Chapter 7: Depreciation

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

NEW LEGISLATION

In addition to creating the well-publicized tax rebates, the Economic Stimulus Act of 2008 (ESA) also expanded depreciation options for businesses. Congressional intent is to give businesses an incentive for investing in capital assets in the hopes that such investments will boost the lagging economy. Projected tax savings from the two changes is expected to be $44.8 billion.[1]

The first depreciation change is a 1-year increase in the allowable IRC §179 deduction. The second is a revival of 50% bonus depreciation.

STATES MAY DECOUPLE

Many states decouple from the federal rules regarding bonus depreciation and the IRC §179 deduction. This creates different state and federal depreciation computations in the year of acquisition, for each year of ownership, and in the year of disposition. Tax professionals must understand the depreciation rules for all state returns prepared by checking with each state for specific tax guidance.

1. CCH Tax Briefing: *Economic Stimulus Package*, February 13, 2008

ENHANCED IRC §179 DEDUCTION

For taxable years **beginning in 2008,** the maximum amount that a taxpayer can deduct under §179 is $250,000 (up from the $128,000 limit that would have been in place for 2008 absent of ESA). This amount is reduced when the amount of qualifying property placed in service during the year exceeds $800,000 (previously $510,000).

For taxable years **beginning after** December 31, 2008, the limits revert to the inflation-adjusted amounts under previous law.

These changes do not affect the $25,000 limitation on sport utility vehicles.

REBIRTH OF 50% BONUS DEPRECIATION

For qualified property purchased and placed in service during the 2008 calendar year, taxpayers must deduct (unless they elect out) an additional 50% of the purchase price remaining after any §179 deduction is taken (and before figuring the regular depreciation deduction). This chapter refers to the additional deduction as bonus depreciation. Another common phrase used in IRS publications for this additional deduction is the **special depreciation allowance.**

Qualified Property[2]

The following types of property may qualify for the bonus depreciation election:

- Tangible property with a recovery period of 20 years or less, depreciated under MACRS
- Water utility property
- Off-the-shelf computer software
- Certain leasehold improvements between unrelated parties

All the following tests must be met:

1. The property must be **purchased** during calendar year **2008.**
2. The property must be **placed in service** during calendar year **2008.** However, the placed-in-service date is extended through 2009 for certain transportation property and certain property with a recovery period of 10 years or longer.
3. The taxpayer must be the **original user** of the property.

Property that **does not qualify** includes:

- Property placed in service and disposed of during the same tax year,
- Property converted from business use to personal use in the same tax year as it is acquired,
- Property required to be depreciated under the alternative depreciation system (ADS),
- Property for which a purchase contract was in force prior to January 1, 2008,
- Property built by the taxpayer for the taxpayer's own use if construction began prior to January 1, 2008, and
- Property that is listed property with business use of 50% or less.

2. *Depreciation and Section 179 Expense*, www.irs.gov/formspubs/article/0,,id=177054,00.html, accessed March 8, 2008

Vehicles

Business vehicles are normally subject to limited depreciation under the listed property rules. For 2008, the limits for vehicles that qualify for bonus depreciation are increased by $8,000. The maximum depreciation deduction allowed for a passenger automobile is $10,960 and the maximum for trucks and vans is $11,160. These limits are reduced if the vehicle's business use is less than 100%.[3] Bonus depreciation is not allowed when business use is 50% or less.[4]

> **Note.** An in-depth discussion of depreciating vehicles is found later in this chapter.

Highlights of Provisions[5]

The 50% bonus depreciation allowance is generally patterned after prior bonus depreciation statutes. As of April 2008, the IRS indicated that it intended to issue **guidance** on the new law, but that until it did, taxpayers could generally rely on Treas. Reg. §1.168(k)-1.[6] As of August 2008, the IRS has not yet issued guidance. The following six points highlight the key provisions of bonus depreciation:

1. Bonus depreciation is automatic unless the taxpayer makes an election out for all assets in the same MACRS class purchased during the year. To elect out, a statement is attached to the return indicating the taxpayer elects not to claim any special allowance for the class indicated. The election must be made separately for each class and by each person who owns the qualified property. Once made, the election cannot be revoked without IRS consent.[7]

2. **Bonus depreciation is taken for both regular tax and AMT purposes.** Once it has been used, the remaining MACRS depreciation is not adjusted for AMT purposes in subsequent years.

3. Unqualified property cannot be converted to qualified property via transactions with related parties. For example, property under construction during 2007 is not considered qualified property if it is sold to a related taxpayer in 2008.

4. The §179 deduction is taken first.

5. **Unlike the §179 deduction, there are no overall limits to the total amount of bonus depreciation that may be claimed, nor are there any limits based on the total cost of assets purchased during the year.**

6. If qualified property is acquired in a like-kind exchange, the carryover basis in the old asset plus the excess basis (boot) of the new asset qualify for bonus depreciation.[8]

> **Note.** The 2007 *University of Illinois Federal Tax Workbook* contains a comprehensive discussion of what constitutes boot on pages 142–144.

Special rules applying to **sale-leaseback** arrangements are not covered in this material. See IRS Pub. 946, *How to Depreciate Property*, Chapter 3.

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3. Ibid

4. IRS 2007 Form 4562-FY Instructions, p. 4

5. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 5140, the "Economic Stimulus Act of 2008" as passed by the House of Representatives and the Senate on February 7, 2008* (JCX-16-08), February 8, 2008

6. IR-2008-58, *IRS To Issue Guidance on Special 50-Percent Depreciation Allowance,* April 11, 2008

7. IRS 2007 Form 4562-FY Instructions, p. 5

8. Treas. Reg. §1.168(k)-1(f)(5)(iii)

Special Definitions

Original Use. The first use of the property, whether or not such use corresponds to the use of the property by the taxpayer, is considered original use.[9]

> **Example 1.** Marti bought an electronic organizer in 2007 for use in her retail sales shop. However, frustrated by the set-up requirements, she only used it as a paperweight. In January 2008, she sold it to one of her customers, Jan, who uses it as an organizer. Jan's use is not considered the first use of the property.

Additional capital expenditures incurred by the taxpayer to recondition or rebuild property satisfy the original-use requirement. However, the cost of purchasing already-reconditioned or rebuilt property does not.[10]

If, in the normal course of its business, a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first use of each fractional interest. Each fractional owner is considered the original user of its proportionate share of that property.[11]

Qualified Leasehold Improvements.[12] To qualify for bonus depreciation, improvements to nonresidential real property must be made pursuant to a lease agreement and must be between unrelated parties. The leasehold improvements must also be:

- To the interior portion of the building,
- Placed in service more than three years after the date the building was first placed in service, and
- In the portion of the building occupied exclusively by the lessee (or sub-lessee).

> **Note.** Bonus depreciation for leasehold improvements is available to the taxpayer who pays for the improvements, whether that taxpayer is the lessor, lessee, or sub-lessee.

The following leasehold improvements **do not qualify:**

- Enlargements of the building
- Elevators or escalators
- Common area improvements
- Changes to the structural framework of the building

Related parties include immediate family members, taxpayers having more than 80% ownership in common, and members of an affiliated group as defined in IRC §1504. An extensive list of additional relationships disqualifying leasehold improvements from bonus depreciation can be found in IRC §267(b). However, 80% is substituted for 50% wherever it appears in that section.

Extended Placed-in-Service Date through 2009. In order to qualify for the extended placed-in-service date, the property must have an estimated production period exceeding one year and a cost exceeding $1 million.[13] In addition, it must be qualified transportation property **or** have a recovery period of at least 10 years.

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9. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 5140, the "Economic Stimulus Act of 2008" as passed by the House of Representatives and the Senate on February 7, 2008* (JCX-16-08), February 8, 2008
10. Treas. Reg. §1.168(k)-1(b)(3)(i)
11. Treas. Reg. §1.168(k)-1(b)(3)(iv)
12. IRC §168(k)(3)
13. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 5140, the "Economic Stimulus Act of 2008" as passed by the House of Representatives and the Senate on February 7, 2008* (JCX-16-08), February 8, 2008

Only the portion of the cost incurred prior to January 1, 2009, qualifies for the bonus depreciation.[14]

Property That Cannot Be Depreciated under MACRS.[15] The most common types of property excluded from MACRS are:

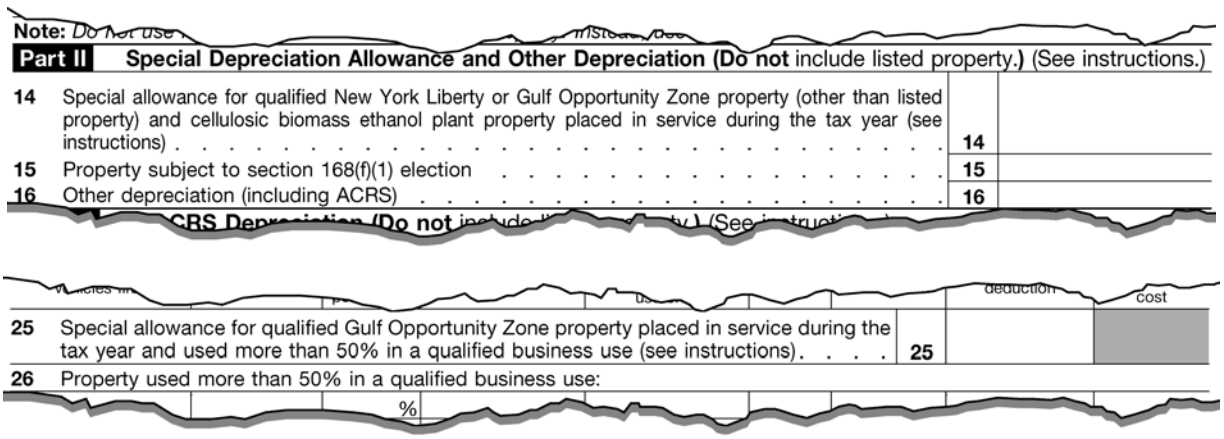
- Intangible property;
- Films, video tapes, and recordings; and
- Certain corporate or partnership property acquired in a nontaxable transfer.

Fiscal-Year Filers

Taxpayers with fiscal years beginning in 2007 and ending in 2008 may purchase property that qualifies for the bonus depreciation. The IRS issued a new form, **2007 Form 4562-FY,** *Depreciation and Amortization,* for fiscal-year filers who want to claim the bonus depreciation for property placed in service after December 31, 2007. This is a transition-year form that will not be necessary after 2007.

The form is substantially the same as the original 2007 Form 4562. Lines 14 and 25 have been reworded to reflect the new law.

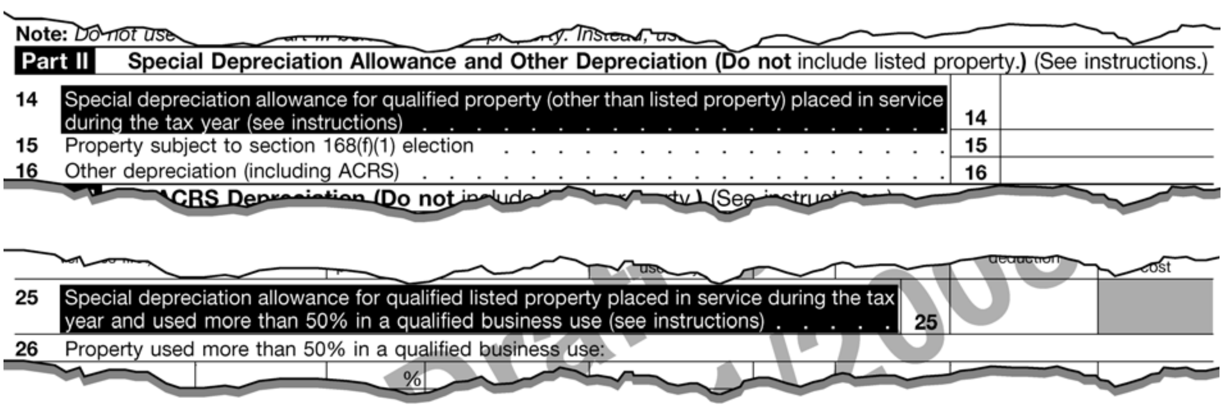
The original wording on 2007 Form 4562:


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

14	Special allowance for qualified New York Liberty or Gulf Opportunity Zone property (other than listed property) and cellulosic biomass ethanol plant property placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

25	Special allowance for qualified Gulf Opportunity Zone 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:			

The new wording on 2007 Form 4562-FY:


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

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

25	Special depreciation allowance for qualified 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:			

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14. IRC §168(k)(2)(B)(ii)

15. IRS Pub. 946, *How to Depreciate Property*

As of this writing, the wording in the current draft of the 2008 Form 4562 has not changed.

Caution. While both of the depreciation provisions are available for 2008 only, the effective dates of each of them need to be considered carefully. There is no problem for calendar-year taxpayers. For fiscal-year taxpayers, the §179 deduction applies to the fiscal year beginning in 2008. Bonus depreciation applies to property acquired from January 1 to December 31, 2008. A corporation with a fiscal year beginning November 1, 2007 may not use the §179 deduction on any purchases made in their 2007–2008 tax year. However, it may use the bonus depreciation on purchases made after January 1, 2008 and through December 31, 2008.

IRS Q&A on ESA

The following information about ESA is from the IRS's website:[16]

Question A. Am I entitled to the depreciation provisions of the stimulus package even if my adjusted gross income exceeds the threshold that phases out eligibility for the rebate?

Answer A. **Yes.** The individual and business parts of the legislation are separate and have different qualifications.

Question B. What types of acquisitions qualify for the 50% depreciation deduction? I am specifically wondering if farm buildings qualify for this accelerated depreciation.

Answer B. To qualify for this deduction, property must have a recovery period of 20 years or less. Farm buildings normally qualify since they have a general depreciation recovery period of 20 years.

HOUSING ASSISTANCE TAX ACT OF 2008

The Housing Tax Act of 2008 (HATA) contains a provision to allow C corporations to accelerate certain unused credits if they forgo the bonus depreciation.

Note. See Chapter 11, "New Legislation," for more information on HATA.

DETERMINING MACRS CLASS LIFE

Although most practitioners rely upon computer programs to calculate depreciation, the program must be told which type of property is being depreciated. While it is easy to rely on the basic categories, there are exceptions and special circumstances that can cause property to be in a different class.

Having assets in the proper classes can make a significant difference in current year income. It is also important when making elections that affect the entire class of assets, such as electing out of bonus depreciation.

This section reviews the basics in determining class life and discusses some of the exceptions. For more information, practitioners may consult IRS Pub. 946, *How to Depreciate Property*.

Note. Pages 135–142 of the 2007 *University of Illinois Federal Tax Workbook* include detailed instructions about how to handle depreciation for assets involved in like-kind exchanges.

16. www.irs.gov/newsroom/article/0,,id=182005,00.html

DEPRECIATION SYSTEMS

There are two depreciation systems used under MACRS. The most common is the general depreciation system (GDS) and the other is the alternative depreciation system (ADS). GDS allows higher deductions in the earlier years and shorter recovery periods.

ADS is required for the following property:

- Listed property with business use of 50% or less
- Tangible property used predominantly outside the U.S. during the year
- Tax-exempt use property
- Tax-exempt bond-financed property
- Farm property placed in service during a tax year when an election not to apply the uniform capitalization rules to certain farming costs is in effect
- Property imported from a foreign country for which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts

Caution. Bonus depreciation is **not allowed** on property required to be depreciated using ADS.

Taxpayers may **elect** to use ADS for property that is qualified for GDS. The election is usually made for the entire class of assets placed in service during the tax year. However, the election may be made on a property-by-property basis for residential rental property and nonresidential real property. The election is made on Form 4562, Part III and is **irrevocable**.

Observation. The election to use ADS instead of GDS might be appropriate if the taxpayer expects the business income to be taxed in a significantly higher tax bracket in future years.

CLASS LIVES

The following is a list of the nine property-class lives under GDS and examples of the types of property included in each class. This list is excerpted from IRS Pub. 946.

3-year property	a) Tractor units for over-the-road use b) Any race horse over two years old when placed in service c) Any other horse over 12 years old when placed in service d) Any race horse placed in service after 2008 and before 2014[17] e) Qualified rent-to-own property
5-year property	a) Automobiles, taxis, buses, and trucks b) Computers and peripheral equipment c) Office machinery (such as typewriters, calculators, and copiers) d) Any property used in research and experimentation e) Breeding cattle and dairy cattle f) Appliances, carpets, furniture, etc, used in a residential rental real estate activity g) Certain geothermal, solar, and wind energy property
7-year property	a) Office furniture and fixtures (such as desks, files, and safes) b) Agricultural machinery and equipment c) Any property that does not have a class life and has not been designated by law as being in any other class d) Vine trellises[18]
10-year property	a) Vessels, barges, tugs, and similar water transportation equipment b) Any single purpose agricultural or horticultural structure c) Any tree or vine bearing fruits or nuts
15-year property	Certain improvements made directly to land or added to it, such as shrubbery, fences, roads, and bridges
20-year property	Farm buildings (other than single purpose agricultural or horticultural structures)
25-year property	Limited to water utility property
Residential rental property	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. It does not include a unit in a hotel, motel, or other establishment in which more than half the units are used on a transient basis. The recovery period for this class is 27.5 years.
Nonresidential real property	Real estate such as an office building, store, or warehouse that is neither residential rental property nor property with a class life of less than 27.5 years. The recovery period for this class is 39 years.

For property not listed above, the Table of Class Lives and Recovery Periods in Appendix B of IRS Pub. 946 is used. Use of these tables is described below. Generally, the property class is the same as the GDS (MACRS) recovery period in the table.

EXCEPTIONS TO THE GENERAL CATEGORIES FOR CLASS LIVES

There are assets that appear at first glance to belong to a particular class, but because of the type of activity in which the property is used, the property is in a different class. Table B-2 of IRS Pub. 946 includes an exhaustive list of activities and related property that have recovery periods specified by law.

Table B-1 and Table B-2 of IRS Pub. 946, *How to Depreciate Property,* must be used in conjunction with each other in determining the proper class life. Table B-1 is shown on the following page and examples of its interaction with Table B-2 follow. **The table most applicable to each situation is the one used.**

17. Added by the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill)

18. *Trentadue*, 128 TC 91 (2007)

Table B-1. **Table of Class Lives and Recovery Periods**

Asset class	Description of assets included	Recovery Periods (in years) Class Life (in years)	GDS (MACRS)	ADS
	SPECIFIC DEPRECIABLE ASSETS USED IN ALL BUSINESS ACTIVITIES, EXCEPT AS NOTED:			
00.11	**Office Furniture, Fixtures, and Equipment:** Includes furniture and fixtures that are not a structural component of a building. Includes such assets as desks, files, safes, and communications equipment. Does not include communications equipment that is included in other classes.	10	7	10
00.12	**Information Systems:** Includes computers and their peripheral equipment used in administering normal business transactions and the maintenance of business records, their retrieval and analysis. Information systems are defined as: 1) Computers: A computer is a programmable electronically activated device capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention. It usually consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. Excluded from this category are adding machines, electronic desk calculators, etc., and other equipment described in class 00.13. 2) Peripheral equipment consists of the auxiliary machines which are designed to be placed under control of the central processing unit. Nonlimiting examples are: Card readers, card punches, magnetic tape feeds, high speed printers, optical character readers, tape cassettes, mass storage units, paper tape equipment, keypunches, data entry devices, teleprinters, terminals, tape drives, disc drives, disc files, disc packs, visual image projector tubes, card sorters, plotters, and collators. Peripheral equipment may be used on-line or off-line. Does not incude equipment that is an integral part of other capital equipment that is included in other classes of economic activity, i.e., computers used primarily for process or production control, switching, channeling, and automating distributive trades and services such as point of sale (POS) computer systems. Also, does not include equipment of a kind used primarily for amusement or entertainment of the user.	6	5	5
00.13	**Data Handling Equipment; except Computers:** Includes only typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment.	6	5	6
00.21	**Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines)**	6	5	6
00.22	**Automobiles, Taxis**	3	5	5
00.23	**Buses**	9	5	9
00.241	**Light General Purpose Trucks:** Includes trucks for use over the road (actual weight less than 13,000 pounds)	4	5	5
00.242	**Heavy General Purpose Trucks:** Includes heavy general purpose trucks, concrete ready mix-trucks, and ore trucks, for use over the road (actual unloaded weight 13,000 pounds or more)	6	5	6
00.25	**Railroad Cars and Locomotives, except those owned by railroad transportation companies**	15	7	15
00.26	**Tractor Units for Use Over-The-Road**	4	3	4
00.27	**Trailers and Trailer-Mounted Containers**	6	5	6
00.28	**Vessels, Barges, Tugs, and Similar Water Transportation Equipment, except those used in marine construction**	18	10	18
00.3	**Land Improvements:** Includes improvements directly to or added to land, whether such improvements are section 1245 property or section 1250 property, provided such improvements are depreciable. Examples of such assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping shrubbery, or radio and television transmitting towers. Does not include land improvements that are explicitly included in any other class, and buildings and structural components as defined in section 1.48-1(e) of the regulations. Excludes public utility initial clearing and grading land improvements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102.	20	15	20
00.4	**Industrial Steam and Electric Generation and/or Distribution Systems:** Includes assets, whether such assets are section 1245 property or 1250 property, providing such assets are depreciable, used in the production and/or distribution of electricity with rated total capacity in excess of 500 Kilowatts and/or assets used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in section 1.48-1(e) of the regulations. Assets used to generate and/or distribute electricity or steam of the type described above, but of lesser rated capacity, are not included, but are included in the appropriate manufacturing equipment classes elsewhere specified. Also includes electric generating and steam distribution assets, which may utilize steam produced by a waste reduction and resource recovery plant, used by the taxpayer in its industrial manufacturing process or plant activity. Steam and chemical recovery boiler systems used for the recovery and regeneration of chemicals used in manufacturing, with rated capacity in excess of that described above, with specifically related distribution and return systems are not included but are included in appropriate manufacturing equipment classes elsewhere specified. An example of an excluded steam and chemical recovery boiler system is that used in the pulp and paper manufacturing equipment classes elsewhere specified. An example of an excluded steam and chemical recovery boiler system is that used in the pulp and paper manufacturing industry.	22	15	22

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Example 2. FITS, LLC, is a tax-preparation service. It purchased a hydraulic hand dolly for $1,200, which it used to distribute boxes of printing paper to each preparer's office. Hand dollies are not specifically listed in Table B-1, so by default the appropriate class appears to be *Office Furniture, Fixtures, and Equipment.* This has a 7-year recovery period under the GDS. **However,** professional services are specifically included under *Distributive Trades and Services* in Table B-2. Assets used in *Distributive Trades and Services* have a 5-year recovery period. Consequently, the dolly qualifies to be depreciated over five years.

Table B-2. **Table of Class Lives and Recovery Periods**

Asset class	Description of assets included	Recovery Periods (in years) Class Life (in years)	GDS (MACRS)	ADS
45.0	**Air Transport:** Includes assets (except helicopters) used in commercial and contract carrying of passengers and freight by air. For purposes of section 1.167(a)-11(d)(2)(iv)(a) of the regulations, expenditures for "repair, maintenance, rehabilitation, or improvement," shall consist of direct maintenance expenses (irrespective of airworthiness provisions or charges) as defined by Civil Aeronautics Board uniform accounts 5200, maintenance burden (exclusive of expenses pertaining to maintenance buildings and improvements) as defined by Civil Aeronautics Board accounts 5300, and expenditures which are not "excluded additions" as defined in section 1.167(a)-11(d)(2)(vi) of the regulations and which would be charged to property and equipment accounts in the Civil Aeronautics Board uniform system of accounts.	12	7	12
57.0	**Distributive Trades and Services:** Includes assets used in wholesale and retail trade, and personal and professional services. Includes section 1245 assets used in marketing petroleum and petroleum products.	9	5	9*

Example 3. FITS, LLC, also purchased a new desk for its managing partner. Desks **are** specifically listed in Table B-1 under *Office Furniture, Fixtures, and Equipment* and **are not** specifically listed in Table B-2 under *Distributive Trades and Services.* Therefore, the desk is properly depreciated over seven years.

Note. There is no IRS guidance defining *Distributive Trades and Services*. Wholesale and retail trade involves supplying goods without any intermediate physical transformation of the products.

Example 4. Steve has a small business providing charter airplane flights to people. Table B-1 includes airplanes, but excludes those used in carrying passengers. Therefore, he must use Table B-2, which lists airplanes used to carry passengers as 7-year assets.

He also owns a helicopter. Table B-1 specifically mentions "all helicopters." Steve can depreciate it over five years, even though it is used to carry passengers.

The table on the following page lists recovery periods and class lives for some industries and assets used in those industries that are covered by Table B-2.

Observation. This list is intended to alert practitioners to some of the less obvious classifications; the actual table should be reviewed for detailed information on the assets specifically included within each category.

Excerpts from Table B-2

	GDS Recovery Period and Property Class
Agriculture Property	
Grain bins	7
Fences used in agricultural activities	7
Breeding/work horse age $\leq$ 12 yrs	7
Breeding or dairy cattle	5
Breeding hogs	3
Breeding sheep and goats	5
Farm buildings	20
Single purpose agricultural/horticultural structures	10
Construction	
Assets used by construction businesses (except railroad construction)	5
Cutting of timber	5
Distributive Trades and Services	
Assets used in wholesale and resale trade, and personal and professional services	5
Manufacturing of:	
Grain and grain mill products	10
Sugar and sugar products	10
Vegetable oils and related products	10
Food and beverage special handling devices	3
Knitted and netted fabrics and lace	5
Yarn, thread, and woven fabrics	7
Carpets	5
Textile products	5
Medical and dental supplies	5
Textile yarns — certain assets	5
Apparel and other finished products	5
Chemicals and allied products	5
Rubber products — special tools only	3
Finished plastic products — special tools only	3
Glass products — special tools only	3
Cement (not concrete)	15
Nonferrous metals — special tools only	5
Fabricated metals — special tools only	3
Electronic components, products, and systems	5
Semiconductors	5
Motor vehicles — special tools only	3
Sawmills	
Machinery and equipment installed in permanent sawmills	7
Machinery and equipment installed in temporary sawmills	5
Ship and Boat Building and Repairs	
Machinery and equipment	7
Dry docks and land improvements	10
Special tools only	5
Transportation	
Assets used to ferry freight or passengers on water	15
Assets used to carry freight or passengers by air, except helicopters	7

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Several industries have numerous listings in Table B-2. Practitioners should consult the table when computing depreciation for the following industries:

- Railroads
- Pipeline transportation
- Telephone communications
- Radio and television broadcasting
- Telegraph, ocean cable, and satellite communications
- Cable television
- Electric, gas, water, and steam utility services
- Municipal wastewater treatment and sewer systems
- Petroleum marketing (service stations, etc.)

THE IRC §179 DEDUCTION — SPECIAL ISSUES

With the increase in limits for §179 deductions, practitioners will likely see more complications related to the election. This section is intended to answer some questions that practitioners may have when dealing with these complications.

COMMON QUESTIONS

Question A. When does the §179 deduction limitation return to $25,000 per year?[19]

Answer A. For tax years beginning in **2011** and later, the maximum §179 deduction is $25,000.

Currently, the limits are:

- $250,000 for tax years beginning in **2008,** and
- $125,000 (adjusted for inflation) for tax years beginning in **2009** and **2010.**

Question B. Must the tax return be timely filed for the §179 election to be valid?

Answer B. **No.** The tax return does not have to be filed on time for the taxpayer to make a valid §179 election.[20]

Question C. Can the election be changed after the return is filed?

Answer C. **Yes.** For tax years beginning after 2002 and before 2011, a taxpayer may amend a previously-filed return to:[21]

- Make a §179 election previously not made,
- Revoke a §179 election previously made, or
- Change the amount of the election for any eligible property.

> **Caution.** The IRS indicated in Rev. Proc. 2008-54, 2008-38 IRB, that it intends to amend the Treasury Regulations to allow a new §179 election on an amended return despite a technicality in the law that extended the ability to revoke the election without extending the ability to make an election on an amended return. If the Treasury Regulations are not amended, current law prohibits making new §179 elections on amended returns. Answers C and D assume that the IRS amends the regulations to be consistent with Congressional intent.

19. IRC §179(b)(5)
20. Treas. Reg. §1.179-5(a)
21. IRC §179(c)(2)

Revoking the §179 election for any particular asset is binding, and the taxpayer cannot choose later to reinstate the election for that portion of the cost of that asset.[22]

> **Example 5.** Meowever Yours, Inc., operates a feline accessory store. In 2008, it purchased a new cash register for $4,000. On its 2008 return, it elected to write off the entire cost of the cash register.
>
> After the return was filed, its new accountant realized that future income will be in a much higher tax bracket. She amends the return and revokes the §179 election for the cash register. This revocation is binding and cannot be undone.
>
> **Example 6.** BowWow Me, LLC, operates a canine toy store. In 2008, it purchased a $60,000 scent-dispensing apparatus to lure pups into the store. On its 2008 return, it elected to deduct $10,000 of the cost of the machine under §179. The remaining $50,000 was depreciated as 5-year MACRS property.
>
> After the return was filed, its new accountant realized that future income would be in a higher tax bracket. He amends the return and revokes the §179 election. This revocation is binding for the $10,000 that was deducted.
>
> Unfortunately, the 2008 return is audited in 2011. The auditor finds a typo on the return that understated taxable income by $80,000. BowWow Me may amend its return to expense the remaining $50,000 of the apparatus's cost under §179 (the amount that was not expensed on the original return.) However, it will have to recalculate the MACRS depreciation deduction for 2008 and subsequent years.

Amending the return to make a new election or to increase the amount elected for a property is not considered a revocation. The choice to take additional §179 can be rescinded.[23]

> **Example 7.** Shippo, LTD operates a self-defense school. In 2008, it purchased a high-tech grappling dummy for $60,000. On its 2008 return, it elected to deduct $10,000 of the cost under §179.
>
> After the return was filed, it ran short of cash. It amended the return to claim an additional $30,000 under §179. If it needed to revoke the election in the future, the entire $40,000 is eligible for revocation.

Question D. How long does the taxpayer have to amend a return to change the §179 election?

Answer D. The same time restrictions that exist for amending returns in general also apply to amending a §179 election.[24] A claim for refund must be filed within three years of the date the original return is filed or within two years of the date the tax is paid, whichever is later.[25] Returns filed and taxes paid before the due date of the return are considered filed and paid on the due date. [26]

There is no statutory deadline for amending returns to pay additional tax, or to make changes that do not change the tax due. The IRS generally accepts amended returns filed within three years of the original due date.

Question E. How does the §179 election affect the mid-quarter convention requirement?

Answer E. The cost of §179 property properly expensed is not part of the aggregate basis for purposes of the 40% test in determining whether the mid-quarter convention applies.[27] When the aggregate basis of property placed in service during the last quarter equals **more than 40%** of the total basis of MACRS property placed in service during the tax year, taxpayers are required to use the mid-quarter convention instead of the half-year convention to calculate depreciation for all of that year's assets.[28]

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22. Treas. Reg. §1.179-5(c)(3)(ii)
23. Treas. Reg. §1.179-5(c)(4), Example 2
24. Treas. Reg. §1.179-5(c)(1); however, note that the regulations indicate the ability to change the election expires after December 31, 2007. The Small Business and Work Opportunity Tax Act of 2007 extended that ability through 2010.
25. IRC §6511(a)
26. IRC §6513
27. Ltr. Rul. 9126014 (January 1, 1991)
28. IRC §168(d)(3)(A)

The following are excluded from this requirement and the related calculation:[29]

- Nonresidential real property
- Residential rental property
- Railroad grading and tunnel bore
- Property placed in service and disposed of in the same tax year
- Property being depreciated under a method other than MACRS
- Amounts elected to be deducted under §179

Example 8. Sango's Demon Slayers is a calendar-year taxpayer. In 2008, she purchased and placed in service the following:

Filtration mask	January 22	$ 5,500	55%
Hiraikotsu boomerang	October 31	4,500	45%
Total 2008 purchases		$10,000	100%

If she does not elect to write off any of the purchases under §179, she must use the mid-quarter convention for both purchases.

If she elects the §179 deduction for the entire cost of the **mask** only, the boomerang must be depreciated under the mid-quarter convention.

If she elects the §179 deduction for the entire cost of the **boomerang** only, the mask will be depreciated using the half-year convention.

She does not have to deduct the **entire** cost of the boomerang in order to avoid the mid-quarter convention, only enough to lower the percentage of fourth-quarter purchases to 40% or below. If she elects to write off $900 of the cost, the mid-quarter convention is not required:

			§179	Net	Round %
Filtration mask	1Q	$ 5,500	$ 0	$5,500	60%
Hiraikotsu boomerang	4Q	4,500	900	3,600	40%
Total 2008 purchases		$10,000	$900	$9,100	100%

Note. Bonus depreciation does not affect the calculation to determine if the mid-quarter convention is required.

Question F. When must the §179 deduction be recaptured?[30]

Answer F. The §179 deduction must be recaptured in the tax year the percentage of business use drops to 50% or less during the property's recovery period. **These rules do not apply if the property is sold, exchanged, or otherwise disposed of.** Separate rules apply to listed property, discussed later in the section titled Special Depreciation Rules for Vehicles.

29. Treas. Reg. §1.168(d)-1

30. Treas. Reg. §1.179-1(e)

Question G. How is the recapture amount calculated?[31]

Answer G. The first step in calculating the recapture amount is to figure the depreciation that would have been allowable if the §179 deduction had not been claimed. Second, subtract the allowable depreciation from the §179 deduction claimed. The result is the amount to be recaptured.

> **Example 9.** Miroku Blessings is a sole proprietorship providing monk-certified blessings and protective sutras printed on rice paper. In 2006, he purchased a new printing press for $5,000, which he elected to write off using §179. In 2008, he began printing flyers advertising his availability for marriage. He was so intent on this personal mission that 60% of his use of the press was devoted to this activity.
>
> His recapture amount is calculated as follows:

§179 deduction claimed in 2006		$5,000
Allowable depreciation (MACRS 7-year property) instead of §179 deduction:		
2006 ($5,000 × 14.29%)	$ 715	
2007 ($5,000 × 24.49%)	1,225	
2008 ($5,000 × 17.49% × 40%)	350	
Total allowable depreciation	$2,290	($2,290)
Recapture amount		$2,710

Question H. How is the recapture amount reported?[32]

Answer H. The recapture amount is calculated on Form 4797, *Sales of Business Property*, in Part IV. It is then reported as other income on the same form on which the §179 deduction was originally taken. In **Example 9,** Miroku reports $2,710 on his Schedule C. The recaptured amount is also added back into the basis.

IRC §179 CARRYOVERS

TAXABLE BUSINESS INCOME

The amount of the §179 deduction that a taxpayer is allowed in any year is limited by its taxable income from the active conduct of any trade or business during the year.[33] Taxable business income is calculated differently depending on the form of the business.

Individuals

The business income limit includes the taxable income from the active conduct of all trades and businesses during the year. Net income from a trade or business also includes:

- §1231 gains or losses;
- Interest from working capital of trades/businesses; and
- Wages, salaries, tips, or other pay earned as an employee.

At the individual level, business income **does not include:**

- §179 deductions,
- The self-employment tax deduction,
- Any net operating loss deduction, or
- Any unreimbursed employee business expenses.

31. Ibid
32. IRS 2007 Form 4797 Instructions
33. IRC §179(b)(3)(A)

Partnerships

Partnership income includes all of the trades/businesses actively conducted by the partnership during the year. However, the partnership's taxable income for purposes of the §179 deduction **does not include:**

- Credits,
- Tax-exempt income,
- §179 deductions, or
- Guaranteed payments to partners.

S Corporations

S corporation income includes all the year's income from all active trades or businesses conducted by the corporation. However, the corporation's taxable income for purposes of the §179 deduction **does not include:**

- Credits,
- Tax-exempt income,
- §179 deductions, or
- Compensation paid to shareholder-employees.

C Corporations

C corporation income includes all the year's income from all active trades or businesses conducted by the corporation. However, the corporation's taxable income for purposes of the §179 deduction **does not include:**

- Any net operating loss deduction,
- Tax-exempt income,
- §179 deductions,
- Special deductions also limited by net income, or
- Income and deductions not derived from a trade or business actively conducted by the corporation.

MULTIPLE DEDUCTIONS

The §179 deduction is limited to the taxpayer's current year business income. Sometimes the taxpayer has another deduction that is also limited by business income. The following steps must be followed in order to calculate the allowable amount of each deduction.

1. Calculate taxable income without the §179 deduction or the other deduction.
2. Calculate a hypothetical §179 deduction using taxable income determined in Step 1.
3. Subtract the hypothetical §179 deduction from Step 1 taxable income.
4. Calculate the hypothetical amount for the other deduction based on the hypothetical net income determined in Step 3.
5. Subtract the Step 4 deduction from the Step 1 taxable income.
6. Calculate the actual §179 deduction from taxable income determined in Step 5. This is the lesser of the hypothetical net income (Step 5) or the hypothetical §179 deduction (Step 2).
7. Subtract the actual §179 deduction from Step 1 taxable income.
8. Calculate the actual other deduction using Step 7 income.

Example 10. Inuyasha, Inc., a C corporation, had net business income of $130,000 in 2008. It purchased and placed in service $125,000 of qualified §179 property during 2008. It also donated $10,000 to a local orphanage. As a C corporation, its charitable deduction is limited to 10% of its net business income. The §179 deduction and the charitable deduction are calculated as follows:

1. Net business income before consideration of either deduction	$130,000
2. The hypothetical §179 deduction	125,000
3. The hypothetical net income (Step 1 minus Step 2)	5,000
4. The hypothetical charitable deduction (10% of Step 3)	500
5. The revised hypothetical net income	129,500
6. Actual §179 deduction (lesser of $125,000 or $129,500)	125,000
7. Net income before the charitable deduction (Step 1 minus Step 6)	5,000
8. The actual charitable deduction (10% of Step 7)	500
Net taxable income (Step 7 minus Step 8)	4,500
Remaining charitable deduction (not allowed for 2008; carried forward for up to five years)	9,500

Carryover Examples

Elected §179 deductions in excess of taxable business income are carried forward to future years.

7

Example 11. In 2008, Ducky Enterprises, a calendar-year taxpayer, purchased a crawler crane for $200,000. Its taxable income without regard to the §179 deduction is $15,000. Ducky elected to expense the entire purchase price of $200,000. The remaining $185,000 is carried forward to 2009. Its 2008 Form 4562, Part I, *Depreciation and Amortization,* is shown below.

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

Depreciation and Amortization
(Including Information on Listed Property)
▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172 — **2008** — Attachment Sequence No. **67**

Name(s) shown on return: **Ducky Enterprises** | Business or activity to which this form relates: | Identifying number: **20-1122334**

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	*$250,000*
2	Total cost of section 179 property placed in service (see instructions)	2	200,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	*$800,000*
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
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	250,000

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	Crawler Crane	200,000	200,000
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	200,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	200,000
10	Carryover of disallowed deduction from line 13 of your 2007 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	15,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	15,000
13	Carryover of disallowed deduction to 2009. Add lines 9 and 10, less line 12 ▶	13	185,000

...Part II or Part III below for listed property... Part V.

The amount of the carryover that can be used each year is also limited by that year's maximum §179 deduction.[34]

34. IRC §179(b)(3)(B)(ii)

Example 12. In 2009, Ducky Enterprises did not purchase any equipment. Its 2009 taxable income is $300,000 without regard to the §179 deduction. Assume the 2009 §179 limit is $130,000. Only $130,000 of the $185,000 carried forward from 2008 is deductible in 2009 due to the overall dollar limit for the year. See Part I of its 2009 Form 4562, shown following:

Form **4562** — **Depreciation and Amortization (Including Information on Listed Property)**

Department of the Treasury Internal Revenue Service (99) ▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172 — **2009** — Attachment Sequence No. **67**

Name(s) shown on return: **Ducky Enterprises** | Business or activity to which this form relates: | Identifying number: **20-11223344**

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	$130,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$500,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
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	130,000

	(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 2008 Form 4562	10	185,000
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	130,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	130,000
13	Carryover of disallowed deduction to 2010. Add lines 9 and 10, less line 12 ▶ 13 — 55,000		

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

When the §179 election is made for more than one asset, but the deduction is limited by taxable income, the taxpayer may choose which assets' costs are in the carryover. This choice is maintained in the books and records of the taxpayer. If a selection is not made at the time the return is filed, the carryover is apportioned equally among the properties for which the election was made in that year.[35]

> **Caution.** If one of the assets is sold in a later year or if a change in use causes the §179 deduction to be recaptured, the allocation of costs included in the carryover could make a significant difference in taxable income for the taxpayer.

§179 CARRYOVER QUESTIONS AND ANSWERS

Question A. When does the carryover expire?

Answer A. Any excess is carried over indefinitely until used.[36]

Question B. In what order are multiple years used?

Answer B. If a carryover includes multiple years, the earliest year is used first.[37]

35. Treas. Reg. §1.179-3(e)
36. Treas. Reg. §1.179-3(a)
37. Treas. Reg. §1.179-3(e)

Question C. What happens if the asset is sold before all the §179 carryover is used?

Answer C. If there is a sale or other disposition of the asset before the full amount of any outstanding §179 carryover is used, then the unused amount is added back to the property's basis. This amount is subtracted from the carryover available for the current year.[38]

Example 13. DuBois Electronics, LLC, is a single-member LLC (SMLLC). It reports its income on Schedule C. In 2007 it purchased a computer for $2,500, which it elected to write off under §179. However, because it had a loss before consideration of this election, the entire amount of $2,500 was carried over to 2008.

In 2008, DuBois sold the computer for $1,000. The $2,500 is added back to the computer's basis. The sale is shown at a loss of $1,500 on Form 4797. The carryover amount shown on Form 4562, line 10 is $0.

Question D. What occurs if the asset is transferred in a nontaxable exchange before the §179 carryover is used?

Answer D. The unused amount is added back into basis immediately before the transfer.[39]

Example 14. Use the same facts as **Example 13.** In 2008, Joe DuBois, the sole owner of DuBois Electronics, died. Prior to his death, the company was still operating at a loss. The $2,500 carryover is effectively lost. The cost is added back to basis and the carryover is not allowed as a deduction for 2008. However, the estate's basis in the asset is limited to the FMV at the time of his death.

Question E. What occurs if the §179 deduction must be recaptured before the §179 carryover is used?

Answer E. If the business use of the property drops to 50% or less, the remaining carryover from that asset is added back to basis. The §179 carryover is reduced by this amount.[40]

Example 15. In 2007, Claire Bennet, doing business as Bennet Cheerleading, purchased a trampoline for $1,900. At the time, the trampoline was used only for cheerleading lessons. She elected to write off the entire purchase price under §179. However, because her net business income was only $900, her deduction was limited and $1,000 was carried over to 2008.

In 2008, her business use dropped to 50%. She must recapture the portion of the §179 deduction she claimed in 2007 that was in excess of the depreciation that would have been allowed under MACRS.

Calculation of allowable depreciation:

If she had not elected the §179 deduction, her 2007 depreciation would have been $380 (MACRS 5-year property, half-year convention equals 20% of $1,900).

Her 2008 depreciation deduction would have been $304 (50% use × 32% depreciation).

Her recapture amount is $216, as calculated below:

§179 depreciation deduction claimed in 2007	$900
Less allowable depreciation:	
2007	(380)
2008	(304)
2008 §179 recapture amount	$216

38. Treas. Reg. §1.179-3(f)(1)

39. Ibid

40. Treas. Reg. §1.179-3(f)(2)

Effect on forms:

The $216 is calculated in Form 4797, Part IV.

According to Form 4797 instructions, the recapture amount is reported on the same form on which she took the original deduction. Therefore, the $216 is claimed as other income on Schedule C.

Claire's Form 4562 shows $0 on line 10.

Her remaining basis in the asset is $1,216, which equals the recaptured amount of $216 plus the outstanding carryover of $1,000.

Her 2009 depreciation deduction will be calculated based on the original cost of $1,900.

PARTNERSHIPS AND S CORPORATIONS — §179 ISSUES

The pass-through rules are similar for partnerships and S corporations with respect to §179 issues. For purposes of this section, the use of partner and partnership in this section are interchangeable with shareholder and S corporation.

The §179 deduction limits apply both to the partnership and to each partner. The partnership determines its §179 deduction subject to the limits. It then allocates the deduction among its partners.

Each partner adds the amount allocated from partnerships to her other §179 elections and then applies the dollar limit to this total. However, **none of the cost of §179 assets placed in service** by the partnership is added to the other assets placed in service by the individual partner in determining if the §179 threshold has been exceeded.

Example 16. Peter and Quagmire are 50/50 partners in Quahog Fine Dining, LLC. In 2008, the restaurant put $850,000 of §179 assets into service. The partnership is $50,000 over the threshold, so the $250,000 maximum deduction is reduced by $50,000. The partnership elects to deduct the entire $200,000 under §179.

Peter's share of the partnership's §179 deduction is $100,000. He also owns Pete's Putt-Putt Golf, a sole proprietorship. He purchased $600,000 of equipment for the course.

None of the $850,000 is added to the $600,000 to determine if his total cost of assets placed in service exceeds $800,000. Therefore, his personal §179 limit is still $250,000.

Business income limits are applied at both the partnership level and the individual level.

Example 17. Peter from **Example 16** elects to write off $250,000 of §179 assets. To determine if he can actually use the entire $250,000, or if he must carry some of it forward, he must figure his taxable business income. His taxable business income includes:

Net partnership income from the K-1 before §179	$50,000
Guaranteed payments from the partnership	75,000
Wages from his job at the toy factory	20,000
Net Schedule C loss before §179	(95,000)
Net business income before applying §179	$50,000

Peter's §179 deduction is limited to $50,000. The remaining $200,000 is carried forward to 2009.

If the partner and partnership's **tax years are different,** the partner generally treats the income and other items reported on the Schedule K-1 as occurring in the partner's fiscal year. For example, an individual calendar-year partner receiving a K-1 from a partnership with a June 30 yearend reports the entire amount of the June 30 K-1 in her current year income and uses that amount in computing her business income for purposes of calculating the §179 limits.

A partner must reduce the **basis of her partnership interest** by the total amount of §179 expenses allocated from the partnership. This is true even if the partner's deduction was limited. If the partner disposes of her partnership interest, her basis for determining gain/loss is increased by any outstanding §179 carryover related to the partnership.

The **partnership's basis in the §179 property** is reduced by the elected §179 deduction regardless of the treatment of the §179 deduction on the individual partners' returns.

> **Note.** See Rev. Proc. 2008-54 on page 279 for further clarification.

SPECIAL DEPRECIATION RULES FOR VEHICLES

Passenger automobiles are subject to limits on the amount of depreciation that can be deducted each year. These limits include regular depreciation, the §179 deduction, and bonus depreciation. These restrictions are often referred to as the **luxury auto** limits. However, due to inflation, vehicles that are not luxurious may fall prey to the depreciation caps.

Heavy vehicles, in contrast to passenger automobiles, are only subject to limits on the §179 deduction.

> **Caution.** Taxpayers electing a §179 deduction for vehicles should continue to keep records documenting the business versus personal use of the vehicle for the remainder of the recovery period. In a recent Tax Court case, the court sustained the IRS's recapture of the §179 deduction because the taxpayer failed to meet the substantiation requirements of IRC §274. See *Birdsell v. Comm'r* in Chapter 15, "Rulings and Cases."

HEAVY VEHICLES

Heavy vehicles are passenger vehicles that are **not** subject to the rules for passenger automobiles because their **gross vehicle weight (GVW) exceeds 6,000 lbs.** Heavy vehicles may include sport utility vehicles (SUVs), trucks, vans, and even a few cars. However, in this chapter all of them are referred to as SUVs.

Due to perceived abuses, Congress limited the §179 deduction for these vehicles to $25,000.[41] To qualify for the §179 deduction, an SUV must be used more than 50% for business.

The $25,000 limit **does not apply** to any vehicle:

- With a GVW of 14,000 pounds or more;
- Designed to seat more than nine passengers behind the driver's seat;
- Equipped with a cargo area (either open or enclosed by a cap) of at least six feet in interior length that is not readily accessible from the passenger compartment; or
- That has an integral enclosure fully enclosing the driver 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.

There are no special requirements for SUVs to qualify for the bonus depreciation deduction. Other than the §179 cap, there are no limits on the amount of depreciation that may be claimed for SUVs in any particular year.

Example 18. Mr. Linderman purchases a brand new, fully-loaded 2008 Porsche Cayenne for $90,000 on March 16, 2008. The GVW is 6,790 pounds; the SUV is used 100% for business. His maximum 2008 depreciation deduction is calculated as follows:

§179 deduction	$25,000
Bonus depreciation: 50% of ($90,000 − $25,000)	32,500
MACRS 1st year depreciation: 20% of $32,500	6,500
Maximum 2008 depreciation on the Cayenne	$64,000

41. IRC §179(b)(6)

PASSENGER AUTOMOBILES DEFINED

Passenger automobiles are defined as any four-wheeled vehicle made primarily for use on public streets, roads, and highways. Automobiles with an **unloaded GVW** of 6,000 pounds or less are subject to depreciation limits for listed property. Trucks and vans with a **GVW** of 6,000 pounds or less are also subject to these limits.

The following vehicles are **not** considered passenger automobiles for these purposes:

- An ambulance, hearse, or combination ambulance-hearse used directly in a trade or business
- A vehicle used directly in the trade or business of transporting persons or property for hire
- A truck or van that is a qualified nonpersonal use vehicle (see definition below)
- Any vehicle with a loaded GVW of over 14,000 pounds that is designed to carry cargo
- Bucket trucks, cherry pickers, cement mixers, dump trucks, garbage trucks, flatbed trucks, and refrigerated trucks
- Combines, cranes, derricks, and forklifts
- Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat
- Qualified moving vans
- Qualified specialized utility repair trucks
- School buses used in transporting students and school employees
- Other buses with a capacity of at least 20 passengers that are used as passenger buses
- Tractors and other special-purpose farm vehicles

Qualified nonpersonal use vehicles are those that, by their nature, are not likely to be used more than a minimal amount for personal purposes. They include trucks and vans that have been specifically modified, such as by installation of permanent shelving and painting the vehicle to display advertising or the company's name.

> **Observation.** Many taxpayers are under the impression that painting the company name on the vehicle is sufficient to render the truck or van a nonpersonal use vehicle. The vehicle must still meet the requirement that it is **unlikely** to be used for more than a minimal amount of personal use before it qualifies as an exception to the depreciation limits.

BUSINESS USE REQUIREMENT

To be eligible for the §179 deduction, bonus depreciation, and/or MACRS, the vehicle must be used more than 50% for qualified business use. If used 50% or less for business, it must be depreciated using the straight-line method and the ADS recovery period of five years.

Qualified business use is any use of the property in a trade or business. However, it does not include the following uses:

- The use of property as pay for services by a 5% owner or related person
- The use of property as pay for services of any other person, unless the value of the use is included in that person's gross income and, when required, income tax is withheld on that amount
- The leasing of property to any 5% owner or related person

> **Caution.** This may be a problem for business owners wishing to take advantage of the increased limits for vehicles qualifying for bonus depreciation.

Example 19. John is the sole proprietor of a plumbing contracting business. His girlfriend, Sue, runs the office. As part of her compensation, she is allowed to drive the company-owned Lexus. Her personal use is properly reported as income on her W-2 and taxes are withheld. Because she is not related to him and her use is treated correctly for payroll purposes, her personal use counts as qualified business use.

Example 20. John, from **Example 19,** also employs his brother, Richard. Richard drives a company-owned van for both business and personal use. The business miles constitute 40% of the total miles driven. The value of the remaining 60% use is included in Richard's gross income on his W-2 and taxes are properly withheld. The personal use of the van is **pay for services by a related person**, therefore it is **not a qualified business use.**

2008 PASSENGER AUTOMOBILE LIMITS[42]

For 2008, there are two levels of limits for automobiles and two levels for trucks and vans, depending on whether the vehicle qualifies for bonus depreciation.

The maximum depreciation deduction for **passenger automobiles** placed in service in 2008 is:

1st Year	2nd Year	3rd Year	4th and Later Years
Qualifying for bonus depreciation:			
$10,960	$4,800	$2,850	$1,775
Not qualifying for bonus depreciation:			
2,960	4,800	2,850	1,775

The maximum depreciation deduction for **trucks and vans** placed in service in 2008 is:

1st Year	2nd Year	3rd Year	4th and Later Years
Qualifying for bonus depreciation:			
$11,160	$5,100	$3,050	$1,875
Not qualifying for bonus depreciation:			
3,160	5,100	3,050	1,875

Factors that **disqualify** the vehicle for bonus depreciation include:

- Not being new when purchased,
- Having a business use of 50% or less, or
- Being in a class for which the taxpayer elected out of bonus depreciation.

Note. If the vehicle qualifies for bonus depreciation in 2008, the §280F limitations begin to apply when the cost exceeds $18,267. For a nonqualifying vehicle, the limitations begin to apply when the cost exceeds $14,800.

42. Rev. Proc. 2008-22, IRB 2008-12

Applying the Bonus Depreciation Limits

The following examples show how depreciation is calculated for vehicles when bonus depreciation is taken.

Example 21. Mick is the sole proprietor of a detective agency. In 2008, he purchases a new car for $21,000. He uses the car 100% for business. He does not elect any §179 deduction related to the car. He chooses to take the 50% bonus depreciation. His 2008 depreciation deduction for the car is $10,960, calculated as follows:

A. Cost of vehicle	$21,000
B. Percentage of business use	100%
C. Eligible cost (A × B)	$21,000
D. Bonus depreciation (50% of C)	(10,500)
E. Remaining basis (C – D)	$10,500
F. MACRS 1st year depreciation (20% of E)	2,100
G. Potential depreciation deduction (E + F)	$12,600
H. Automobile limit for 2008	$10,960
Allowed depreciation deduction (the lesser of G or H)	$10,960

The limits must be multiplied by the business-use percentage in determining the maximum deduction for that vehicle.

Example 22. Beth is an independent reporter for a web-based news service. In 2008, she purchases a new car for $15,000. She uses the car 60% for business. She does not elect any §179 deduction related to the car. She chooses to take the 50% bonus depreciation. Her 2008 depreciation deduction for the car is $5,400, calculated as follows:

A. Cost of vehicle	$15,000
B. Percentage of business use	60%
C. Eligible Cost (A × B)	$ 9,000
D. Bonus depreciation (50% of C)	(4,500)
E. Remaining basis (C – D)	$ 4,500
F. MACRS 1st year depreciation (20% of E)	900
G. Potential depreciation deduction (E plus F)	$ 5,400
H. Automobile limit for 2008	$10,960
I. Percentage of business use	60%
J. Limit based on business use	$ 6,576
Allowed depreciation deduction (the lesser of G or J)	$ 5,400

The §179 deduction is taken before bonus depreciation is calculated.

Example 23. Beth, from **Example 22,** decides she wants to maximize her deduction without using any more of the §179 deduction than necessary.

A. Cost of vehicle	$15,000
B. Percentage of business use	60%
C. Eligible cost (A × B)	$ 9,000
D. Elected §179 deduction	**(2,940)**
E. Remaining basis (C – D)	$ 6,060
F. Bonus depreciation (50% of E)	**(3,030)**
G. Remaining basis (E – F)	$ 3,030
H. MACRS 1st year depreciation (20% of G)	**606**
I. Potential depreciation deduction (D + F + H)	$ 6,576
J. Automobile limit for 2008	$10,960
K. Percentage of business use	60%
L. Limit based on business use	$ 6,576
Allowed depreciation deduction (the lesser of I or L)	$ 6,576

Deductions After the Recovery Period

If depreciation deductions for an automobile are limited under the passenger automobile limits, there may be unrecovered basis after the recovery period ends. Assuming the vehicle is still used for business, the unrecovered basis continues to be deducted in each succeeding year until the full business basis is recovered. The maximum amount that can be claimed each year is determined by the placed-in-service date and the percentage of business use.

Example 24. Mo owns a local tavern. In 2008, he purchases a used car for $20,000, which he uses 60% for business. His depreciable basis is 60% of $20,000, or $12,000. If he continues to use it 60% for business, at the end of the recovery period he will have claimed only $9,561 of the $12,000, as shown in the table below.

Year	MACRS %	Potential Deduction	Limit	Business Use	Adjusted Limit	Depreciation Allowed
2008	20.00%	$ 2,400	$2,960	60%	$1,776	$1,776
2009	32.00%	3,840	4,800	60%	2,880	2,880
2010	19.20%	2,304	2,850	60%	1,710	1,710
2011	11.52%	1,382	1,775	60%	1,065	1,065
2012	11.52%	1,382	1,775	60%	1,065	1,065
2013	5.76%	691	1,775	60%	1,065	1,065
Totals		**$12,000**			**$9,561**	**$9,561**

Each remaining year, Mo can claim the lesser of the adjusted limit or his remaining basis until his entire business basis is recovered.

Year	Beginning Basis	Remaining Basis	Limit	Business Use	Adjusted Limit	Depreciation Allowed
2013		$2,439				
2014	$2,439	1,374	$1,775	60%	$1,065	$1,065
2015	1,374	309	1,775	60%	1,065	1,065
2016	309	0	1,775	60%	1,065	309

TRADE-INS

There are several methods for depreciating passenger automobiles acquired via trade-in.

Method 1. If the taxpayer uses Method 1, he continues to depreciate the old basis as if the traded vehicle was still in service. The boot (or excess basis) used to purchase the replacement vehicle is then depreciated separately. Each component is individually subject to limitations based on its placed-in-service date, and the two components together are limited by the maximum deduction for the most recently purchased vehicle's placed in service year. Additional rules and explanations can be found in Treas. Reg. §1.168(i)-6(d)(3).

Method 2. If the taxpayer uses Method 2, he elects to add the old vehicle's remaining basis to the cash price of the replacement vehicle to determine the depreciable basis of the replacement vehicle. The entire basis is generally treated as placed in service on the date of the trade. To make the election, the taxpayer attaches a statement to the return indicating "Election made under §1.168(i)" for each affected property. The election must be made on a timely-filed return (including extensions) and is revocable only with the IRS's consent.

Both the business and personal use of the vehicle must be accounted for when determining the remaining basis on the trade-in under this method.[43]

43. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*

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Example 25. Mo, from **Example 24,** decides to trade his vehicle for a newer model in March of 2010. He must first figure his remaining basis in the old vehicle as if it was sold on the date of the trade-in, taking into account both his business use and personal use of the car.

Depreciation that would have been allowed **if the vehicle was used 100% for business:**

Year	MACRS %	Potential Deduction	Limit	Depreciation
2008	20.00%	$ 4,000	$ 2,960	$ 2,960
2009	32.00%	6,400	4,800	4,800
2010 ½ yr	9.60%	1,920	2,850	2,850
Totals		$12,320	$10,610	$10,610

The 2010 depreciation amount exceeds the potential deduction because prior year depreciation amounts were limited.

Basis on the old vehicle is calculated according to instructions in IRS Pub. 463, *Travel, Entertainment, Gift and Car Expenses:*

> ***Unrecovered Basis.*** *This is your cost or other basis in the car reduced by any clean-fuel vehicle deduction, alternative motor vehicle credit, electric vehicle credit, and depreciation and section 179 deductions that* ***would have been allowable if you had used the car 100% for business and investment use.***

Calculation of remaining adjusted basis:

Cost of old vehicle	$20,000
Depreciation at 100% business use	10,610
Adjusted basis (cannot be less than $0)	$ 9,390

The remaining $9,390 is added to the cash he pays for the replacement car to determine his depreciable basis in the replacement car, before adjustments for business use.

Method 3. The taxpayer uses Method 3 when the standard mileage rate (SMR) was used instead of MACRS depreciation for the old vehicle.[44] As in Method 2, both personal and business use must be accounted for in determining the remaining basis.[45] For this calculation, it is necessary to know the depreciation component of the SMR for each year the old vehicle was in service and the total miles driven each year. The depreciation component for each year from 1980 to the present can be found in IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses.*

Depreciation on the vehicle is calculated by multiplying the miles driven by the depreciation component of SMR. The result is subtracted from the purchase price of the vehicle. Any positive amount remaining is added to the boot paid for the replacement vehicle.

44. The SMR is considered a depreciation method other than MACRS. As such, the vehicles would not fall under the scope of Treas. Reg. §1.168(i)-6.

45. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*

Example 26. PJ is an independent karaoke DJ. In 2007, she purchased a lightweight truck for transportation to and from her gigs. She paid $3,000 for the truck, which she drove a total of 20,000 miles in 2007. She opted to use the SMR to calculate her 2007 deduction for the 10,000 business miles she drove.

The depreciation component of the SMR was $0.19 per mile in 2007.[46] The value of both personal and business depreciation on her truck in 2007 was $3,800 using the SMR (20,000 miles x $0.19 per mile).

In 2008, she trades the truck and $12,000 for a newer model. Since the depreciation component of the SMR exceeds her actual cost of the old truck, her basis in the new truck is limited to the cash paid for it.

Note. The depreciation component of the SMR for 2008 is $0.21.

Electing the SMR for Vehicles Acquired Via Trade-In

If the SMR was used for the original vehicle, then the taxpayer may continue to use the SMR for the replacement vehicle. If the original vehicle was depreciated using the straight-line method, then the taxpayer may switch to the SMR for the replacement vehicle.

In contrast, if the original vehicle was depreciated under MACRS, then there is no substantial authority that allows the taxpayer to switch to the SMR for the replacement vehicle.

Note. There is also no substantial authority that **expressly** prohibits the switch.

The argument against the switch is based on the provision which allows a taxpayer to elect out of the regulations for like-kind exchanges.[47] This provision applies to a taxpayer who trades MACRS property for MACRS property. However, if the taxpayer elects to use the SMR, the replacement vehicle is no longer MACRS property. Consequently, the election out is no longer an option. By default, the regulations for like-kind exchanges apply and the taxpayer must use Method 1 or Method 2 as described above.

The argument supporting the switch is that the replacement vehicle is MACRS property at the time the taxpayer elects out of the like-kind exchange regulations. The election out is done first; the choice to use the SMR is made after the taxpayer is free of the restrictions under the regulations.

Caution. The argument for the switch is aggressive given the double-dipping nature of the proposed method. Practitioners adopting this argument must indicate on the return that the taxpayer is making the election under Treas. Reg. §1.168(i) for each asset. **Furthermore, practitioners should consider disclosing the position with the return to avoid potential preparer penalties.**

46. Rev. Proc. 2007-70, IRB 2007-50

47. Treas. Reg. §1.168(i)-6(i)(1)

Example 27. Paul is a self-employed realtor who uses his vehicle 100% for business purposes. In 2007, he purchases a used SUV for $27,000. On his 2007 return, he deducted $25,000 of the cost under §179 and $400 under MACRS (20% x ($27,000 – $25,000)).

Due to soaring gas prices, he trades the SUV for a hybrid car in 2008. He pays only $5,000 cash on the hybrid.

Paul's marginal tax bracket is 25%. He drives an average of 12,000 miles per year. Paul continues to use the hybrid 100% for business over the next six years.

Tax Result 1 for Example 27. Under Method 1, Paul continues to depreciate the SUV over its recovery period and starts depreciating the cash price of the hybrid under MACRS. His income tax and self-employment tax savings from depreciation average about $450 per year over the next six years. In addition to depreciation expense, Paul can also deduct his actual costs of operating the vehicle, including gas, insurance, repairs, and license. The number of miles he drives per year does not change this savings rate.

Tax Result 2 for Example 27. Paul elects out of Treas. Reg. §1.168(i). On his return, he discloses his contention that this election allows him to switch to the SMR for the replacement vehicle. His income tax and self-employment tax savings average $2,800 per year, based on an SMR of $0.585 per mile. Changes in the SMR and in the number of miles he drives will cause these savings to fluctuate.

Switching to Actual Costs After Using the SMR

If after using the business SMR, the taxpayer uses actual costs, then he must use straight-line depreciation for the automobile's remaining estimated useful life. The annual depreciation deduction is still subject to the listed property limitations.[48]

Note. Vehicles owned by a C corporation are not eligible for SMR.

RECAPTURE OF §179 DEDUCTIONS AND BONUS DEPRECIATION FOR LISTED PROPERTY[49]

Caution. This recapture rule applies to **all listed property,**[50] not just to passenger automobiles subject to the luxury auto limits. SUVs, motorcycles, boats, and airplanes are included in listed property. For the complete list of listed property see IRS Pub. 946, *How to Depreciate Property*.

When the business use of any listed property falls to 50% or below during the recovery period, any **excess depreciation** must be recaptured. Excess depreciation is calculated as follows:

	Depreciation allowable in prior years (including claimed §179 deduction and bonus depreciation)[51]
–	Depreciation **recalculated** using straight-line depreciation and the ADS recovery period
	Excess depreciation

The ADS recovery period for automobiles and trucks is five years.

Note. These rules differ from recapture discussed earlier by two main factors:

1. The recalculation of prior years' depreciation is done under ADS instead of MACRS.
2. Listed property is the only property for which bonus depreciation must be recaptured.

48. Rev. Proc. 2007-70, IRB 2007-50

49. IRC §280F

50. Treas. Reg. §1.280F-6(b)

51. IRC §168(k)(2)(F)(ii)

The recapture amount is calculated on Form 4797. It is reported as other income on the same form or schedule where the depreciation deduction was originally taken.

Example 28. Mr. Linderman, from **Example 18,** continues to use the SUV 100% for business in 2009 and 2010. In 2011, he only uses it 40% for business because he spends six months following the tour of a Grateful Dead tribute band. His recapture, reported on his 2011 return, is calculated as follows:

Depreciation allowed or allowable		
2008	$64,000	
2009 ($32,500 × 32%)	10,400	
2010 ($32,500 × 19.2%)	6,240	
Total depreciation claimed	$80,640	$80,640
Depreciation calculated using ADS (straight-line over five years, half-year convention)		
2008 ($90,000 × 10%)	$ 9,000	
2009 ($90,000 × 20%)	18,000	
2010 ($90,000 × 20%)	18,000	
Depreciation allowable under ADS	$45,000	(45,000)
Recapture amount		**$35,640**

Mr. Linderman deducted the depreciation on Form 2106, *Employee Business Expense*. The recapture amount will be reported on the 2011 Form 1040, on the line for other income.

Any benefit derived from the §179 expense must be recaptured, including those amounts that did not reduce the taxpayer's liability. Carryovers are excluded from this rule. The following is excerpted from Treas. Reg. §1.179-1(e)(1):

...the taxpayer must recapture in the taxable year in which the section 179 property is not used predominantly in a trade or business any benefit derived from expensing such property... (regardless of whether such excess reduced the taxpayer's tax liability).

Therefore, the recapture amount reported on the front of Form 1040 is not reduced by any deduction previously disallowed by the 2% AGI floor or the itemized deductions limitations.

Any depreciation claimed in a subsequent year must be calculated under ADS.[52]

Observation. The death of a sole proprietor does not trigger recapture under the regulations for listed property. As long as the property was used more than 50% for business prior to the owner's death, neither the §179 deduction nor the bonus depreciation is recaptured on the decedent's final return.[53] In addition, there is nothing in the Code or regulations that prohibit the §179 deduction or bonus depreciation from being used on the decedent's final return.

52. IRC §280F(b)(1)

53. Treas. Reg. §1.280F-6(d)4(ii)

COST SEGREGATION[54]

Cost segregation is the process of separating a single purchase into multiple depreciation classes. This allows the taxpayer to maximize shorter depreciation periods instead of keeping the entire cost of the purchase lumped into one asset with a longer depreciation period.

When a purchase or project involves several types of assets, properly allocating the costs may involve a significant amount of time. The allocation may also involve estimation and will probably require the services of a firm specializing in cost-segregation studies.

BENEFITS

The most common situation that could benefit from cost segregation involves allocating building costs to tangible personal property. Since commercial real estate is generally depreciated straight-line over 39 years and personal property is generally depreciated over five to seven years using the double-declining method, the immediate tax savings can be significant.

Bedford Capital Consulting, a firm specializing in cost-segregation studies, reports on its website that for every $100,000 of costs allocated to personal property instead of real estate, the taxpayer's 10-year net present value savings is approximately $28,000.[55]

PROPERTY CLASSIFICATION

Proper classification is a facts and circumstance test. Each component must be evaluated based on its particular use and the governing tax law.

Some less obvious examples of tangible personal property that may qualify for faster depreciation include:

- Patient corridor handrails,
- Partitions,
- Plumbing to an X-ray machine,
- Electrical wiring for an intercom system, and
- Exterior decorative lighting.

WHEN TO COST SEGREGATE

Cost segregation is ideally done at the time a building is constructed. It may even be beneficial to have a cost-segregation expert involved as early as the design phase. Design choices that affect depreciation include wall partitions, floor coverings, and lighting.[56] However, cost segregation can be done at any time.

Of course, the sooner the costs are segregated, the better the savings results. The results also are more accurate when the studies are done closer to the time of the original construction.

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54. The primary source document for this section is the IRS Market Segment Specialization Program's *Cost Segregation Audit Techniques Guide* as revised December 2007. Information from other sources is specifically footnoted.

55. www.bedfordcap.com/cost_segregation/faqs.asp#FAQ6

56. www.bedfordcap.com/resources/articles/practical_applications_design_construction.asp

COST SEGREGATION AFTER DEPRECIATION STARTS

The IRS considers a change in depreciation method, recovery period, or convention resulting from a reclassification of property to be a change in method of accounting.[57] As such, the IRS requires a Form 3115, *Application for Change in Accounting Method*, to be filed according to the instructions on the form.

The cumulative depreciation deduction missed during prior years is deducted on the current year's return when a change is made in the method of accounting. Depending on the taxpayer's situation, this may not create the most favorable tax result.

STANDARDS FOR A COST-SEGREGATION STUDY

A plethora of legislative acts, court decisions, and IRS rulings have produced complex and often conflicting guidance with respect to distinguishing personal property from real estate. Related issues, such as the **capitalization of interest and production costs** and **changes in accounting method,** add to the complexity.

Unfortunately, there are no standards regarding the preparation of these studies. Accordingly, studies vary widely in terms of the methodology, documentation, depth, format, and expertise of the studies' preparers. This lack of consistency, coupled with the complexity of the law, motivated the IRS to update its *Cost Segregation Audit Techniques Guide* in 2007.

AUDIT OF A COST-SEGREGATION STUDY

Although there is no specific methodology required for a valid cost-segregation study, taxpayers must substantiate their depreciation deductions and classifications of property. The IRS Market Segment Specialization Program's *Cost Segregation Audit Techniques Guide* (the Audit Guide) provides in-depth guidance on the characteristics of a **quality** study and the resulting report. A quality study, meeting the standards set forth by the IRS, may reduce the scope and depth of an examination related to cost segregation.

A quality study is both accurate and well documented. The resulting report should always:

- Classify assets into property classes (e.g., land, land improvements, building, equipment, furniture and fixtures);
- Explain the rationale (including legal citations) for classifying assets as either §1245 or §1250 property; and
- Substantiate the cost basis of each asset and reconcile total allocated costs to total actual costs.

The 13 principal elements of a quality study are:

1. Preparation by an individual with expertise and experience,
2. Detailed description of the methodology,
3. Use of appropriate documentation,
4. Interviews conducted with appropriate parties,
5. Use of a common nomenclature,
6. Use of a standard numbering system,
7. Explanation of the legal analysis,
8. Determination of unit costs and engineering "take-offs,"
9. Organization of assets into lists or groups,
10. Reconciliation of total allocated costs to total actual costs,

57. Treas. Reg. §1.446-1(e)(2)(ii)(d)

11. Explanation of the treatment of indirect costs,
12. Identification and listing of §1245 property, and
13. Consideration of related aspects (e.g., IRC §263A, change in accounting method, and sampling techniques).

GUIDANCE FOR SPECIFIC INDUSTRIES

Proper classification of an asset depends on how the asset is used. Different industries may use the same assets in different ways. To help taxpayers and examiners properly classify property, the IRS included asset lists for several industries within the Audit Guide. It also included chapters on cost segregation within specific industry audit guides.

The following industries are included in the cost segregation audit guide:

- Casinos
- Restaurants
- Retail industries
- Biotech and pharmaceutical industries
- Auto dealerships

Note. The information on auto dealerships was added to the Audit Guide on February 25, 2008. The most current version of the guide can be accessed online at **www.irs.gov/businesses/article/0,,id=134180,00.html.**

CHANGE IN ACCOUNTING METHOD

AMENDING VERSUS FILING FORM 3115

Some depreciation changes may be made by amendment under the revenue procedures established by the IRS. However, other depreciation changes require filing Form 3115, *Application for Change in Accounting Method.*

In general, the following are not considered changes in accounting methods and **do not require Form 3115:**[58]

1. Corrections to mathematical or posting errors
2. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is actually based on the useful life, as opposed to being based on assigned life
3. A change in computing depreciation allowances caused by a change in the **taxpayer's use** (not dispositions)
4. A change in salvage value, unless a salvage value of zero is expressly required, as in the case of ACRS, MACRS, and §197 intangibles
5. Any change in the placed-in-service date of a depreciable or amortizable asset unless provided otherwise in the Code, regulations, or other IRS guidance
6. The required change for MACRS assets from a declining-balance method to the straight-line method in the year that the straight-line method produces a larger deduction

The making of a late depreciation election or the revocation of a timely valid depreciation election **requires a private letter ruling unless otherwise directed.**

58. Treas. Reg. §1.446-1(e)(2)

When a taxpayer uses a method of accounting on two or more consecutively-filed tax returns, the taxpayer has adopted a method of accounting.[59] This is true even if the method is impermissible. Except as listed above, the following are considered changes in accounting methods and filing **Form 3115 is required:**[60]

1. A change in treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice-versa)
2. A change in treatment of property purchases from expensable to depreciable
3. A change in the depreciation or amortization **method, period of recovery,** or **convention** of a depreciable or amortizable asset
4. A change **from not claiming to claiming** bonus depreciation, except when the taxpayer made an election not to claim the bonus depreciation for that property's class
5. A change **from claiming to not claiming** bonus depreciation for an asset that is **not qualified** for bonus depreciation, including those not qualified because an election out was made for that property's class
6. A change in salvage value to zero for an asset that should have had a zero salvage value under the Code, regulations, or other IRS guidance
7. A change from a single-asset account to a multiple-asset account (or vice-versa) or a change from one type of multiple-asset account to another
8. For depreciable or amortizable assets that are **mass assets** accounted for in multiple-asset accounts, a change in the method of identifying which assets have been disposed

Mass assets means a group of individual items of assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, are impractical to separately identify, and are placed in service in the same taxable year. Mass assets are not the same as assets grouped together in a General Asset Account.[61]

The following situations help clarify when Form 3115 is required.

Situation 1. Melinda is the owner of Tattered Treasures, a calendar-year taxpayer. In August 2007, she purchased special tilt-proof shelving for use in her store. She accidentally included the cost of the shelving as inventory on her 2007 return. In 2008, she discovered the mistake.

To correct the mistake, she may file an amended return for 2007. Since the improper treatment was only used for one return, she has not adopted a method of accounting. However, under Rev. Proc. 2004-11, she may elect to file Form 3115 for 2008.[62]

Situation 2. Charlie is a calendar-year taxpayer. In 2006, he purchased an electronic whiteboard for use in his sideline business of authoring books. In 2006 and 2007, he accidentally omitted the cost of the board from his returns. In 2008, he discovered the mistake.

To correct the mistake, he must file Form 3115 for his 2008 return. Because he used the improper method of claiming no depreciation for two returns, he adopted the method and must file Form 3115 to change it.

59. Rev. Rul. 90-38, 1990-1 CB 57

60. Treas. Reg. §1.446-1(e)(2)

61. Ibid

62. Rev. Proc. 2004-11 Appendix Section 1.01(1)(d), IRB 2004-3

Situation 3. In 2006, Cosmo S. Spacely, purchased a sprocket-packing robot. Spacely incorrectly classified the robot as 7-year property. He used the MACRS 7-year property depreciation rates on his 2006 and 2007 returns. In 2008, he realized the robot was 5-year property.

To correct the mistake, he must file Form 3115. Changing the period of recovery for an asset is a change in accounting method.

Situation 4. W.C. Cogswell is a calendar-year taxpayer. In December 2006, he purchased and placed in service a cog-stamping machine. The invoice for the machine did not arrive until January 2007. As a result, the asset was recorded in his books and records as having been placed in service in 2007. On his 2007 and 2008 returns, he depreciated the asset based on this date. In 2009, he realized that the placed-in-service date was really 2006, and therefore depreciation should have begun in 2006 instead of 2007.

To correct this mistake, Cogswell should file amended returns for 2006, 2007, and 2008. Correcting the placed-in-service date is not a change in accounting method.[63]

REPORTING THE §481(a) ADJUSTMENT

The adjustment calculated when changing methods of accounting is commonly referred to as the "§481(a) adjustment." Rev. Proc. 2002-9 and its successors control how the adjustment for a change in accounting method affects taxable income and on which returns the adjustment is reported.

Impermissible to Permissible Method

When changing from an impermissible method to a permissible method, the first step is to calculate the correct amount of depreciation that should have been reported for all assets improperly depreciated. This is done for both open and closed years prior to the year of change.

If the correct depreciation total is greater than the amount actually deducted, there is a negative adjustment to net income. This adjustment is taken as an adjustment on the return for the year that the error is corrected.[64] However, for disposed property, it is taken on the return for the year in which the property was disposed.

If the correct depreciation total is less than the amount actually deducted, there is a positive adjustment to net income. This increase in income is generally taken over four years if the taxpayer voluntarily changes the method of accounting.[65] However, if the resulting change is less than $25,000, the taxpayer may elect to take the entire increase into income in the year of change.[66] Also, if the taxpayer ceases the business for which the asset was used, any remaining adjustment is taken in the final year of the business.

Finally, all involuntary changes in accounting methods required by an IRS examination must be taken into account in the year of change.

Permissible to Permissible Method

The change from one permissible method of depreciation to another does not result in an adjustment.

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63. Treas. Reg. §1.446-1(e)(2)(ii)(d)(3)(v)

64. Rev. Proc. 2002-9, 2002-1 CB 327

65. Rev. Proc. 2002-19, 2002-1 CB 696

66. Ibid

REFERENCE INFORMATION FOR FORM 3115

> **Caution.** The instructions for Form 3115 may not reflect all the revenue procedures and notices that relate to making a change in accounting method. The first revenue procedure issued each year by the IRS includes an update for applications for changes in accounting methods. Practitioners should refer to this revenue procedure and subsequent current year guidance for changes that may affect the filing of Form 3115.

As of this writing, the current version of the **instructions** for Form 3115 is dated May 2006. The following resources, issued after May 2006, should be consulted before filing an amendment or Form 3115 for changes involving the stated depreciation issue:

- Rev. Proc. 2006-43, IRB 2006-45 — Liberty Zone bonus depreciation
- Rev. Proc. 2007-16, IRB 2007-4 — Disposed underdepreciated property
- Notice 2006-47, IRB 2006-20 — Small business refiner
- Notice 2006-77, IRB 2006-40 — GO Zone bonus depreciation
- Treas. Reg. §1.168(i)-6(k)(3)(ii) — Pre-February 26, 2007, like-kind exchanges

Rev. Proc. 2007-16 revised the rules for changing from an improper method of accounting to a proper method of accounting for **disposed property.** Under this procedure a taxpayer who claimed less than the allowable depreciation for disposed property is generally required to file Form 3115 to correct the depreciation. Previously, a taxpayer who claimed the improper depreciation for only one year was required to file an amended return to correct the previous year's depreciation. Under this procedure, a taxpayer may instead choose to file Form 3115 to correct that year's depreciation on the return for the year of disposition.

> **Note.** See pages 324–331 in the 2007 *University of Illinois Federal Tax Workbook* for a thorough discussion of Form 3115 and a sample completed form for underdepreciated property. Pages 329–342 in the 2004 *University of Illinois Federal Tax Workbook* also include several sample issues and completed forms.

> **Caution.** The outcomes reported in workbook examples prior to 2008 may have been modified by subsequent pronouncements.

REV. PROC. 2008-54

The increased §179 limitation from the Economic Stimulus Act (ESA) only applies to property placed in service during taxable year 2008. Section 4 of Rev. Proc. 2008-54 addresses the impact of this increased 2008 limitation in situations where the taxable year of a pass-through entity (partnership or S corporation) is different from the taxable year of its partners or shareholders.

A pass-through entity with a 2008 fiscal year has a taxable year beginning in 2008 and ending in 2009. These entities are subject to the increased §179 limitation under the ESA of $250,000 for eligible property purchased and placed in service during the 2008 fiscal year. Information for these fiscal-year entities pertaining to the §179 deduction for eligible property purchased during the 2008 fiscal year will be reported on 2008 Schedules K-1 to the partners or shareholders of the entity, which the partners or shareholders will receive in 2009. However, a partner or S corporation shareholder that is a calendar-year taxpayer is subject to the §179 limitation under the ESA of $250,000 for property placed in service by the partner or S corporation shareholder during 2008 and its share of the §179 deduction from any pass-through entity with a taxable year ending in 2008.

In 2009, the §179 limitation for calendar-year taxpayers who are partners or S corporation shareholders reverts back to the pre-ESA amounts, plus an inflation-indexed amount. Consequently, it is important for calendar-year taxpayers who are partners or S corporation shareholders to be aware that they are subject to the reduced §179 limitation in effect for 2009. This is true even though these taxpayers may receive 2008 Schedules K-1 from pass-through entities for fiscal years ending in 2009 which reflect the higher §179 limitation in effect for the 2008 taxable year.

Example 29. Xanadu Co., an S corporation, has a taxable year beginning April 1, 2008, and ending March 31, 2009. Javier, a calendar-year taxpayer, is the sole shareholder of Xanadu. Javier is engaged in the active conduct of Xanadu’s trade or business. Javier does not own any interests in any other partnerships or S corporations. During its taxable year ending March 31, 2009, Xanadu purchases only one item of §179 property, costing $250,000, and places this property in service on May 18, 2008. For its taxable year ending March 31, 2009, Xanadu elects under §179 to expense the $250,000 cost of the property and allocates its §179 deduction of $250,000 to Javier. Because Xanadu's taxable year ends within Javier’s 2009 taxable year, Javier cannot claim the §179 deduction reported on his Schedule K-1 from Xanadu until his 2009 taxable year. As a result, Javier is subject to the 2009 §179(b)(1) dollar limitation, instead of the ESA increased limitation of $250,000 for his taxable year beginning in 2009. Thus, Javier’s §179 deduction for 2009 will be limited to $125,000, plus the additional inflation-indexed amount.