Chapter 7: Depreciation

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

2005 CHANGES TO DEPRECIATION

The following changes affect depreciation deductions for assets placed in service in 2005 and are discussed in greater detail later in this chapter:

- The maximum IRC §179 expense deduction has increased to $105,000, with a phaseout range from $420,000–$525,000.
- For certain SUVs and other vehicles placed in service after October 22, 2004, the maximum §179 expense deduction has been limited to $25,000.
- Certain qualified leasehold improvements and qualified restaurant property placed in service after October 22, 2004 and before January 1, 2006 can be treated as 15-year property under MACRS.
- The 30% and/or 50% bonus depreciation allowances expired for most assets placed in service after December 31, 2004.

OVERVIEW

Depreciation expense represents the **systematic and rational allocation of the cost of an asset over its useful life.** The purpose of depreciation is to allow a taxpayer to deduct a portion of the cost of an asset to reflect its normal wear and tear and obsolescence.[1] However, the life assigned to various types of assets by the IRS often does not reflect the physical life of the property.

Depreciation decisions can be complex. Before starting the process, a practitioner must determine whether an expenditure should be capitalized or whether it can be treated as an ordinary and necessary business expense qualifying as a current income tax deduction under IRC §162. Assets that should be capitalized include those items whose useful life is expected to exceed more than one year and whose cost is significant in relation to the taxpayer's trade or business.

Once it is established that an asset should be capitalized, a practitioner can exercise some flexibility in calculating its first year deduction by using the 50% bonus depreciation allowance (restricted after 2004) and/or additional depreciation under IRC §179. Any basis remaining in an asset after these reductions should be depreciated over time.

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1. IRC §168

To begin the depreciation process, a practitioner must determine the class of property to which an item belongs, its recovery period, a method of recovery, and the appropriate convention to apply. Practitioners should also be alert to special situations that require modifications to the calculation of depreciation, such as alternative minimum tax (AMT) concerns, short tax years, and correcting depreciation errors via a "catch-up" provision.

BONUS DEPRECIATION

The 30% and/or 50% bonus depreciation provisions created in response to the September 11, 2001 terrorist attacks **was eliminated for most assets placed in service after December 31, 2004.** However, certain IRC §168(k)(2)(B) properties having longer production periods can still qualify for the 30% and/or 50% bonus depreciation deduction if placed in service prior to January 1, 2006, but only on the basis attributable to production completed by December 31, 2004. Examples include airplanes purchased and in construction and commercial leasehold improvements.

ADDITIONAL FIRST YEAR DEPRECIATION (§ 179)

Since the 30% and/or 50% depreciation deductions terminated for most assets placed in service after December 31, 2004, §179 deductions have regained importance. Practitioners can create substantial depreciation allowances by claiming §179 deductions on property placed in service during the tax year.

The §179 election must be filed with the original return (even if filed late) or an amended return within the extension period for filing the original tax return. However, changes made by the 2003 and 2004 Tax Acts now provide a window (years 2003 through 2007) for taxpayers to amend prior years' tax returns for the purpose of **either** revoking a previous §179 election, or electing §179 without prior approval from the IRS.

Estates and trusts are **not** eligible to claim the §179 deduction.

> **Caution.** The election to claim a §179 deduction must be made on a properly completed Form 4562, *Depreciation and Amortization*. When a formal §179 election is not properly made, the IRS may deny additional first-year depreciation deductions to taxpayers who merely compute the extra depreciation on a depreciation schedule and carry the amount forward to Schedule C.

LIMITATIONS

The IRS imposes various limitations on the amount of §179 deductions that may be claimed on a return. These limits are based on the different factors discussed below.

Type of Property

Property must be tangible personal property to qualify for the §179 deduction. This generally applies to IRC §1245 tangible personal property such as machinery, equipment, computers, autos, and office equipment purchased during the year from non-related parties. However, not all tangible personal property qualifies. The property must be used in an active trade or business.

> **Example 1.** Mary purchases a computer to track her stock investments and to keep records for her four rental properties. The computer does not qualify for the §179 deduction since it is not being used in an active trade or business.

Qualifying items that are sometimes overlooked include:

- Real property assets that are not buildings or their structural components, and certain agricultural land improvements such as drainage tile, fence, and so on. However, general land improvements such as parking lots and landscaping are not included.

- Real property that is an integral part of an asset and requires a modification of the surrounding real property in which it is housed, such as specialized computers.

Building costs, structural components of buildings, and tangible personal property located in residential rentals do not qualify for the §179 deduction, nor does leased property or property used primarily outside of the U.S. However, tangible personal proeprty within nonresidential real property does qualify for the §179 deduction. Qualifying property also includes the purchase of property previously leased by the taxpayer.

Business automobiles and trucks qualify if used more than 50% in the taxpayer's trade or business, but can be subject to the limitations discussed next.

Limitation of Available §179 Deductions for Certain SUVs. The American Jobs Creation Act of 2004 limited the amount of §179 deductions allowed to $25,000 on certain SUVs and other vehicles. Any balance remaining after taking the §179 expense deduction is depreciated over the normal five-year recovery period for an SUV.

The following vehicles (otherwise exempt from the luxury depreciation limitations) are subject to the new $25,000 §179 limitation. These are vehicles placed in service after October 22, 2004, that are

- Not subject to IRC §280F, and
- Rated at 14,000 lbs. of gross vehicle weight or less.

There is no maximum depreciation limitation, but standard limitations still apply such as percentage of business use.

Exempt Vehicles Not Subject to the $25,000 §179 Limitation. Exempt vehicles are not subject to the $25,000 §179 limitation if they are:

- Designed to have a seating capacity of more than nine persons behind the driver's seat;
- Equipped with a cargo area of at least six feet in interior length, which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible from the passenger compartment; or

Observation. This is the exception for the full size pickup truck.

- Designed with an integral enclosure fully enclosing the driver's compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

IRS Pub. 463, *Travel, Entertainment, Gift and Car Expenses;* IRS Pub. 946, *How to Depreciate Property;* and Rev. Proc. 2004-20 contain additional information about allowable depreciation deductions for vehicles.

Example 2. Dexter Bromley acquired and placed in service his 2005 Cadillac Escalade on March 10, 2005. His cost for this heavy duty SUV is $52,000. Dexter can document 100% business use of this vehicle in his real estate sales business. He wants to claim the maximum depreciation deduction for 2005. Dexter has sufficient 2005 income ($94,600) to absorb any first-year depreciation. The 2005 maximum allowable depreciation of $30,400 is determined as follows:

Cost of Cadillac Escalade	$52,000	
Less: maximum allowable §179	(25,000)	$25,000
Balance available for regular depreciation	$27,000	
2005 depreciation MACRS 5-year life (20%)	(5,400)	5,400
Adjusted basis at end of 2005	$21,600	
Total depreciation expense for 2005		$30,400

Form 4562 (2005) **Dexter P Bromley** **888-55-9999** Page **2**

Part V **Listed Property** (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete* ***only*** *24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

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

24a Do you have evidence to support the business/investment use claimed? ☒ **Yes** ☐ **No** **24b** If "Yes," is the evidence written? ☒ **Yes** ☐ **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
25 Special allowance for qualified New York Liberty Zone listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)						**25**		
26 Property used more than 50% in a qualified business use:								
2005 Cadilac Escalade	03/10/05	100 %	52,000	27,000	5.00	200DB/HY	5,400	25,000
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%				S/L –		
		%				S/L –		
		%				S/L –		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1.						**28**	5,400	
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1.							**29**	25,000

Section B—Information on Use of Vehicles

For Example 2

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
2005
Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Dexter P Bromley	Real estate sales	888-55-9999

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

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$105,000
2	Total cost of section 179 property placed in service (see instructions)	2	52,000
3	Threshold cost of section 179 property before reduction in limitation	3	$420,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	105,000

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6			
7	Listed property. Enter the amount from line 29	7	25,000

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	25,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	25,000
10	Carryover of disallowed deduction from line 13 of your 2004 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	94,600
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	25,000
13	Carryover of disallowed deduction to 2006. Add lines 9 and 10, less line 12 ▶	13	

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.**)** (See instructions.)

14	Special allowance for certain aircraft, certain property with a long production period, and qualified New York Liberty Zone property (other than listed property) placed in service during the tax year	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Do not** include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2005	17	
18	If you are electing 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 2005 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						
b 5-year property						
c 7-year property						
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 2005 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 instructions)

21	Listed property. Enter amount from line 28	21	5,400
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	30,400
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** (2005)

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Dollar Limitation

Increase in §179 Allowances. The maximum §179 expense deduction increased from $102,000 to $105,000 for tax years beginning in 2005. However, this maximum deduction must be reduced dollar-for-dollar by the total cost of qualified depreciable assets over $420,000 placed in service during the tax year. If the total cost of assets exceeds $525,000, the taxpayer is not allowed to take a §179 deduction for 2005. The maximum §179 expense deduction is increased and the phaseout range is modified for qualified Liberty Zone property and certain assets placed in service by enterprise zone businesses.

> **Example 3.** Tommy Tenpenny, a calendar-year Schedule C contractor, bought $460,000 of §179 property in 2005. Since he exceeded the total expenditure threshold of $420,000 by $40,000, his 2005 §179 maximum deduction is reduced from $105,000 to $65,000.

Married couples filing separate tax returns are treated as one taxpayer for purposes of the dollar limitation and must combine their asset costs for the limitation test and then allocate the maximum allowed deduction between their two returns. If the allocation percentages elected by each spouse do not total 100%, the IRS allocates 50% to each taxpayer.

> **Note.** For 2006, the maximum §179 expense deduction increases to $108,000 per taxpayer (except those filing MFS) with the phaseout range between $432,000 and $540,000.

Pass-Through Dollar Limitation

If a taxpayer receives multiple pass-through §179 deductions exceeding the annual limit ($105,000 in 2005), the excess deductions are lost. However, the taxpayer must still reduce her basis in the pass-through entity by the entire amount of §179 deduction passed through to her.[2] If the taxpayer disposes of her share of an entity, she may increase her basis by the disallowed §179 deduction related to that entity.[3]

> **Example 4.** Dale and Jeff Auto Repair, LLC purchases $120,000 of qualified §179 property in 2005. Jeff, a 50% member of the business, receives a Schedule K-1 reporting his share of the allowable §179 deduction as $52,500 (50% × $105,000).The LLC is treated as a partnership for income tax purposes.
>
> Jeff is also a 60% shareholder in PDQ Gas, Inc., an S corporation. The corporation purchases $100,000 of qualified §179 property in 2005. Jeff's Schedule K-1 from PDQ shows his share of §179 expense as $60,000.
>
> Jeff's pass-through deductions total $112,500. Assuming he meets the income limits, he may only deduct up to $105,000 of §179 expenses. Jeff chooses to use the $60,000 from PDQ first, then $45,000 of the pass-through from the LLC. He reduces his basis in PDQ by $60,000 and his basis in the LLC by $52,500. He notes in his tax records that if he sells his interest in the LLC, he can restore the $7,500 that was not deducted when calculating his gain or loss from the sale.

> **Note.** When possible, shareholders/partners in multiple pass-through entities should try to coordinate §179 deductions among the entities to avoid having excess deductions, which reduce basis without giving any tax benefits. If the taxpayer never sells her interest in the entity, the basis will never be restored.

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2. Rev. Rul. 89-7, January 1, 1989
3. IRS Pub. 946, *How to Depreciate Property*

Income Limitation

The annual §179 deduction cannot exceed the net income derived from all of the taxpayer's **trade or business** activities during the year.[4] Taxable income limits apply at both the individual and entity levels.

> **Example 5.** In 2005, Andy receives a partnership Schedule K-1 reporting $80,000 as his share of taxable active business income and a $70,000 §179 deduction. Andy is also the sole proprietor of a business which has a loss of $30,000. Andy has no other trade or business income. Therefore, Andy's §179 deduction is limited to $50,000 ($80,000 – $30,000). The excess §179 deduction of $20,000 is carried forward to 2006.

> **Observation.** In **Example 4,** Jeff's §179 deduction is limited by the dollar limitation. In **Example 5,** Andy's deduction is limited by the income limitation. Only the income limitation can create a §179 carryforward.

If a sole proprietor operates his business at a loss, he may still be able to claim a §179 deduction if he has wages or other trade or business income on his return. This is the case even if the other income is earned by his spouse.

The taxpayer must also **actively participate** in the trade or business for the income of the business to be used in calculating the income limitation. Generally, a partner must meaningfully participate in the management or operations of the partnership's business in order to qualify as actively participating. A **passive investor** in a partnership does not actively conduct the business of a partnership.[5]

> **Example 6.** Bob is a retired investor whose sole sources of income are social security benefits and investments. He does not actively participate in the partnership or any other business activities. Bob receives a 2005 partnership Schedule K-1 showing $90,000 as his share of taxable business income and an $80,000 §179 deduction. There are no §1231 gains listed on the Schedule K-1.
>
> Because Bob is not an active participant in the partnership or any other business, the $80,000 of §179 expense cannot be taken in the current tax year. While the partnership has sufficient income to meet the income limitations and even though Bob's elected §179 expense is not above the dollar limitation, he is **not** an active participant in the partnership or any other business and therefore his §179 deduction is limited to $0. To add insult to injury, Bob's basis in the partnership is still reduced by the full amount of the §179 deduction allocated to him. If he never sells his interest in the partnership, the tax benefit of the §179 limitation is lost forever.

> **Observation.** Fortunately for Bob, there might be a resolution. Bob's personal tax advisor should notify the accountant for the partnership that Bob loses the tax benefits of the §179 election. The partnership may file an amended return to revoke the §179 election.

Controlled Groups

Members of controlled groups of corporations must aggregate their purchases to compute the §179 limit. However, S corporations are not considered component members of the controlled group in regard to the §179 deduction.[6]

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4. IRC §179(b)(3)
5. Treas. Reg. §1.179-2(c)(6)(ii)
6. Treas. Reg. §1.1563-1(b)(2)(ii)(c)

Multiple Limitations on Income (C Corporations Only)

Income limitations on certain deductions can present problems when trying to determine the correct amount of allowable deductions. For example, both the §179 deduction and the charitable deduction have limits tied to taxable income. This can create a "catch-22" situation if both limits come into play. This is because the §179 deduction is limited to taxable income **after** claiming the charitable deduction but, the charitable deduction is limited to taxable income **after** taking the §179 deduction.

To determine the correct amount of each deduction, a hypothetical §179 deduction should be used. The charitable deduction is computed first using taxable income less the hypothetical §179 deduction. Then the actual §179 deduction is computed after reducing taxable income by the amount of the charitable deduction previously calculated.

Example 7. ABC Corporation has taxable income of $30,000 before claiming either a $15,000 §179 deduction or a $5,000 charitable deduction. ABC has qualified asset purchases of $15,000. It elects to deduct all of the expense using the §179 deduction. The contribution deduction is calculated as follows:

Taxable income before deductions	$30,000
Less: maximum hypothetical §179 deduction	(15,000)
Hypothetical taxable income	$15,000
10% corporate income limitation applied	× .10
Maximum allowed charitable deduction	$ 1,500

Taxable income before deductions	$30,000
Less: maximum charitable deduction after hypothetical §179 deduction	(1,500)
Taxable income limit for §179 deduction	$28,500
Less §179 deduction	(15,000)
Taxable income after both the §179 and charitable deductions	$13,500

CLASS OF PROPERTY

The class life of an asset determines the recovery period and the depreciation system to be used. Class lives can range from 3 to 39 years. The following table provides descriptions of assets in various classes, the class life assigned to each asset, and the prescribed recovery periods under the General Depreciation System (GDS) and the Alternative Depreciation System (ADS).

Information on additional assets can be found in IRS Pub. 946, *How to Depreciate Property,* in Appendix B. The property class is generally the same as the GDS recovery period indicated in the table.

Asset Class	Description	Class Life	GDS Life (MACRS)	ADS Life
00.26	Tractor units for over-the-road use	4	3	4
01.223	Any race horse over two years old when placed in service		3	12
01.224	Any other horse (other than a race horse) over 12 years old when placed in service.		3	12
	Qualified rent-to-own property (defined later)		3	
00.22	Automobiles, taxis, buses, and trucks	3	5	5
00.12	Computers and peripheral equipment	6	5	5
00.13	Office machinery (such as typewriters, calculators, and copiers)	6	5	6
	Any property used in research and experimentation		5	Class life
01.21	Breeding cattle and dairy cattle	7	5	7
	Appliances, carpets, furniture, etc., used in a residential rental real estate activity		5	
	Any qualified Liberty Zone leasehold improvement property that the taxpayer elects not to treat as five-year property		5	
	Gasoline pump canopies — non-permanent structures (supporting concrete footings are considered permanent structures and are classified as 15-year land improvements)		5	
00.11	Office furniture and fixtures (such as desks, files, and safes)	10	7	10
01.1	Agricultural machinery and equipment, agricultural fences, and grain bins	10	7	10
	Any property that does not have a class life and has not been designated by law as being in any other class		7	12
	Certain motor sports entertainment complex property placed in service after October 22, 2004, and before January 1, 2008		7	
00.28	Vessels, barges, tugs, and similar water transportation equipment	18	10	18
01.4	Single-purpose agricultural or horticultural structures	15	10	15
	Trees or vines bearing fruits or nuts		10	
00.3	Certain improvements made directly to land or added to it (such as shrubbery, fences, roads, and bridges)	20	15	20
57.0	Distributive trades or services, including assets used in wholesale and retail trade, and personal and professional services	9	5	9

Asset Class	Description	Class Life	GDS Life (MACRS)	ADS Life
57.1	Retail motor fuels outlets, such as a convenience store	20	15	20
50	Municipal wastewater treatment plants	24	15	24
	Qualified leasehold-improvement property (defined later) placed in service after October 22, 2004, and before January 1, 2006		15	
	Qualified restaurant property (defined later) placed in service after October 22, 2004, and before January 1, 2006		15	
	Initial clearing and grading land improvements for gas utility property placed in service after October 22, 2004		15	
01.3	Farm buildings (other than single purpose agricultural or horticultural structures)	25	20	25
	Municipal sewers not classified as 25-year property		20	
	Initial clearing and grading land improvements for electric utility transmission and distribution plants placed in service after October 22, 2004		20	
	Water utility properties:		25	
	• 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*		25	
	• Municipal sewers placed in service after June 12, 1996, other than property placed in service under a binding contract in effect at all times since June 9, 1996**		25	
	Personal property with no class life		7	12
	§1245 real property with no class life		7	40
	Residential rental property*		27.5	40
	Nonresidential real property**		31.5 or 39	40

* This includes any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. It does not include a unit in a hotel, motel, or other establishment where more than half the units are used on a transient basis. If the taxpayer occupies any part of the building or structure for personal use, its gross rental income includes the fair rental value of the part occupied.

** This includes structures such as office buildings, stores, and warehouses. It is real property which is neither residential rental property nor property with a class life of less than 27.5 years. These properties are considered §1250 properties.

SPECIAL ASSET CLASSES

Luxury Vehicles

Depreciation Limitations for Luxury Automobiles. The maximum allowable deductions for luxury vehicles did not increase from the 2004 limitations. The maximum first-year depreciation remains at $2,960 for cars, while light trucks (under 6000 lbs. gross vehicle weight) and vans remain at $3,260.

> **Note.** See Chapter 9, "Small Business Issues," in this workbook for more information on deducting vehicle expenses. The luxury vehicle depreciation limits are also included in Chapter 15, "Tax Rates and Useful Tables."

Leasehold Improvements

Improvements a tenant or landlord makes on leased nonresidential real property have a 39-year life under the MACRS rules. This 39-year life applies even if the basic lease between the tenant and landlord is for a lesser period. Any unrecovered leasehold improvement costs abandoned by the tenant at the termination of the lease are deducted as ordinary losses under IRC §1231 and are not includable as income by the leasor.

However, qualified leasehold improvements and qualified restaurant property placed in service after October 22, 2004, and before January 1, 2006, can be treated as 15-year property under MACRS using the straight-line method. In addition, certain leasehold improvements placed in service before January 1, 2006 qualify for the 30% and/or 50% depreciation as mentioned previously. This abbreviated recovery period provides a greater benefit to taxpayers; however, the window is narrow. Beginning in 2006, leasehold improvements placed in service after December 31, 2005 revert back to the 39-year recovery period.

To qualify for the 15-year recovery period, the improvements must be made more than three years from the date the building was first placed in service. Expenditures made for the benefit of a common area of the property, or for an escalator or elevator, do not qualify. The landlord and tenant cannot be related, as determined in IRC §267(b), in order to use this 15-year recovery period.

> **Caution.** The 15-year recovery period is only available to leasehold improvements. If the property is owned and used by the same taxpayer, it is not a qualified leasehold property. This includes self-rental arrangements.

Intangible Assets

Generally, if intangible property is depreciable, the straight-line method of depreciation must be used. However, taxpayers can elect to depreciate certain intangible property under the income forecast method.

IRC §197 intangibles cannot be depreciated. This property must be amortized instead.

Patents and Copyrights. If the cost of a patent or copyright is depreciable, the straight-line method is used over the useful life. The useful life of a patent or copyright is the lesser of the life granted to it by the government or the remaining life when acquired. However, if the patent or copyright becomes valueless before the end of its useful life, any of its remaining cost or other basis is deducted in that year.

> **Example 8.** In April, Frank bought a patent for $5,100. It was not acquired in connection with the acquisition of any part of a trade or business. He depreciates the patent under the straight-line method, using a 17-year useful life and no salvage value.
>
> **$5,100 basis ÷ 17 years = $300 yearly depreciation deduction**
>
> Since he only used the patent for nine months during the first year, his first-year deduction is $225.
>
> **$300 × 9/12 = $225 first-year deduction**
>
> Frank can deduct $300 for subsequent full years. (Further information is provided later in this chapter for calculations of depreciation deductions for short tax years.)

Computer Software. If the cost of computer software cannot be deducted, the straight-line method over a useful life of 36 months is used. This is the case if the cost of the software is not material or the life is less than one year.

Certain Created Intangibles: Websites. A business may spend thousands of dollars to develop a website. If the website is simply an electronic advertisement, then the costs may be deducted currently. Costs of maintaining and updating the site are also currently deductible.

However, if the website is designed for complex applications, such as a virtual store, the costs are more properly capitalized. According to the IRS, websites qualify as "software" for depreciation purposes and as such should be amortized over 36 months starting the month that the site is placed in service.

Organization Costs and Start-Up Costs

Corporations or partnerships can elect to expense up to $5,000 of **organizational costs** paid or incurred after October 22, 2004. This $5,000 amount is reduced, but not below zero, for organizational costs exceeding $50,000. Organizational costs above $5,000 are to be amortized over a 180-month period.

Taxpayers can elect to expense up to $5,000 of **start-up costs,** paid or incurred after October 22, 2004, in the year in which the trade or business begins. If the start-up costs exceed $50,000, the expense deduction is reduced by the excess over $50,000 (but not below zero). Start-up costs in excess of $5,000 are amortized over 180 months.

> **Example 9.** Roland River spends $8,300 in various start-up costs during 2005 before opening his new restaurant on November 1, 2005. His start-up costs are for marketing studies, legal and accounting services, and costs incurred in finding a suitable location.
>
> Prior to October 22, 2004, these costs were capitalized and deducted over 60 months. Mr. River can now elect to expense $5,000 of these costs on his 2005 tax return, and amortize the remaining $3,300 (excess above the $5,000 expense amount) over 180 months beginning on November 1, 2005. His amortization deductions are $37 for 2005 and $220 for each subsequent full year.

DEPRECIATION METHODS

The Modified Accelerated Cost Recovery System (MACRS) has been in use for almost two decades. MACRS replaced the Accelerated Cost Recovery System (ACRS) for assets placed in service after December 31, 1986. ACRS was used for depreciating tangible personal property placed in service after 1980 and before 1987. Prior to ACRS, the IRS permitted a wide variety of depreciation methods, including straight-line depreciation, double-declining balance, and sum-of-the-years' digits.

Before discussing MACRS, it is important to understand some general depreciation concepts. The taxpayer's use of either GDS or ADS to depreciate property under MACRS determines what recovery period he uses. He generally must use GDS unless the Code requires the use of ADS, or he elects to use ADS.

REQUIRED USE OF DEPRECIATION: ALTERNATIVE DEPRECIATION SYSTEM (ADS)

Taxpayers must use ADS for the following property:

- Listed property used 50% or less in a qualified business,
- Tangible property used predominantly outside the United States during the year,
- Property used for tax-exempt purposes,
- Property financed with tax-exempt bonds,
- Property used predominantly in a farming business and placed in service in any tax year during which an election not to apply the uniform capitalization rules to certain farming costs is in effect,[7]
- Property imported from a foreign country for which an Executive Order is in effect because the country maintained trade restrictions or engaged in other discriminatory acts.

> **Caution.** A taxpayer required to use ADS to depreciate his property cannot claim a special depreciation allowance (30% and/or 50%) or special Liberty Zone depreciation allowance for the property.

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7. This only refers to farmers, such as citrus producers, who elect under IRC §263A(d)(3) to not capitalize plant production.

ELECTING ADS

Although property may qualify for GDS, a taxpayer can elect to use ADS. This irrevocable election applies to all property in the same class placed in service during the same tax year. However, the election for residential rental property and nonresidential real property can be made on a property-by-property basis.

Taxpayers make the election by completing line 20, Part III of Form 4562 as shown.

16	Other depreciation (including ACRS)	16

Part III **MACRS Depreciation (Do not** include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2005	17
18	If you are electing 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 2005 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						
b 5-year property						
c 7-year property						
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 2005 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 instructions)

21	Listed property. Enter amount from line 28	21
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
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** (2005)

MACRS RATES

The MACRS rates under the general depreciation system (GDS) depend on the recovery period of the asset and whether the half-year or mid-quarter conventions apply. The MACRS tables can be found in Pub. 946.

For non-farm 3-, 5-, 7-, and 10-year properties, the standard MACRS tables compute depreciation percentage rates using a modified 200% declining balance (DB) method. These tables begin with 200% DB rates but switch to straight-line percentage rates when the straight-line rates provide an equal or greater deduction.

> **Note.** See page 469 of the *2003 University of Illinois Federal Tax Workbook* for a detailed example of how to compute MACRS "longhand."

150% Rate Election

Taxpayers can **elect** to depreciate assets over a 150% DB rate instead of the 200% DB rate. This slower rate is beneficial to taxpayers subject to the alternative minimum tax (AMT). Farmers must use the 150% rate or elect to use the straight-line method over either the ADS or GDS life of an asset. With the expiration of 30% and/or 50% depreciation as of December 31, 2004, consideration should be given to electing 150% depreciation over the MACRS recovery period to avoid an AMT liability.

Straight-Line Method

An even slower rate of recovery is available to taxpayers who make the irrevocable election to use straight-line depreciation. Taxpayers can opt to use the straight-line method under either the GDS or ADS systems.

This method lets the taxpayer deduct the same amount of depreciation each year over the useful life of the property. To figure the deduction, first the adjusted basis, salvage value, and estimated useful life of the property is determined. If any salvage value exists, it is subtracted from the adjusted basis. The balance is the total depreciation that can be taken over the useful life of the property.

To calculate the yearly depreciation deduction, the balance is divided by the number of years in the useful life. Unless there is a big change in adjusted basis or useful life, this amount remains the same throughout the time the taxpayer depreciates the property. If the property is used for less than a full year, the depreciation deduction must be prorated for the number of months in use during the year.

CONVENTIONS

The depreciation period begins when property is treated as being placed into service. This is the date the property is ready and available for a specific use. For property which is converted from personal use to business use, it is the conversion date. In order to prevent taxpayers from reducing taxable income by claiming large depreciation deductions on year-end purchases, the IRS has established conventions that limit the amount of regular first year depreciation.

HALF-YEAR CONVENTION

This is the most commonly used method of depreciating business assets. The half-year convention treats assets as if they were purchased at the midpoint of the tax year regardless of when they were actually acquired. The effect is to provide the taxpayer with a half-year depreciation deduction on the asset in the first and last years and a full-year depreciation deduction in the intervening years. Therefore, five-year property is actually depreciated over a six year period. **No depreciation or §179 deduction is allowed on assets acquired and disposed of in the same year.**

MID-QUARTER CONVENTION

This convention applies if the total cost of business assets placed in service during the last three months of the year exceeds 40% of the total cost of all assets acquired during the tax year. The mid-quarter convention depreciates assets as if they were acquired at the midway point of the quarter, resulting in a smaller allowable depreciation deduction during the first year of service. Taxpayers can often avoid applying the mid-quarter convention by selecting assets acquired in the final quarter for the §179 deduction since the cost of assets expensed under §179 are not included in the 40% computation.

MID-MONTH CONVENTION

This convention only applies to nonresidential real property, residential rental property, and railroad gradings or tunnel bores. These assets are depreciated by allowing a half month of depreciation in the month acquired and a half month in the month of disposition.

SPECIAL SITUATIONS

DEPRECIATION FOR REGULAR TAX AND AMT

Taxpayers need to be aware of the difference between allowable depreciation deductions for regular tax purposes and AMT purposes when using GDS. This difference becomes a tax adjustment item that can create additional tax liability under AMT. To avoid AMT, taxpayers can opt to use the ADS for regular tax. ADS calculates depreciation on a 150% DB rate instead of a 200% DB rate.

A taxpayer may elect to apply ADS (150 DB or SL) to any class of property for any taxable year. In the case of residential real property or nonresidential real property, the election may be made separately for each class of property.

For assets placed in service after 1998, taxpayers can make an election to use the same class life for both regular and AMT purposes. Making this election allows taxpayers to use 150% DB method over the normal MACRS recovery period for both regular and AMT purposes.

> **Observation.** This election may be beneficial to taxpayers subject to AMT in the current year or who have a minimum tax credit carryforward but do not anticipate sufficient regular tax available in future tax years to absorb the credit.

Example 10. Harvey Pepper, a self-employed trucking contractor, bought three new Peterbilt tractors for use in his business in 2005. Each of the tractors cost $120,000. For regular depreciation purposes under three-year MACRS and the half-year convention, Mr. Pepper can take a $40,000 depreciation deduction for each rig for a total deduction of $120,000. For AMT purposes, using the 150 DB over a four-year midpoint, Pepper is only allowed a depreciation deduction of $22,500 per tractor or $67,500. The $52,500 difference between regular MACRS depreciation and AMT depreciation is an adjustment item that can lead to an AMT liability.

If Mr. Pepper is subject to AMT or has a minimum tax credit carryforward available to use, he should consider making an election to use ADS depreciation for the tractors purchased in 2005. While his regular depreciation deduction would be reduced to $67,500, it would match his AMT depreciation deduction, so the preference item adjustment would be unnecessary.

SHORT YEAR DEPRECIATION

A short tax year is any tax year with less than 12 full months. This section discusses the rules for determining the depreciation deduction allowed for property placed in service or disposed of in a short tax year. The most common examples of a short year are upon a business start-up or termination, corporate merger with different tax years, and conversions of C corporations to S corporations. It also discusses rules for determining depreciation when there is a short tax year during the recovery period (other than the year the property is placed in service or disposed of).

The MACRS percentage tables should not be used to determine depreciation for a short tax year. For more information on figuring depreciation for a short tax year, see Rev. Proc. 89-15 in Internal Revenue Bulletin 1989-9.

> **Observation.** Schedule C and F businesses may be started or terminated at any time during the individual's tax year and are excepted from the short year rules.

Using the Applicable Convention in a Short Tax Year

The applicable convention establishes the date property is determined to be placed in service and disposed of. Depreciation is allowable only for that part of the tax year the property is treated as in service. The recovery period begins on the placed-in-service date determined by applying the convention. The remaining recovery period at the beginning of the next tax year is the full recovery period less the part for which depreciation was allowable in the first tax year.

The following discussions explain how to use each applicable convention in a short tax year.

Half-Year and Mid-Month Conventions

First or Last Day of Month. For a short tax year beginning on the first day of a month or ending on the last day of a month, the tax year consists of the number of months in the tax year. If the short tax year includes part of a month, the full month is generally included in the number of months in the tax year. To determine the midpoint of the tax year, divide the number of months in the tax year by two. For the half-year convention, property is treated as placed in service or disposed of on either the first day or the midpoint of a month.

> **Example 11.** Tara Corporation, a calendar-year taxpayer, incorporates on March 15. Since its tax year ends on December 31, Tara's short tax year is treated as beginning on March 1 instead of March 15. During the short (10-month) tax year, Tara places property in service using the half-year convention. Tara treats this property as placed in service on the first day of the sixth month of the short tax year, or August 1.

Not on First or Last Day of Month. For a short tax year not beginning on the first day of a month and not ending on the last day of a month, the tax year consists of the number of days in the tax year. The midpoint of the tax year is determined by dividing the number of days in the tax year by two. For the half-year convention, property is treated as placed in service or disposed of on either the first day or the midpoint of a month. If the result of dividing the number of days in the tax year by two is not the first day or the midpoint of a month, the property is treated as placed in service or disposed of on the nearest preceding first day or midpoint.

Mid-Quarter Convention

To determine if the mid-quarter convention is required, compare the basis of property placed in service in the last three months of the tax year to property placed in service during the full tax year. The length of the tax year does not matter. If this is a short tax year of three months or less, use the mid-quarter convention for all applicable property placed in service during that tax year.

Property under the mid-quarter convention is treated as placed in service or disposed of on the midpoint of the quarter of the tax year in which it is placed in service or disposed of. The short tax year is divided into four quarters to determine the midpoint of each quarter.

For a short tax year of four or eight full calendar months, quarters are determined on the basis of whole months. The midpoint of each quarter is either the first day or the midpoint of a month. Property is treated as placed in service or disposed of on this midpoint.

To determine the midpoint of a quarter for a short tax year of other than four or eight full calendar months, complete the following steps:

1. Determine the number of days in the short tax year.
2. Determine the number of days in each quarter by dividing the number of days in the short tax year by four.
3. Determine the midpoint of each quarter by dividing the number of days in each quarter by two.

If Step 3 results in a quarter's midpoint falling on a day other than the first day or midpoint of a month, the property is treated as placed in service or disposed of on the nearest preceding first day or midpoint of that month.

Example 12. Tara Corporation, a calendar-year taxpayer, incorporates and begins business on March 15. During December, it places property in service for which it must use the mid-quarter convention. Consequently, Tara has a short tax year of 9½ months. Since this is a short tax year and is not four or eight full calendar months, it must determine the midpoint for each quarter:

1. Its short tax year consists of 292 days (beginning March 15 and ending December 31).
2. The length of each quarter is 73 days (292 days ÷ 4).
3. The midpoint of each quarter is the 37th day (73 days ÷ 2).

The following table shows the quarters of Tara Corporation's short tax year, the midpoint of each quarter, and the date in each quarter that Tara must treat its property as placed in service.

Quarter	Midpoint	Placed in Service
March 15–May 26	April 20	April 15
May 27–August 7	July 2	July 1
August 8–October 19	September 13	September 1
October 20–December 31	November 25	November 15

The last quarter of the short tax year begins on October 20, which is 73 days from December 31, the end of Tara's tax year. The 37th day of the last quarter is November 25, which is the midpoint of the quarter. November 25 is not the first day or the midpoint of November, so Tara Corporation must treat the property as placed in service in the middle of November (the nearest preceding first day or midpoint of that month).

Property Placed in Service in a Short Tax Year

To compute the MACRS depreciation deduction for a short tax year, first the deduction is determined that would be allowed for a full tax year under the 200% DB method (if using MACRS GDS tables, double the rate for the first year because it is computed on a half-year convention). Then, the full-year deduction is multiplied by a fraction; the numerator is the number of months (including parts of a month) the property is treated as being in service during the tax year, and the denominator is 12.

> **Note.** See "Depreciation after a Short Tax Year," later in this chapter for information on how to compute depreciation for subsequent years.

Example 13. Tara Corporation, with a short tax year beginning March 15 and ending December 31, placed an item of five-year property with a basis of $1,000 in service on March 16. This is the only property the corporation placed in service during the short tax year. Tara does not elect to claim a §179 deduction. The full-year depreciation rate is 40% under the 200% DB GDS method for five-year property (200% ÷ 5 = 40%).

Tara treats the property as placed in service on August 1. (See **Example 11.**) Tara is allowed five months depreciation for half of its 10-month short tax year. To determine the allowable short-year depreciation deduction, the asset's $1,000 basis is multiplied by 40% to determine the depreciation deduction allowable for a full tax year. The $400 result is then multiplied by 5/12 to get the short tax year depreciation deduction of $167 ($1,000 × 40% = $400 × $^{5}/_{12}$ = $167).

Example 14. Use the same facts as in **Example 11,** except Tara does not place the item in service until October 16. Since all property was placed in service during the last three months of the tax year, the mid-quarter convention must be applied.

Tara treats the property as placed in service on September 1, in the third quarter of its short year. (See **Example 12.**) To determine the allowable short-year depreciation deduction under the mid-quarter convention, the asset's $1,000 basis is multiplied by 40% to determine the depreciation deduction allowable for a full tax year. The $400 result is then multiplied by 4/12 to get the short tax year depreciation deduction of $133 (($1,000 × 40%) × (4 ÷ 12)).

Property Placed in Service before a Short Tax Year

If a short tax year occurs after the tax year in which property was first depreciated, the depreciation computation method for that property must be changed and the MACRS percentage tables no longer apply. Depreciation calculations for the short tax year and each subsequent tax year are explained next.

Depreciation after a Short Tax Year. Either of the following methods may be used to compute depreciation for years following a short tax year, but the method chosen must be applied consistently thereafter:

1. The simplified method
2. The allocation method

Using the Simplified Method for a 12-Month Year. Under the simplified method, the depreciation is computed for a later 12-month year in the recovery period by multiplying the adjusted basis of the property at the beginning of the year by the applicable depreciation rate.

Example 15. Use the same facts as in **Example 13.** The Tara Corporation claimed depreciation of $167 for its short tax year. The adjusted basis on January 1 of the following year is $833 ($1,000 – $167). Tara's depreciation for that next year is 40% of $833, or $333.

Using the Simplified Method for a Short Year. If a later tax year in the recovery period is a short tax year, depreciation for that year is calculated by multiplying the adjusted basis of the property at the beginning of the tax year by the applicable depreciation rate. The result is then multiplied by a fraction, the numerator is the number of months (including parts of a month) in the short tax year and the denominator is 12.

Using the Simplified Method for an Early Disposition. If property is disposed of in a later tax year, but before the end of the recovery period, determine the depreciation for the year of disposition by multiplying the adjusted basis of the property at the beginning of the tax year by the applicable depreciation rate and then multiplying the result by a fraction. The fraction's numerator is the number of months (including parts of a month) the property is treated as being placed in service during the tax year (applying the appropriate convention) and the denominator is 12.

Using the Allocation Method for a 12-Month or Short Tax Year. Under the allocation method, depreciation is calculated for each later tax year by allocating to that year the depreciation attributable to the parts of the recovery years that fall within that year. Whether the tax year is a 12-month or short tax year, the depreciation is calculated by determining which recovery years are included in that year. For each recovery year included, multiply the depreciation attributable to that recovery year by a fraction. The fraction's numerator is the number of months (including parts of a month) of the recovery year that are included in the tax year and its denominator is 12. The allowable depreciation for the tax year is the sum of the depreciation calculated for each recovery year.

Example 16. Use the same facts as in **Example 13.** Tara Corporation's first tax year after the short tax year is a full 12 months, beginning January 1 and ending December 31. The first recovery year for the five-year property placed in service during the short tax year extends from August 1 to July 31. Tara deducted five months of the first recovery year on its short-year tax return. Seven months of the first recovery year and five months of the second recovery year fall within the next tax year. The depreciation for the next tax year is $333, which is the sum of the following:

1. $233 — the depreciation for the first recovery year ($400 × 7/12), plus
2. $100 — the depreciation for the second recovery year (figured by multiplying the adjusted basis of $600 ($1,000 ($167 + $233)) by 40%, then multiplying the $240 result by 5/12.

Using the Allocation Method for an Early Disposition. If property is disposed of before the end of the recovery period in a later tax year, the depreciation for the year of disposition is determined by multiplying the depreciation figured for each recovery year or part of a recovery year included in the tax year by a fraction. The numerator of the fraction is the number of months (including parts of months) the property is treated as in service in the tax year (applying the applicable convention), and the denominator is 12. If there is more than one recovery year in the tax year, add together the depreciation for each recovery year.

> **Observation.** The simplified method will usually be the method of choice.

CORRECTING PRIOR DEPRECIATION ERRORS

> **Observation.** This continues to be a windfall for new or existing clients who have not claimed allowable depreciation in prior years. This provision gives the taxpayer the opportunity to claim the full amount of missed depreciation of all prior years in the current year. This effectively eliminates the "use it or lose it" rule.

The IRS allows taxpayers to "catch-up" on missed depreciation deductions under the provisions of various revenue procedures issued over the past nine years. To claim missed depreciation, even if the tax year of the missed deduction is closed, taxpayers file Form 3115, *Application for Change in Accounting Method*. No user fee is required with this filing.

> **Observation.** An amended return may be filed instead of Form 3115 for any open tax year which ended prior to December 30, 2003. For example, if a 2004 tax return has been filed, the only such year would be a tax year beginning in 2002. This could be advantageous when significant missed depreciation could create a NOL in 2002 that would be eligible for the five-year carryback period.

Rev. Proc. 2002-9 provides guidance for computing "catch-up" depreciation. Although it is considered a change in the method of accounting by the taxpayer, the IRS allows the additional depreciation under the "automatic consent" guidelines of Rev. Proc. 2004-11. Prior to the issuance of Rev. Proc. 2002-9, taxpayers with a "favorable change" were required under IRC §481(a) to spread the depreciation difference over four years when the dollar amount was over $25,000.[8] Now, if the adjustment is taxpayer friendly (a negative §481(a) adjustment), the entire amount of the adjustment is taken into account in the year of change.

Practitioners will sometimes find errors in depreciation made by a client, but not file Form 3115 to claim the missed depreciation. For example, a new client may have depreciated residential apartment appliances over seven years instead of the permitted five years under MACRS. If these assets are nearing the end of their seven-year period, catching-up missed depreciation may not be worth the effort.

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8. Rev. Proc. 96-31, April 26, 1996

Note. A tax practitioner may be faced with the problem of reconstructing depreciation for a new client when no prior depreciation records are available. For example, a taxpayer with rental properties has no supporting depreciation schedules to back up the depreciation claimed on his most recently filed tax return. His prior accountant has no information regarding depreciation schedules. The initial step is to gather all prior returns of the taxpayer to get opening cost records and starting methods for depreciation. Then, the taxpayer's source documents, such as closing statements for the purchase of property and costs of improvements over the years must be reviewed. Once all available supporting information is obtained, the practitioner must construct a current depreciation schedule and match the prior depreciation claimed on the tax returns with the accumulated depreciation.

Note. A detailed discussion and completed example of a change in depreciation is found on pages 329–342 of the *2004 University of Illinois Federal Tax Workbook.*

BASIS OF DEPRECIABLE PROPERTY

Generally, the purchase price of an asset represents its basis. However, the rules for determining basis change for other methods of acquisition, such as receipt of property by inheritance, gift, nontaxable exchange, or an IRC §754 election.

PURCHASED ASSETS: COST SEGREGATION

Cost segregation studies are becoming more important in the purchase of real properties. Rather than depreciating the entire cost of commercial real estate over a 39-year life, or residential rental property over a 27.5-year life using the straight-line method, taxpayers may be able to identify and segregate the respective property assets included in the purchase having shorter recovery periods. This allows these items to be depreciated faster.

Example 17. Jacob Pixcar decided to take advantage of the current real estate craze by acquiring a building lot zoned for multi-family construction. He then constructed a 16-unit apartment building on the site. At the end of his first year of operation, Mr. Pixcar provides his tax practitioner with these costs:

Land	$ 54,500
Building costs	580,000
Total	$634,500

Mr. Pixcar knows that the cost of land cannot be depreciated. Since the apartments were first available for rent on August 1, 2005, he also knows he is allowed only 4½ months of depreciation in 2005 on the $580,000 it cost to build them. Using the 27.5-year MACRS tables, he estimates his depreciation deduction for the five-month period at $7,909.

Mr. Pixcar's tax practitioner reviews his building costs, looking for items included in the purchase price that have shorter cost-recovery periods under MACRS. He identifies the following eligible assets:

	Cost	Class
Appliances (kitchen appliances, washer/dryer)	$36,000	5 year
Parking lot and sidewalks	26,500	15 year
Landscaping	8,500	15 year
	$71,000	
Building	$509,000	

Using this information, the practitioner was able to compute an allowable 2005 depreciation deduction of $15,891, **more than twice Mr. Pixcar's estimate**.

For Example 17

JACOB D PIXCAR 456-12-9870 2

Form 4562 Continued

Regular Tax Depreciation Report

Activity: Sch E MULTI UNIT APT BUILDING - 2004

Description	Auto	Home	Imp	In Service / Disposed	Cost / Basis	Land / 179	Bus % / Listed	Type / Meth	Class / Life	Conv / Yr	Depr / Prior
APARTMENT BUILDING				8/31/04	563,500	54,500	100.00	MACRS	R	MM	6,941
					509,000			SL	27.5	1	
APPLIANCES				8/01/04	36,000		100.00	MACRS	5	HY	7,200
					36,000			200DB	5.0	1	
PARKING LOT/SIDEWALKS				8/01/04	26,500		100.00	MACRS	15	HY	1,325
					26,500			150DB	15.0	1	
LANDSCAPING				8/01/04	8,500		100.00	MACRS	15	HY	425
					8,500			150DB	15.0	1	
Total					634,500	54,500					15,891
					580,000						

3

Form 4562

Alternative Minimum Tax Depreciation Report

Activity: Sch E MULTI UNIT APT BUILDING - 2004

Description	Real	Leased	AMT Cost / AMT Basis	AMT Life / AMT Meth	AMT Depr / AMT Prior	AMT Adj / AMT Pref
APARTMENT BUILDING			563,500	40.0	4,772	2,169
			509,000	SL		
APPLIANCES			36,000	9.0	2,999	4,201
			36,000	150DB		
PARKING LOT/SIDEWALKS			26,500	15.0	1,325	0
			26,500	150DB		
LANDSCAPING			8,500	15.0	425	0
			8,500	150DB		
Total			634,500		9,521	6,370
			580,000			

For AMT purposes, the AMT midpoint for appliances is 9 years.[9]

9. Rev. Proc. 87-56, October 19, 1987

For Example 17

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
2005
Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Jacob D Pixar	Schedule E Multi Unit Apt Building	456-12-9870

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

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$105,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$420,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6			
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	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2004 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2006. Add lines 9 and 10, less line 12 ▶	13	

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.**)** (See instructions.)

14	Special allowance for certain aircraft, certain property with a long production period, and qualified New York Liberty Zone property (other than listed property) placed in service during the tax year	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Do not** include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2005	17	
18	If you are electing 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 2005 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						
b 5-year property		36,000	5.0 yrs	HY	200 DB	7,200
c 7-year property						
d 10-year property						
e 15-year property		35,000	15.0 yrs	HY	150 DB	1,750
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property	08/04	509,000	27.5 yrs.	MM	S/L	6,941
			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 2005 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 instructions)

21	Listed property. Enter amount from line 28	21	
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	15,891
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** (2005)

INHERITED PROPERTY

In most cases, the basis of depreciable property received as an inheritance is the fair market value (FMV) on the decedent's date of death, unless the estate elects an alternative valuation. The beneficiary of inherited property must use the applicable depreciation method available at the time of transfer, even if the decedent used a different system or the property was fully depreciated.

Example 18. Dilbert Rogg, a self-employed contractor, inherited a Cat skid loader from his father's estate. His dad had fully depreciated this piece of equipment but the skid loader was appraised at $21,500 in the estate. Dilbert is treated as if he purchased the asset and can use the seven-year recovery period under MACRS to depreciate it. However, he cannot elect to expense the inherited asset under §179 because he did not purchase it.

The basis of property received by a surviving joint tenant (owned with the decedent as tenants by the entirety, or joint tenants with rights of survivorship) receives a "step-up" in basis equal to the FMV reported in the decedent's estate.

Example 19. Norman and Lillian Sparks bought a Florida condo for $80,000 in 1986 to use as rental property. After adjusting for land costs of $8,000, they fully depreciated the remainder of the property by the time Norman died in 2005. At the time of his death, the condo had an FMV of $450,000. One-half of this jointly owned property, or $225,000, was reported in Norman's estate. As the surviving joint tenant, Lillian received a step-up in basis of $225,000.

The basis to the surviving joint tenant must be allocated based on the relevant FMVs of the building versus the land.

Note. Additional information regarding the basis and holding periods of inherited property appears in Chapter 8, "Basic Estate and Trust Taxation," of this workbook.

PROPERTY ACQUIRED BY GIFT

The basis of depreciable property received by gift is the lesser of the donor's adjusted basis at the time of gifting or the FMV of the asset.

The basis of gifted depreciable property is increased by the applicable portion of any gift tax paid by the donor plus any suspended passive losses attributed to the property. The depreciable portion of the gift tax is allocated based on the net appreciation of the gifted asset.

Example 20. Lucy Lu was gifted a rental duplex by her father. At the time of the gift, the FMV was $115,000 (building only) and her father's adjusted basis was $30,000. There was also a suspended passive loss of $10,000 attributed to the property. Since her father had made multiple transfers over the years, he had completely exhausted his $1 million unified credit for gifting purposes. As a result, he filed a Form 709 and paid gift tax of $46,740. As a result, Lucy's basis in the gifted property (exclusive of any land costs) is computed as follows:

Less: donor's adjusted basis	(30,000)
Net increase in value	$ 85,000
Percentage of increase in value ($85,000 ÷ $115,000):	74%
Gift tax paid	$ 46,740
Percentage attributable to increase	× .74
Allocated gift tax	$ 34,588
Donor's adjusted basis	$ 30,000
Plus: allocated gift tax	34,588
Plus: suspended passive loss	10,000
Recipient's depreciable basis	$ 74,588

Lucy must commence depreciating the property using the 27.5-year recovery period, straight-line method, and a basis of $74,588.

PROPERTY ACQUIRED INCIDENT TO DIVORCE

In divorce situations, suspended passive losses attributable to the relinquished property are added to the basis of the spouse receiving the property.

Even if there are no passive losses, the spouse receiving the property has two depreciation schedules. One is a continuation of his half of the property. The other schedule shows a property with the basis of the contributing spouse, but requires a new recovery period.

Example 21. Sue and Steve are in the process of a divorce. Among other assets, they own two rental condos as joint tenancy with rights of survivorship (JTWROS). The divorce decree gives condo A to Sue and condo B to Steve, effective January 1, 2005.

	Condo A	Condo B
Acquisition date	June 6, 2001	July 1, 2002
Original purchase price	$200,000	$300,000
Accumulated depreciation (assume all basis in the approvements)	(25,756)	(26,817)
Adjusted basis	$174,244	$273,183
Sue's share	87,122	136,592
Steve's share	87,122	136,591

Since Sue acquires title to condo A on January 1, 2005, her starting basis is $174,244. However, for depreciation purposes, her basis is allocated due to the divorce.

Description	Date Acquired	Cost	Acc. Depr.	Remaining Basis	Method	Conv.	Orig. Life	Remain Life	Current Depr.
Undivided ½ Condo A (original purchase)	6/1/01	$100,000	$12,878	$87,122	SL	MM	27.5	24	$3,636
Undivided ½ Condo A (acquired in divorce)	1/1/05	100,000	12,878	87,122	SL	MM	27.5	27.5	3,036
Total depreciation deduction for Sue									$6,672
Deduction for Sue had there been no divorce									$7,272

Steve also makes a similar calculation for condo B which he received in the divorce.

PROPERTY ACQUIRED IN A NONTAXABLE EXCHANGE

Temporary regulations were issued in February 2004 which incorporated the principles originally outlined in Notice 2000-4. These described the tax treatment for depreciating MACRS property acquired in a like-kind exchange under IRC §1031 or via an involuntary conversion under IRC §1033.[10]

The taxpayer should treat the replacement property's basis as two separate assets on the depreciation schedule:

1. The first asset is the depreciation's excess basis, or additional cost to acquire the replacement property on the trade.
2. The second asset for depreciation purposes is the depreciable exchanged basis for the property traded in the like-kind exchange. The remaining basis is depreciated over the remaining life of the traded asset.

Taxpayers can elect out of the above requirements. If this election is made, the basis for depreciation of the new asset is the adjusted basis of the relinquished property plus the cash difference to acquire the replacement property.

[10] Treas. Decision 9115, February 27, 2004

IRC §754 ELECTIONS

A partnership or LLC can make an election under §754(b) to adjust the basis of its assets when there is a transfer of one or more of the partner's or member's interests. This election must be made with the tax return for the year of transfer.

If the property represents IRC §1250 residential rental property, the step-up in basis is depreciated over the property's useful life.

Example 22. In 1982, Albert, Bobby, Claude, and Dewayne form a partnership to acquire a 64-unit residential rental complex for $1 million. All four individuals have an equal 25% interest in the partnership. At the time of the purchase, $100,000 is allocated to land and the remaining $900,000 is allocated to the building. The FMV of the complex is $2.5 million on January 1, 2005. Claude sells his interest to the remaining partners for 25% of the FMV, or $625,000.

The practitioner for the partnership suggests making a §754 election so the acquiring partners can get a tax benefit from the buy-out. This election allows 90% of the buyout (the portion attributed to the building) to be depreciated over 27.5 years.

Cost of Claude's interest	$625,000
Less: allocation of land costs	(62,500)
Balance	$562,500
Annual deduction under §754 ($562,500 ÷ 27.5 years)	$ 20,455

If the individual partners did not make a §754 election, the entire $625,000 would be added to their "outside basis" and their tax benefit will only occur on a subsequent sale of their respective partnership interest. If a partner dies owning his partnership interest, the FMV of the interest becomes part of his estate and his share of the purchase of the outgoing partner will, in effect, be lost.

Note. IRC §754 is also discussed in Chapter 5, "Entity Issues," in this workbook. A discussion on recapture is found in Chapter 9, "Small Business Issues," in this workbook.