and are effective July 7, 2003. Specifically, the temporary regulations exclude from the definition of passenger automobile any truck or van that is a nonpersonal use vehicle as defined in Temp. Reg. §1.274-5T(k).

"Qualified nonpersonal use vehicle"

(i) In general—For purposes of IRC 274(d) and this section, the term "qualified nonpersonal use vehicle" means any vehicle which, by reason of its nature (i.e., design), it is not likely to be used more than a de minimis amount for personal purposes.

The temporary regulations exclude from the definition of passenger automobile any truck or van that is a qualified nonpersonal use vehicle as defined in Temp. Reg. §1.274-5T. Qualified nonpersonal use vehicles include the trucks and vans listed in Temp. Reg. §1.274-5T(k)(2). These are:

- Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds,
- Bucket trucks ("cherry pickers"),
- Cement mixers,
- Cranes and derricks,
- Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat,
- Dump trucks (including garbage trucks),
- Flatbed trucks,
- Qualified moving vans (as defined in paragraph (k)(4) of this section),
- Qualified specialized utility repair trucks (as defined in paragraph (k)(5) of this section),
- Refrigerated trucks, and
- School buses (as defined in section 4221(d)(7)(C)).

Qualified nonpersonal use vehicles also include trucks and vans described in Temp. Reg. §1.274-5T(k)(7) defined as follows.

Trucks or Vans. A truck or van is defined as one that has been specifically modified resulting in a vehicle that it is not likely to be used more than a de minimis amount for personal purposes. An example is a van that has only a front bench for seating and has permanent shelving that fills most of the cargo area. It constantly carries merchandise or equipment and is specially painted with advertising or the company's name. The vehicle is not likely to be used more than a de minimis amount for personal purposes.

The results of removing these types of vehicles from the definition of passenger automobile or truck are twofold:

1. The annual cost recovery deductions are not limited by the passenger automobile "luxury car limits."
2. The entire business basis qualifies for the IRC §179 deduction, which under JGTRRA is $100,000 for taxable years beginning after 2002 and before 2006.

Observation. The purpose of these temporary regulations is to clarify that these types of nonpersonal use vehicles do qualify for increased deduction amounts.

REV. PROC. 2003-50 (JUNE 26, 2003)

Changing Selection of IRC §179 Property

After filing their taxes in 2001, taxpayers found their tax liabilities may have been different had they made different choices regarding the 30% special depreciation allowance and the IRC §179 deduction. This is due to:

- The passage of the Jobs Creation and Workers Assistance Act (JCWAA) passed in March 2002, and
- The confusion over the interaction between the 30% special depreciation allowance and the IRC §179 deduction.

To provide equitable relief for these taxpayers, Rev. Proc. 2003-50 was issued. Rev. Proc. 2003-50 only applies to 2000 fiscal year returns (that include September 11, 2001) and 2001 calendar year returns that were filed timely and made the IRC §179 election for property. These taxpayers may now change the selection of the IRC §179 properties on the 2000 fiscal return (that include September 11, 2001) or 2001 calendar year return if:

1. On that return, the taxpayer did not deduct the 30% special depreciation allowance for any property or did not elect out of the 30% special depreciation allowance,
2. The taxpayer made the IRC §179 election for property placed in service after September 10, 2001, and
3. The taxpayer now wants to claim the 30% special depreciation allowance for that same property and apply the IRC §179 election to other property placed in service by the taxpayer in the taxable year that included September 11, 2001.

An amended federal tax return must be filed on or before December 31, 2003, for the taxable year that included September 11, 2001, and any affected subsequent taxable year. The taxpayer must include the statement **"Filed pursuant to Rev. Proc. 2003-50"** at the top of the amended federal tax return.

30%/50% SPECIAL DEPRECIATION ALLOWANCE

Enacted in 2002 as part of JCWAA, the 30% special depreciation allowance makes the biggest changes to the depreciation rules since the Modified Accelerated Cost Recovery System (MACRS) was introduced in 1986.

As originally enacted in 2002, the 30% special depreciation allowance applied to qualified property:

1. Acquired by a taxpayer after September 10, 2001, and before September 11, 2004, and
2. Placed in service by the taxpayer before January 1, 2005 (January 1, 2006, for certain property with a longer production period).

No written binding contract for the acquisition of the property could have been in effect before September 11, 2001.

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the special depreciation allowance may be claimed on qualified property:

1. Acquired after September 10, 2001, and before January 1, 2005, and
2. Placed in service by the taxpayer before January 1, 2005 (January 1, 2006, for certain property with a longer production period).

The special depreciation allowance was increased from 30% to 50% if the qualifying property was acquired after May 5, 2003. However, the 50% rate does not apply if a written binding contract for the acquisition of the property was in effect prior to May 6, 2003.

Note. JGTRRA eliminated the requirement that the property must be acquired before September 11, 2004, or alternatively, that a binding contract for its acquisition be entered into before that date.

Property of the type that meets the requirements for the 30% special depreciation allowance will qualify for the 50% rate if the preceding acquisition and placed-in-service dates are met. **However, taxpayers may elect to continue to use the 30% special depreciation allowance, or they may elect to use neither the 30% or 50% rates, and simply depreciate the cost of the asset over the applicable MACRS use-life.**

QUALIFYING PROPERTY

To qualify, property must be new property of one of the following types:

1. Property depreciated using MACRS with a recovery period of 20 years or less. Generally, every type of property except real property has a recovery period of 20 years or less. In addition, the MACRS method is used to depreciate most property.
2. Water utility property, which is either of the following:
   - Property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to this provision, would be 20-year property
   - Any municipal sewer
3. Computer software that is not an IRC §197 intangible, which is software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.
4. Qualified leasehold improvement property.

The property must also meet the following tests:

- Acquisition date test
- Placed in service date test
- Original use test

The property must not be excepted property.

PROPERTY DEPRECIATED UNDER MACRS — 20 YEARS OR LESS

This would include properties in the MACRS 3-, 5-, 7-, 10-, 15-, and 20-year recovery periods. Specific listings of property types included within each recovery period are found in the table of asset classes and use lives included earlier in this chapter.

Computer Software

All of the following conditions must be met for the software **to be eligible** for the special depreciation allowance:

1. The software is a program designed to cause a computer to perform a desired function, but this does not include any database or similar item unless the database or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.
2. A deduction is allowable under IRC §167(a).
3. The software is not an amortizable IRC §197 intangible. IRC §197 excludes from its definition "off-the-shelf" software, meaning unmodified and uncustomized software, and software that is not acquired as part of a purchase of a trade or business.
4. The taxpayer meets the original use, acquisition date, and placed in service date tests.

Note. Most, but not all, types of software are eligible for the special depreciation allowance.

Qualified Leasehold Improvement Property

The term "qualified leasehold improvement property" is defined as any improvement to an interior portion of a building which is nonresidential real property. **Three conditions** must be met:

1. The improvement is made under or pursuant to a lease, either by the lessee, sublessee, or lessor of the building portion.
2. The portion of the building is to be occupied exclusively by the lessee (or sublessee) of that portion.
3. The improvement is placed in service more than three years after the date the building was first placed in service.

Rather than provide a list of leasehold improvement property that qualifies, IRC §168(k)(3)(B) cites examples of what will **not qualify**.

IRC 168(k)(3)(B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to—

i. the enlargement of the building

ii. any elevator or escalator

iii. any structural component benefiting a common area, and

iv. the internal structural framework of the building

Exception for Transportation, 15- and 20-Year Property

An extension of the placed-into-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of 10 years or longer and certain transportation property. "Transportation property" is defined as tangible personal property used in the trade or business of transporting persons or property.

Special Rule. Under the prior rules, the special depreciation allowance on property with a longer production period only applied to the extent of the adjusted basis of the property that was attributable to manufacture, construction, or production before September 11, 2004. Under JGTRRA, the special depreciation allowance is applied to the extent of the adjusted basis of the property that is attributable to the manufacture, construction, or production before January 1, 2005.

ORIGINAL USE (NEW) PROPERTY TEST

According to the Joint Committee's explanation, the term "original use" means the first use to which the property is put. This is whether or not use corresponds to use of property by the taxpayer. When evaluating whether property qualifies as "original use," the same factors are used to determine whether property qualifies as "new IRC §38 property" for purposes of the investment tax credit.[6] Additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) will satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer will not satisfy the "original use" requirement.

13

Unlike the IRC §179 immediate expensing rule,[7] the special 30%/50% special depreciation allowance does not prohibit the purchase of otherwise qualifying property from a "disqualified person."

ALLOWED FOR BOTH REGULAR AND AMT TAX PURPOSES

The 30%/50% special depreciation allowance is treated like an IRC §179 immediate expensing amount since it is not considered an adjustment for AMT purposes for the tax year in which the asset is place into service. As a result, taxpayers claiming the 30%/50% special depreciation allowance receive both of the following tax breaks.

- The amount of the special depreciation allowance is not subject to the alternative minimum tax.
- Since the 30%/50% special depreciation allowance was used, the regular depreciation for the asset is also excluded from the AMT calculation.

HOW MUCH CAN BE DEDUCTED?

The special depreciation allowance for qualified property is an additional 30%/50% of the property's depreciable basis. In a fashion similar to IRC §179, the entire amount of the special depreciation allowance is taken into account regardless of what point in the tax year the property is first placed into service (i.e., there is no pro-ration required). Unlike the IRC §179 expense election, the 30%/50% special depreciation allowance has no annual expense limits or limits on total annual asset investments. In addition, IRC §179 contains a "taxable income" limit, which is not included in the 30%/50% special depreciation allowance rules. In effect, the 30%/50% provides a tax planning opportunity by creating a net operating loss to offset either prior year or subsequent year's taxes. In short, there are no limits on the amount of either the 30% or 50% special depreciation allowances.

The depreciable basis is the property's cost or other basis multiplied by the percentage of business/investment use and then reduced by the following items:

- Any IRC §179 deduction taken with respect to the property
- Any deduction for removal of barriers to the disabled and the elderly with respect to the property
- Any investment credit, disabled access credit, or enhanced oil recovery credit with respect to the property

Example 9. On November 1, 2003, Chris Davis purchased and placed in service qualified property that cost $100,000. He did not elect to claim an IRC §179 deduction. He can deduct either 30% of the cost ($30,000) or 50% of the cost ($50,000) as a special depreciation allowance for 2003. He uses the remaining $70,000 (30%) or $50,000 (50%) to compute his regular MACRS depreciation deduction for 2003 and later years.

Example 10. Assume the same facts as **Example 9**, except Chris chooses to deduct $40,000 as an IRC §179 deduction. He uses the remaining $60,000 of cost to compute his special depreciation allowance of $18,000 (30% × $60,000), or $30,000 (50% × $60,000), Chris uses the remaining $42,000 (30%) or $30,000 (50%) of cost to compute his regular depreciation deduction for 2003 and later years.

SAMPLE DEPRECIATION TABLES (PARTIAL)

All tables assume half-year convention.

Table A — Regular MACRS

Year	3 Year	5 Year	7 Year	10 Year	15 Year	20 Year
1	33.33	20.00	14.29	10.00	5.00	3.75
2	44.45	32.00	24.49	18.00	9.50	7.22
3	14.81	19.20	17.49	14.40	8.55	6.68
4	7.41	11.52	12.49	11.52	7.70	6.18

Source: CCH unofficial tables, May 2003.

Table B — Regular MACRS with 30% Special Depreciation Allowance (Partial)

Year	3 Year	5 Year	7 Year	10 Year	15 Year	20 Year
1	53.33	44.00	40.00	37.00	33.50	32.63
2	31.12	22.40	17.14	12.60	6.65	5.05
3	10.37	13.44	12.24	10.08	5.99	4.67
4	5.19	8.06	8.74	8.06	5.39	4.32

Table C — Regular MACRS with 50% Special Depreciation Allowance (Partial)

Year	3 Year	5 Year	7 Year	10 Year	15 Year	20 Year
1	66.67	60.00	57.15	55.00	52.50	51.88
2	22.23	15.00	12.25	9.00	4.75	3.61
3	7.41	9.60	8.75	7.20	4.28	3.34
4	3.71	5.76	6.25	5.76	3.85	3.09

Note. Tables B and C are only intended to be used as a comparison to the Regular MACRS Table A, and are used to illustrate the differences in depreciation percentages when the 30% and 50% special depreciation allowances are claimed. On Form 4562, the first year percentage reflects both the 30%/50% and the first year regular MACRS deductions, which are reflected on two different lines on Form 4562. The percentage for years after the first year accurately reflects the percentage that will be applied to the adjusted basis of the asset and included on a specific line of Form 4562.

Example 11. Kyle Harrison purchased a new milling machine on July 6, 2003 for a total cost of $127,875. Assume it is seven-year property. Kyle has ample net income against which to claim the maximum deduction, and this is the only asset acquisition for the taxable year. Kyle would like to know his options on depreciating this equipment.

ADS, straight line, 7 year	$127,875	×	7.14	=	$ 9,130				
Regular MACRS	127,875	×	14.29	=	18,273				
Regular MACRS, no IRC §179 + 30%	127,875	×	40.00	=	51,150				
Regular MACRS, no IRC §179 + 50%	127,875	×	57.15	=	73,081				
Regular MACRS, full IRC §179	27,875	×	14.29	=	3,983	+	$100,000	=	$103,983
Regular MACRS, full IRC §179 + 30%	27,875	×	40.00	=	11,150	+	100,000	=	111,150
Regular MACRS, full IRC §179 + 50%	27,875	×	57.15	=	15,931	+	100,000	=	115,931

Note. The options could literally be unlimited based on the amount of IRC §179 deduction the taxpayer would like to claim. However, the **maximum** amount of regular MACRS depreciation and IRC §179 that can be deducted in 2003 in **Example 11** is **$115,931**.

Example 12. George made the following purchases in 2003.

Description	N/U	Date Acquired	Class	Cost
Mack semi tractor	New	03/04/03	3	$134,000
Computer	New	05/08/03	5	1,500
Copier	Used	04/10/03	5	550
Bulldozer	New	04/14/03	5	85,000
Back hoe	New	07/01/03	5	60,000
Paver	New	09/02/03	5	98,000
Office furniture	Used	05/01/03	7	30,000
				$409,050

13

George makes the following depreciation decisions:

Description	§179 Ded.	30%	50%	Reg. Deprec.	Total
Mack semi tractor	$ 0	$40,200	$ 0	$31,264	$ 71,464
Computer	0	0	750	150	900
Copier	0	0	0	110	110
Bulldozer	0	25,500	N/A	11,900	37,400
Back hoe	0	N/A	30,000	6,000	36,000
Paver	90,950	0	3,525	705	95,180
Office furniture	0	0	0	4,287	4,287
	$90,950	$65,700	$34,275	$54,416	$245,341

Note. The IRC §179 deduction is limited because total purchases exceed $400,000.

George could have made the following choices:

Description	§179 Ded.	30%	50%
Mack semi tractor	Yes	Yes	No
Computer	Yes	Yes	Yes
Copier	Yes	No	No
Bulldozer	Yes	Yes	No
Back hoe	Yes	Yes	Yes
Paver	Yes	Yes	Yes
Office furniture	Yes	No	No

George will complete his Form 4562 as follows:

For Example 12

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

Depreciation and Amortization
(Including Information on Listed Property)

► See separate instructions. ► Attach to your tax return.

OMB No. 1545-0172 — **2003** — Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
George	Paving Contractor	888-99-2222

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

1	Maximum amount. See page 2 of the instructions for a higher limit for certain businesses	1	$100,000
2	Total cost of section 179 property placed in service (see page 2 of the instructions)	2	409,050
3	Threshold cost of section 179 property before reduction in limitation	3	$400,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	9,050
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	90,950

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	Paver	98,000	90,950

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	90,950
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	90,950
10	Carryover of disallowed deduction from line 13 of your 2002 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	90,950
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	90,950
13	Carryover of disallowed deduction to 2004. Add lines 9 and 10, less line 12 ►	13	0

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II — Special Depreciation Allowance and Other Depreciation (Do not include listed property.**)**

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see page 3 of the instructions)	14	99,975
15	Property subject to section 168(f)(1) election (see page 4 of the instructions)	15	
16	Other depreciation (including ACRS) (see page 4 of the instructions)	16	

Part III — MACRS Depreciation (Do not include listed property.**)** (See page 4 of the instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2003	17	0
18	If you are electing under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check here ► ☐		

Section B—Assets Placed in Service During 2003 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property		93,800	3	HY	200% DB	31,264
b 5-year property		94,325	5	HY	200% DB	18,865
c 7-year property		30,000	7	HY	200% DB	4,287
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2003 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV — Summary (see page 6 of the instructions)

21	Listed property. Enter amount from line 28	21	0
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	245,341
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2003)

PLANNING POINT

Rev. Proc. 2002-33

Claiming the 30% special depreciation allowance on 2000 fiscal returns and 2001 calendar year returns, where the original return was filed before June 1, 2002

If the taxpayer filed a 2000 fiscal or 2001 calendar return before June 1, 2002 on which qualifying property was listed on Form 4562 (and the 30% special depreciation allowance was not claimed), this revenue procedure provided two options to claim the allowance. The taxpayer could claim the allowance by either:

1. Filing an amended federal tax return on or before the due date **(excluding extensions)** of that federal tax return for the next succeeding tax year. If this alternative was utilized, the amended return should include the statement **"Filed pursuant to Rev. Proc. 2002-33"** at the top of the return; or
2. Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's federal tax return for the next succeeding tax year. The Form 3115 should include the statement **"Automatic Change Filed under Rev. Proc. 2002-33."**

Note. Using Option 1 would place the 30% special depreciation allowance on the 2000 fiscal or 2001 calendar year federal tax return. Using Option 2 would place the 30% special depreciation allowance on the 2001 fiscal or 2002 calendar year federal tax return, even though the property was acquired in the previous tax year.

Rev. Proc. 2003-50 (June 26, 2003)

Allowing taxpayers more time to claim the 30% special depreciation allowance on the 2000 fiscal or 2001 calendar year federal tax return

Because some taxpayers were unaware of the relief provisions of Rev. Proc. 2002-33, or were precluded from the relief because their federal tax returns were filed on or after June 1, 2002, the IRS determined that it was appropriate to extend the relief provided by Rev. Proc. 2002-33 to **any** taxpayer that timely filed his federal tax return for the taxable year that included September 11, 2001. Provided the taxpayer did not originally make the election not to deduct the 30% special depreciation allowance (revocable only with consent of the IRS), the taxpayer has the option of now claiming the 30% allowance for the tax year that included September 11, 2001:

1. By filing an amended federal tax return on or before **December 31, 2003** for the year that included September 11, 2001, and any affected subsequent taxable year, and including the statement **"Filed Pursuant to Rev. Proc. 2003-50"** at the top of any amended federal tax return;
2. By filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed federal tax return for the first taxable year succeeding the taxable year that included September 11, 2001, **if this return has not been filed on or before July 21, 2003** and the taxpayer owns the property as of the first day of this taxable year; or
3. If the taxpayer's federal tax return for the first taxable year succeeding the taxable year that included September 11, 2001, **was filed on or before July 21, 2003**, by:
   - **a.** Filing an amended federal tax return on or before December 31, 2003, for the first taxable year that included September 11, 2001, attaching a Form 3115 to the amended federal tax return, and including the statement **"Filed Pursuant to Rev. Proc. 2003-50"** at the top of the amended federal tax return; or
   - **b.** Filing a Form 3115 with the taxpayer's timely filed federal tax return for the second taxable year succeeding the taxable year that included September 11, 2001, and ending on or before July 31, 2004, if the taxpayer owns the property as of the first day of this taxable year.

30%/50% SPECIAL DEPRECIATION ALLOWANCE AND MID-QUARTER CONVENTION

At the time of writing the *2002 University of Illinois Income Tax Workbook*, there was uncertainty whether the 30% special depreciation allowance would affect the 40% rule when trying to determine whether the taxpayer must use the mid-quarter depreciation convention. While not able to cite a specific regulation or IRS announcement, the consensus of many authors writing about this subject indicates that the 30%/50% special depreciation allowance is not considered in the calculation of whether the mid-quarter convention applies. Unlike the IRC §179 deduction, which can be used to "buy" a taxpayer out of having to use the mid-quarter convention (by claiming the IRC §179 deduction on last quarter asset purchases), there is no specific statutory or regulatory authority for the 30%/50% special depreciation allowance to do the same.

Example 13. In 2003, Henn Corporation, a calendar-year taxpayer, purchased and placed into service $300,000 of used personal property in July, and another $220,000 of new personal property in December. The July property does not qualify for the 30%/50% special depreciation allowance; however, the December property does. Assume the Henn Corporation elects to claim the 50% special depreciation allowance rate.

If the 50% special depreciation allowance is disregarded, Henn Corporation **is subject to the mid-quarter convention** because its fourth quarter purchases ($220,000) exceed 40% of the year's total purchases ($520,000 × 40% = $208,000).

If the 50% special depreciation allowance is subtracted before applying the 40% test, Henn Corporation would **not be subject to the mid-quarter convention** because the $220,000 fourth quarter purchases would be decreased by the 50% special depreciation allowance ($220,000 – $110,000 = $110,000) to $110,000, which does not exceed 40% of the year's total purchases ($520,000 – $110,000 = $410,000 × 40% = $164,000).

The following is from the Internal Revenue Code:

IRC §168(d)(3) Special rule where substantial property placed in service during last 3 months of taxable year.

(A) In general. Except as provided in regulations, if during any taxable year—

(i) the aggregate bases of property to which this section applies placed in service during the last 3 months of the taxable year, exceed

(ii) 40 % of the aggregate bases of property to which this section applies placed in service during such taxable year, the applicable convention for all property to which this section applies placed in service during such taxable year shall be the mid-quarter convention.

IRC §168(k)(2) Qualified property. (for purposes of the 30%/50% special depreciation allowance) For purposes of this subsection—

(A) In general. The term "qualified property" means property——

(i)(1) to which this section applies which has a recovery period of 20 years or less.

Conclusion. The 30%/50% special depreciation allowance cannot be used by a taxpayer to "buy" out of the application of the mid-quarter depreciation convention.

CLAIMING THE 30%/50% SPECIAL DEPRECIATION ALLOWANCE

The special depreciation allowance for nonlisted property is claimed on line 14, Part II of Form 4562. The regular depreciation deduction is claimed separately on line 19, Part III. The special depreciation allowance for listed property is claimed on line 25, Part V of Form 4562, and will be discussed later in this section.

The special depreciation allowance is **mandatory**, so a taxpayer must make an election not to claim the deduction. If no election out of the deduction is made, the taxpayer is considered to have taken the special depreciation allowance. For property that qualifies only for the 30% special depreciation allowance, the taxpayer either claims the allowance or annually elects out on a class-by-class basis. For property that qualifies for the 50% special depreciation allowance, the taxpayer may choose, on a class-by-class basis, to either claim the 50% or the 30% special depreciation allowance, or elect out on a class-by-class basis, or any combination thereof. In many cases, the taxpayer may annually choose no special depreciation allowance on any property acquisitions, and use regular MACRS or ADS instead.

ELECTING OUT OF THE SPECIAL DEPRECIATION ALLOWANCE

The IRS issued Rev. Proc. 2002-33 on April 29, 2002, to provide guidance as to how to make the election out of the special depreciation allowance, and much of this document was devoted to taxpayers who had already filed their 2000 (fiscal returns) or 2001 calendar returns prior to June 1, 2002. For taxpayers who had not filed their returns before June 1, 2002, the rules were much less complex, since specific instructions were available for the "election out" procedure. The instructions to Form 4562 (for the 2002 year) state:

Election out. You may elect, for any class of property, not to treat as qualified property all property in such class placed in service during the tax year. If you make the election, the property may be subject to an AMT adjustment for depreciation. To make the election, attach a statement to your timely filed return indicating that you are electing not to claim the additional allowance and the class of property for which you are making the election. For more details, see Rev. Proc. 2002-33—

> **Note.** If a taxpayer timely filed his return without making the election (not to claim the special depreciation allowance), he can still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Write **"File pursuant to section 301.9100-2"** on the amended return.

Once made, the election may not be revoked without consent from the IRS.

As stated previously, to claim the special depreciation allowance, the amounts claimed must be entered on the appropriate lines (14 or 25) of Form 4562. To "elect out" of the special depreciation allowance, a statement should be attached to the return. Most commercial tax preparation software includes a "depreciation elections" internal form, that when properly completed, generates a separate statement for the "election out" of the special depreciation allowance.

REV. PROC. 2002-33

Electing out for 2000 fiscal returns (which include September 11, 2001) and 2001 calendar returns

This IRS procedure was issued on April 29, 2002, to assist taxpayers in either claiming the correct amount of 30% special depreciation allowance, or to properly elect out. This guidance was needed because the Job Creation and Worker Assistance Act of 2002:

- Was not signed into law until March 9, 2002,
- Was effective for certain qualified property acquired after September 10, 2001, and
- Affected many tax returns that had already been filed.

For tax returns filed **before** June 1, 2002, this revenue procedure indicated no separate "election out" had to be filed if the return was filed without claiming the 30% special depreciation allowance. This procedure was referred to as the "deemed election" rule.

However, taxpayers filing on or **after** June 1, 2002, needed to make the election with the filing of a separate statement, as described previously, with regard to property placed in service after September 10, 2001. Otherwise, the "allowed or allowable" language of the depreciation rules would require that the adjusted basis of such property be reduced even though the taxpayer did not claim the tax benefit associated with the 30% special depreciation allowance.

REV. PROC. 2003-50 (JUNE 26, 2003)

Electing out for 2000 fiscal returns (which include September 11, 2001) and 2001 calendar returns

This revenue procedure was issued in 2003 to provide relief for taxpayers who were unaware of the relief provisions of Rev. Proc. 2002-33 and contains additional information regarding the "election out" procedures.

Rev. Proc. 2003-50 clarifies that a taxpayer has made the election **not** to deduct the 30% special depreciation allowance for the taxable year that included September 11, 2001, for a class of property if the taxpayer met the time restriction prescribed in Rev. Proc. 2002-33, and followed the instructions for the 2001 Form 4562 (Rev. March 2002). It also provides that the taxpayer has made the election not to deduct the 30% special depreciation allowance for the taxable year that included September 11, 2001 for a class of property if the taxpayer met the time restrictions prescribed in Rev. Proc. 2002-33 and included an affirmative statement with the federal tax return. Interestingly, Rev. Proc. 2003-50 specifically states:

The affirmative statement may be a statement attached to, or written on, the return (for example, writing on the Form 4562 "not deducting 30%")

> **Note.** It would appear that this "easing" of the affirmative statement requirement for the election out of the special depreciation allowance is only for the 2000 fiscal returns (which include September 11, 2001) and 2001 calendar year returns. In the absence of any additional information in the yet to be released 2003 Form 4562 instructions, a conservative approach would dictate the use of an attached statement "electing out" of the special depreciation allowance.

> **Note.** Both the JCWAA of 2002 and the JGTRRA of 2003 include additional tax incentives to businesses and investors in downtown Manhattan (the Liberty Zone), which include a 30%/50% special depreciation allowance that is broader than what is available elsewhere, provides faster write-offs for leasehold improvements, and an increased IRC §179 expensing deduction. For more information on the tax incentives for the Liberty Zone, see these two tax bills.

AUTOMOBILE DEPRECIATION DEDUCTIONS

The MACRS deduction, including the IRC §179 deduction and the special 30%/50% special depreciation allowance, is limited for the purchase of a **passenger automobile**. A passenger automobile is any four-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight **(6,000 pounds or less of gross vehicle weight for trucks or vans).** It includes any part, component, or other item physically attached to the automobile or usually included in the purchase of an automobile.

13

The JCWAA of 2002 increased the depreciation limits on new vehicles by $4,600, if the 30% special depreciation allowance was claimed. When added to the previous limit of $3,060, the 2002 limit on first year depreciation was $7,660 ($4,600 + $3,060). The JGTRRA 2003 increased the first year limit on new vehicles by $7,650 ($22,950 for qualified electric vehicles), if the 50% special depreciation allowance is claimed. When added to the previous limit of $3,060, the 2003 limit for a qualified vehicle purchased after May 5, 2003, is $10,710 ($3,060 + $7,650). The $4,600 and the $7,650 are not adjusted for inflation.

Maximum Depreciation Deduction for Passenger Automobiles

Year Placed in Service	1st Year	2nd Year	3rd Year	4th Year and Later
2003	$ 7,660*	$4,900	$2,950	$1,775
2003	10,710**	4,900	2,950	1,775
2002	7,660***	4,900	2,950	1,775

*Automobile acquired prior to May 6, 2003, and for which the 30% special depreciation allowance was claimed. If the taxpayer elected out of the special allowance, or the automobile is not qualified property, the maximum first year deduction is $3,060.

**Automobile acquired after May 5, 2003, is qualified property, and taxpayer claims the 50% special depreciation allowance. If taxpayer claims the 30% special depreciation allowance, the maximum first year deduction is $7,660. If the taxpayer elected out of the 30% or 50% special depreciation allowance, or the automobile is not qualified property, the maximum first year deduction is $3,060.

***If the special depreciation allowance was not claimed for the automobile or the automobile is not qualified property, the maximum first year deduction is $3,060.

Note. Although the IRS has not released the automobile depreciation caps at this time, the anticipated ceiling is $10,710 as listed above.

ENDNOTES

1 *Oberman Manufacturing Co. v. Commr.*, 47 T.C. 471 (1967)

2 *Oberman Manufacturing Co. v. Commr.*, 47 T.C. 471 (1967)

3 CCM 199921045

4 IRC §168(e)(2)(A)(I)

5 IRS Pub. 225, *Farmer's Tax Guide*

6 Treas. Reg. §1.48–2

7 IRC §179(d)(2)(A)