Chapter 4: Depreciation Basics

Corrections were made to this material through January of 2012. No subsequent modifications were made.

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

While the concept of depreciation is relatively simple, Congress has complicated the calculations with the introduction of multiple depreciation methods, lives (recovery periods) that do not reflect the actual life of the asset, and various incentives for business owners to acquire certain types of assets (e.g., expensing election). Tax professionals who prepare returns for businesses, farms, or landlords usually calculate depreciation for the taxpayers. Although tax software can easily make the computations, the tax preparer must understand the concepts to ensure the deduction is correct for the asset being depreciated.

In addition to determining whether the asset is used in a trade or business, there are a number of questions that must be answered before the depreciation deduction can be calculated.

1. Is the property depreciable? (capital item versus repair expense)
2. When was the property acquired? (placed in service)
3. What depreciation system does the property fall under? (ACRS or MACRS)
4. What is the property's basis?
5. What is the recovery period for the property?

To qualify for depreciation, the property must:[2]

- Be owned by the taxpayer,
- Be used in the taxpayer's business or income-producing activity,
- Have a determinable useful life, and
- Be expected to last more than one year.

1. IRC §167(a).
2. IRS Pub. 946, *How to Depreciate Property.*

Property that cannot be depreciated includes the following.

- Land (because it cannot wear out, become obsolete, or get used up)
- Property placed in service and disposed of in the same year
- Equipment used to build capital improvements
- IRC §197 intangible property
- Certain term interests (a life interest in property, an interest in property for a term of years, or income interest in a trust)

> **Caution.** Although most tax professionals rely upon tax software programs to calculate depreciation, correct information must be input in order for the calculation to be accurate. Putting assets into the proper class can make a significant difference in current year income. While it is easy to rely on basic categories provided in tax software, there are exceptions and special circumstances that can cause property to be placed in a different class. This chapter will help tax professionals understand how to arrive at the most accurate depreciation calculation for their clients.

REPAIRS VERSUS CAPITALIZATION

It is sometimes difficult to determine whether an expenditure is currently deductible as a repair or if it must be capitalized and depreciated. The IRS carefully scrutinizes business deductions to determine how to treat the expenditure. Numerous court cases attest to the IRS's determination to adjust business deductions that should have been capitalized. The U.S. Court of Appeals for the 9th Circuit summarized the difference between current deductibility of expenditures and capitalization (as developed in the repair expense context) as:

> *The often-litigated distinction between repair expenses and capital improvements has been characterized as the difference between 'keeping' and 'putting' a capital asset in good condition: the test which normally is to be applied is that if the improvements were made to **'put'** the particular capital asset in efficient operating condition, then they are capital in nature. If, however, they were made merely to **'keep'** the asset in efficient operating condition, then they are repairs and are deductible.*[3] (emphasis added)

Repairs. Repairs are considered incidental repairs if they neither:

- Materially add to the property's value, nor
- Prolong its useful life.

These types of repairs keep the property in an ordinarily efficient operating condition.[4] Consequently, these expenses are currently deductible as ordinary and necessary business expenses.

Capitalization. Any cost that produces a benefit lasting for more than one year is generally not currently deductible. This includes expenses for improvements that:

- Increase the property's value,
- Substantially prolong the property's useful life, or
- Adapt the property to a new or different use.[5]

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3. *Moss v. Comm'r,* 831 F.2d 833 (9th Cir. 1987), *revg.* TC Memo 1986-128 (Mar. 31, 1986).
4. Treas. Reg. §1.162-4.
5. Treas. Regs. §§1.263(a)-1, (b)-2, and 1.461-1(a)(2).

These expenses must be capitalized and depreciated or amortized over the period of benefit or use.

Repairs that stop deterioration of a property's condition and prolong the life of the property are capitalized and depreciated under IRC §167 or charged against the property's depreciation reserve account (if maintained).

> **Note.** Questions often arise concerning the proper handling of expenses associated with tires and tools. The IRS answered the question of whether tires should be depreciated when it issued a safe-harbor method of accounting for the cost of original and replacement tires.[6] Depending on the circumstances, the original tires on a new truck may be expensed as well as any replacement tires.
>
> In general, the cost of small tools is currently deductible if income is not materially distorted and it is not practical to require the taxpayer to maintain records for depreciating the tools. However, IRS regulations state that if the useful life is one year or longer, tools must be capitalized.

Proposed regulations (2008) set forth a **de minimis rule** that is intended to minimize the compliance burden for qualifying taxpayers.[7] If the criteria are satisfied, a de minimis amount spent to acquire property that is expensed on the business's books can also be deducted on the business's income tax return. There is no maximum dollar amount specified, but the IRS will likely examine higher dollar amounts under the **distortion-of-income standard.**[8] The proposed regulation also includes a safe harbor for the application of the distortion-of-income standard. The de minimis rule does **not** apply to amounts paid to improve property, amounts paid for property included in other property produced or acquired for resale, and amounts paid for land. As an alternative, a taxpayer can elect to capitalize the cost of de minimis items on an asset-by-asset basis. Each situation requires an analysis of the facts and circumstances regarding the cap to determine if it qualifies as de minimis.

There is no recordkeeping requirement for using the de minimis rule. The taxpayer's books and records must be reasonably sufficient to determine all of the following.

- The total amount paid and deducted as materials and supplies
- The amount paid and not capitalized under the rule
- The computation of the safe-harbor amount
- That taxable income was not distorted if the safe-harbor amount was exceeded
- That the requirements for an applicable financial statement and written procedures for expensing de minimis acquisition costs were met

A key issue in making the determination of whether an expense is currently deductible or must be capitalized is whether the expenditure adapts the unit of property to a new or different use. Under the proposed regulations,[9] **the following categories of costs are classified as an improvement to property.**

1. Costs that result in a **betterment** to a unit of property
2. Costs that **restore** a unit of property
3. Costs that **adapt** a unit of property to a new or different use

Costs that fall in any of these categories must be capitalized and depreciated.

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6. Rev. Proc. 2002-27, 2002-11 CB 802. Rev. Proc. 2002-27 has been modified and/or amplified numerous times, most recently in Rev. Proc. 2005-9, 2005-1 CB 303.
7. Prop. Treas. Reg. §1.263(a)-2(d)(4).
8. Prop. Treas. Reg. §1.263(a)-2(d)(4)(iv).
9. Prop. Treas. Reg. §1.263(a)-3.

Observation. In determining whether an expenditure constitutes a betterment of an item of property, the condition of the property immediately after the expenditure must be compared with the condition of the property before the expenditure was incurred.[10]

If the expenditure is made to correct normal wear and tear, the condition of the property immediately after the last time the property was maintained is the appropriate comparison.

If the expenditure is to correct for wear and tear when the property is maintained for the first time, the condition of the property at the time the taxpayer placed it in service is the appropriate comparison.

PROPERTY OWNERSHIP

As previously stated, the taxpayer must own the property in order for it to qualify for depreciation. However, having a debt on the asset does not preclude it from being depreciated. The taxpayer must retain the **incidents of ownership** for it to be depreciable. This means the taxpayer bears the burden of exhaustion of the capital investment in the property. Incidents of ownership include all of the following.[11]

1. Legal title to the property
2. Legal obligation to pay for the property
3. Responsibility to pay maintenance and operating expenses
4. Duty to pay any taxes on the property
5. Risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion

When a taxpayer leases property, only capital improvements to the leased property can be depreciated.

Caution. Not all contracts are true leases. Some are actually installment purchases, which may be required to be capitalized and depreciated.

USE IN A BUSINESS OR INCOME-PRODUCING ACTIVITY

As stated previously, the taxpayer must use the property in a business or in an income-producing activity. If the asset is used as an investment, the income produced must be taxable. If property is used for both business and personal purposes, only expenses associated with the business portion are deductible. Records showing the time the taxpayer spent using the property for business, investment, and personal purposes are required.

If the taxpayer uses their home for business purposes, the expenses related to business use may be depreciated.

The property must have a determinable useful life. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.[12]

Example 1. Juan purchases a lot on which he plans to build his office. The land does not wear out or become obsolete and is not depreciable. The office building he erects on the land will be depreciable when it is placed in service.

The useful life of depreciable property must be substantially longer than the year it is placed in service.

Example 2. Sonya purchases the tax library of an accountant who is retiring. These books are depreciable. However, she also purchases a tax manual that is replaced each year. The annual tax manual is treated as a current year deductible business expense.

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10. Prop. Treas. Reg. §1.263(a)-3(f)(2)(iii).

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

12. Ibid.

PLACED IN SERVICE

Depreciation may not be claimed until the property is placed in service for use either in a trade or business or in the production of income. The placed-in-service date is the date the property is ready and available for a specific use. This is not necessarily the date it is first used. If property was held for personal use and is then converted to business use, the property becomes depreciable on the conversion date.[13]

The placed-into-service requirement is met if the property is ready to be placed in service, even though it is not actually used.

> **Example 3.** Heather is a calendar-year taxpayer who is a professional speaker. In preparing for a January 2011 speaking engagement, she pays $2,000 for a portable sound system. She purchases and receives the system in December 2010. She may begin depreciating the system on her 2010 return even though she has not yet used the system. It is in her possession and could be used if she had a December engagement.

Even if property meets the above requirements, it may not be depreciable. It is not depreciable if it is placed in service and withdrawn from service in the same year. If property is idle, it remains depreciable if it will be placed back in service. If the property is permanently taken out of service, depreciation ceases.

DEPRECIATION SYSTEMS

An asset is depreciated under one of two systems — ACRS or MACRS.

ACRS

The accelerated cost recovery system (ACRS) is used for property placed in service after December 31, 1980, and before January 1, 1987. For assets acquired after December 31, 1986, the ACRS system is no longer used. However, taxpayers may still have assets on their depreciation schedules that are depreciated under ACRS. Detailed information on ACRS can be found in IRS Pub. 534, *Depreciating Property Placed in Service Before 1987*.

MACRS

The modified accelerated cost recovery system (MACRS) replaced ACRS for property placed in service after December 31, 1986. MACRS consists of two depreciation systems — the general depreciation system (GDS) and the alternative depreciation system (ADS). These two systems generally provide different methods and recovery periods for calculating depreciation deductions.[14]

General Depreciation System (GDS)

Generally, GDS must be used unless the asset is specifically required by law to be depreciated under ADS, or the taxpayer elects to use ADS.

ADS is required for all the following types of property.

- Listed property used 50% or less in a qualified business purpose
- Any tangible property used predominantly outside the United States during the year
- Any tax-exempt property
- Any tax-exempt bond-financed property

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13. Ibid.

14. Ibid.

- All property placed in service in any tax year during which an election not to apply uniform capitalization rules to certain farming costs is in effect and which is used predominantly in a farming business
- Any 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

Recovery Period. The recovery period of property equals the number of years over which the taxpayer recovers the property's cost or other basis. The recovery period is determined based on the depreciation system used (GDS or ADS). The recovery period does not necessarily relate to the actual expected life of the property.

Under GDS, property that is not qualified Indian reservation property is depreciated over one of nine recovery periods. The following classifications are found in IRS Pub. 946, *How to Depreciate Property*.

1. **3-year property**
   a. Tractor units for over-the-road use
   b. Any race horse over two years old when placed in service (All race horses placed in service after December 31, 2008, and before January 1, 2014, are deemed to be 3-year property, regardless of age.)
   c. Any other horse (other than a race horse) over 12 years old when placed in service
   d. Qualified rent-to-own property[15]
2. **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, and other items used in a residential rental real estate activity
   g. Certain geothermal, solar, and wind energy property
   h. Certain farm machinery or equipment placed in service during calendar year 2009

> **Note.** Assets used in particular activities, such as the **construction industry** and **distributive trades and services** qualify as 5-year property. See "Exceptions to the General Categories for Class Lives" following Table B-1 later in this chapter.

3. **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. Certain motorsports entertainment complex property placed in service before January 1, 2010
   e. Any natural gas gathering line placed in service after April 11, 2005

15. Five years for qualified rent-to-own property placed in service before August 6, 1997 (IRS Pub. 946, *How to Depreciate Property*).

4. **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
   d. Qualified small electric meter and qualified smart electric grid system placed in service on or after October 3, 2008
5. **15-year property**
   a. Certain improvements made directly to land or added to it (such as shrubbery, fences, roads, sidewalks, and bridges)
   b. Any retail motor fuels outlet, such as a convenience store[16]
   c. Any municipal wastewater treatment plant
   d. Any qualified leasehold improvement property placed in service before January 1, 2010
   e. Any qualified restaurant property placed in service before January 1, 2010
   f. Initial clearing and grading land improvements for gas utility property
   g. Electric transmission property (that is §1245 property) used in the transmission at 69 or more kilovolts of electricity placed in service after April 11, 2005
   h. Any natural gas distribution line placed in service after April 11, 2005
   i. Any qualified retail improvement property placed in service before January 1, 2010
6. **20-year property**
   a. Farm buildings (other than single-purpose agricultural or horticultural structures)
   b. Municipal sewers not classified as 25-year property
   c. Initial clearing and grading land improvements for electric utility transmission and distribution plants
7. **25-year property.** This is water utility property.
8. **Residential rental property(27.5 years).** This is any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. It does not include a unit in a hotel, motel, or other establishment where more than half the units are used on a transient basis. If the taxpayer occupies any part of the building or structure for personal use, its gross rental income includes the fair rental value of the part occupied by the taxpayer.
9. **Nonresidential real property (39 years).** This is §1250 property, 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.[17]

Additional property classifications are listed in Appendix B, *Table of Class Lives and Recovery Periods,* of IRS Pub. 946.

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16. 39 years for property that is a retail motor fuels outlet placed in service before August 20, 1996 (31.5 years if placed in service before May 13, 1993), unless an election is made to depreciate it over 15 years (IRS Pub. 946, *How to Depreciate Property*).

17. 31.5 years for property placed in service before May 13, 1993 (or before January 1, 1994, if the purchase or construction of the property is under a binding contract, or if construction began before May 13, 1993) (IRS Pub. 946, *How to Depreciate Property*).

If the property to be depreciated is an office in the home, the recovery period depends on the home. If the taxpayer's home is a single-purpose family residence and the taxpayer is using part of the home as an office, the office is depreciated as nonresidential real property over 39 years. The recovery period is 31.5 years if the office was used before May 13, 1993. However, if the home is an apartment in an apartment building owned by the taxpayer and the building is residential rental property, the office is depreciated over 27.5 years.

If a taxpayer begins renting a home that was used as their personal residence before 1987, the home is depreciated as residential rental property over 27.5 years.

Alternative Depreciation System (ADS)

Although property may qualify for GDS, the taxpayer can elect to use ADS. The election must cover all property in the same property class that the taxpayer placed in service during the year. However, the election for residential rental property and nonresidential real property can be made on a property-by-property basis. Once the election is made, it is irrevocable.

The recovery periods for most property generally are longer under ADS than they are under GDS. 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.

Bonus depreciation, to be discussed later, is not allowed on property required to be depreciated using ADS.

Table B-1 from IRS Pub. 946 is reprinted on the following page. It includes a list of asset types or classes and the applicable class life and GDS and ADS recovery periods. Table B-2 (partial list included later) lists industries or activities that use specific types of assets with their accompanying class lives and recovery periods that are required by law.

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

Asset class	Description of assets included	Class Life (in years)	Recovery Periods (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

Generally, the property class is the same as the GDS (MACRS) recovery period indicated 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 actually in a different class.

Table B-1 and Table B-2 must be used in conjunction with each other in determining the proper class life. Examples of their interaction follow. **The table most applicable to each situation is the one that should be used.**

Example 4. 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. Therefore, by default, the appropriate class from Table B-1 appears to be Office Furniture, Fixtures, and Equipment. This has a 7-year recovery period under 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 under GDS. Consequently, the dolly qualifies to be depreciated over five years. ADS is not used because this activity or asset is not specifically listed under those that must use ADS.

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

Asset class	Description of assets included	Class Life (in years)	Recovery Periods (in years)	
			GDS (MACRS)	ADS
	...tilities:			
50.	**Municipa... ater Treatme...**	24	15	24
51.	**Municipal Sewer**	50	20***	50
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*
57.1	**Distributive Trades and Services—Billboard, Service Station Buildings and Petroleum Marketing Land Improvements:** Includes section 1250 assets, including service station buildings and depreciable land ...ments, whether section 1245 property or sectio... property, used in the marketing ...	20	15	20

Example 5. 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 6. 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.

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

Asset class	Description of assets included	Class Life (in years)	Recovery Periods (in years) GDS (MACRS)	Recovery Periods (in years) ADS
	...d Machinery and Equipment: ... related ...			
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
	Air Transport (restricted): ... each asset ... in the descripti... was held ...			

Observation. The following list is intended to alert tax 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 ≤ 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 retail 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

CONVENTIONS

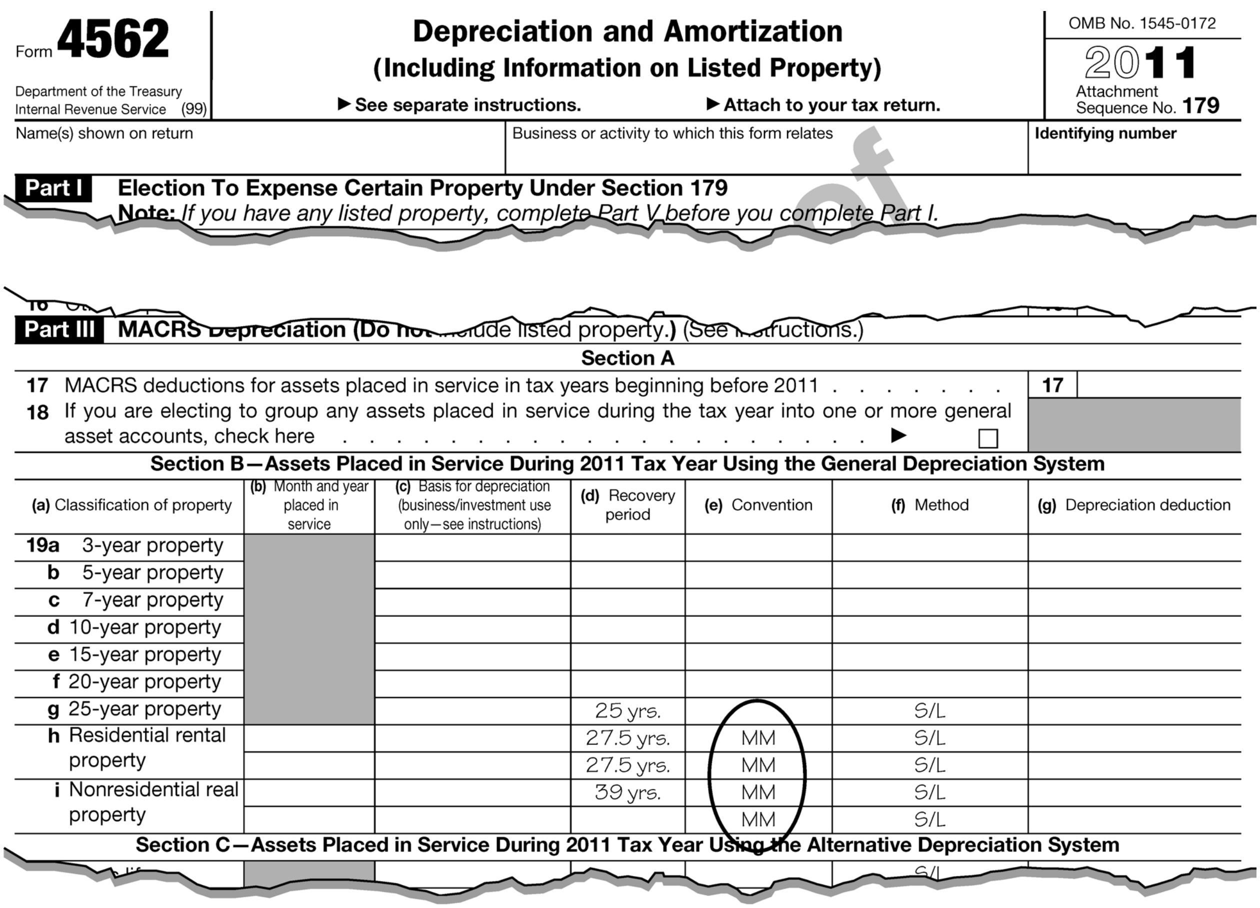
Not all property is placed in service on the first day of the tax year. Consequently, the amount of depreciation to be deducted must be adjusted in the year an asset is placed in service and in the year in which it ceases to be used. Under MACRS, averaging conventions establish when the recovery period begins and ends. The convention used determines the number of months for which the taxpayer can claim depreciation in the year the property is placed in service and in the year of disposition.

Mid-Month Convention

The mid-month convention is used for **nonresidential real property, residential rental property, and any railroad grading or tunnel bore.**

Under this convention, all property placed in service or disposed of during a month is treated as placed in service or disposed of at the midpoint of the month. This means that a one-half month of depreciation is allowed for the month the property is placed in service or disposed of.

On Form 4562, the mid-month convention is indicated by writing "MM" under column e in Part III, as shown.



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 | 2011 | Attachment Sequence No. 179

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

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.*

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

Section A

17 MACRS deductions for assets placed in service in tax years beginning before 2011 17

18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here . . . . ▶ ☐

Section B—Assets Placed in Service During 2011 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2011 Tax Year Using the Alternative Depreciation System

Mid-Quarter Convention

The mid-quarter convention is used if the mid-month convention does not apply and the total depreciable bases of MACRS property placed in service during the last three months of the tax year are more than 40% of the total depreciable bases of all MACRS property placed in service during the entire year.

Under this convention, all property placed in service or disposed of during any quarter of the tax year is treated as placed in service or disposed of at the midpoint of that quarter. This means that 1½ months of depreciation are allowed for the quarter the property is placed in service or disposed of.

On Form 4562, the mid-quarter convention is indicated by writing "MQ" under column e in Part III.

Caution. For purposes of determining whether the mid-quarter convention applies, the depreciable basis of property placed in service during the tax year reflects the reduction in basis for amounts expensed under §179 and the part of the basis of property attributable to personal use. However, it does not reflect any reduction in basis for any special depreciation allowance.

Example 7. Tele Prompter, a television producer, purchases the following equipment in 2011.

Purchase Date	Item	Cost
Jan. 5	Video camera	$ 1,000
Jun. 18	Computer	1,200
Nov. 4	Studio equipment	15,000
		$17,200

Because over 40% of the equipment is purchased in the last quarter of 2011, Tele must use the mid-quarter convention. Tele is entitled to 10½ months (3 quarters + 1½ months) depreciation on the video camera, 7½ months (2 quarters + 1½ months) on the computer, and 1½ months on the studio equipment because it was purchased in the last quarter.

Half-Year Convention

The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies.

Under this convention, all property placed in service or disposed of during a tax year is treated as placed in service or disposed of at the midpoint of the year. This means that one-half year of depreciation is allowed for the year the property is placed in service or disposed of.

On Form 4562, the half-year convention is indicated by writing "HY" under column e in Part III.

Example 8. On January 7, 2011, Marissa bought new office furniture for $7,500 that she uses in her floral supply business. This is the only capital asset purchase that Marissa made for the year. She will calculate the depreciation on the furniture using the half-year convention because neither the mid-quarter nor the mid-month convention applies.

DEPRECIATION METHODS

MACRS provides three depreciation methods under GDS and one depreciation method under ADS.

- The 200% declining balance method over a GDS recovery period
- The 150% declining balance method over a GDS recovery period
- The straight line method over a GDS recovery period
- The straight line method over an ADS recovery period

For property placed in service before 1999, taxpayers could elect the 150% declining balance method using the ADS recovery periods for certain property classes. If they made this election, they must continue to use the same method and recovery period for that property.

Table 4-1,[18] which follows, lists the types of property that can be depreciated under each method. It also gives a brief explanation of the method, including any benefits that may apply.

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

Table 4-1. **Depreciation Methods**

Note. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

Method	Type of Property	Benefit
GDS using 200% DB	• Nonfarm 3-, 5-, 7-, and 10-year property	• Provides a greater deduction during the earlier recovery years • Changes to SL when that method provides an equal or greater deduction
GDS using 150% DB	• All farm property (except real property) • All 15- and 20-year property (except qualified leasehold improvement property and qualified restaurant property placed in service before January 1, 2010) • Nonfarm 3-, 5-, 7-, and 10-year property	• Provides a greater deduction during the earlier recovery years • Changes to SL when that method provides an equal or greater deduction[1]
GDS using SL	• Nonresidential real property • Qualified leasehold improvement property placed in service before January 1, 2010 • Qualified restaurant property placed in service before January 1, 2010 • Residential rental property • Trees or vines bearing fruit or nuts • Water utility property • All 3-, 5-, 7-, 10-, 15-, and 20-year property[2] • Property for which you elected section 168(k)(4)	• Provides for equal yearly deductions (except for the first and last years)
ADS using SL	• Listed property used 50% or less for business • Property used predominantly outside the U.S. • Qualified leasehold improvement property placed in service before January 1, 2010 • Qualified restaurant property placed in service before January 1, 2010 • Tax-exempt property • Tax-exempt bond-financed property • Farm property used when an election not to apply the uniform capitalization rules is in effect • Imported property[3] • Any property for which you elect to use this method[2]	• Provides for equal yearly deductions

[1]The MACRS percentage tables in Appendix A have the switch to the straight line method built into their rates
[2]See section 168(g)(7) of the Internal Revenue Code.
[3]See section 168(g)(6) of the Internal Revenue Code

Farm Property

Personal property placed in service in a farming business after 1988 must generally be depreciated under GDS using the 150% declining-balance method, unless:

- The taxpayer is a farmer who must depreciate the property under ADS using the straight line method, or
- An election is made to depreciate the property under GDS or ADS using the straight line method.

Farmers can depreciate real property using the straight-line method under either GDS or ADS.

Trees and vines bearing fruit or nuts are depreciated under GDS using the straight line method over a recovery period of 10 years.

Uniform capitalization (UNICAP) rules[19] require the capitalization of all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer. Farmers electing not to apply UNICAP rules to any plant produced in the farming business must use ADS. They must use ADS for all property they place in service in any year the election is in effect. See the regulations under IRC §263A for information on the UNICAP rules that apply to farm property.

Electing a Different Method

As shown in Table 4-1 of IRS Pub. 946 (see previous section), a taxpayer can elect a different method of depreciation for certain types of property. The taxpayer must make the election by the due date of the return (including extensions) for the year the property is placed in service. However, if the taxpayer timely filed their return for the year without making the election, they still can make the election by filing an amended return within six months of the due date of the return (excluding extensions). The taxpayer must attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. The amended return is filed at the same address that the taxpayer filed the original return. Once the election is made, it is irrevocable.

> **Caution.** Taxpayers may elect to use ADS for property that qualifies for GDS. Generally, the election must cover all property in the same property class placed in service during the year of the election. However, the election can be made on a property-by-property basis for nonresidential real and residential rental property.

BASIS OF PROPERTY

For business property purchased during the year, the basis is generally the cost of the property.[20] Certain adjustments must be made to the unadjusted basis before calculating allowable depreciation. The result of these adjustments is the **adjusted basis** of property.

The following items increase the basis of property.

- Installing utility lines
- Legal fees paid to defend or perfect a title
- Impact fees
- Capital improvements
- Assessments for local improvements
- Restoring damaged property as a result of casualty losses
- Zoning costs
- Sales tax paid

> **Note.** If state and local general sales taxes are deducted instead of state and local income taxes on Schedule A, those sales taxes **cannot** be used to increase basis.

19. IRC §263A.

20. IRC §1012(a).

The following items decrease the basis of property.

- Amortization, depreciation, and depletion previously allowed or allowable on the property
- Any §179 deduction claimed
- Any bonus depreciation allowance taken on the property
- Casualty and theft losses and insurance reimbursements

DEPRECIATION ALLOWED OR ALLOWABLE

Basis must be adjusted for depreciation allowed or allowable, whichever is greater. Depreciation allowed is the amount that was actually deducted. Depreciation allowable is the amount to which the taxpayer was actually entitled.

If an incorrect amount is deducted in any year, the taxpayer may be able to make a correction by filing an amended return for that year. If the correction cannot be made on an amended return, it may be made on Form 3115, *Application for Change in Accounting Method*. The taxpayer may be allowed to claim all of the missed depreciation in one year.[21]

> **Note.** For more information about basis, see IRS Pub. 551, *Basis of Assets.*

DEPRECIATION CALCULATIONS (MACRS)

MACRS PERCENTAGE TABLES

To simplify the deduction under MACRS, the IRS established percentage tables that incorporate the applicable convention and depreciation method. These tables are found in Appendix A of Pub. 946.

Which Table to Use

Appendix A contains the MACRS Percentage Table Guide, which is designed to help the taxpayer locate the correct percentage table to use for depreciating their property. The percentage tables immediately follow the guide in IRS Pub. 946.

Rules for Use of Tables

The following rules cover the use of the percentage tables.

1. The rates in the percentage tables must be applied to the property's unadjusted basis.
2. The percentage tables cannot be used for a short tax year.
3. Once a taxpayer starts using the percentage tables for any item of property, they generally must continue to use them for the property's entire recovery period.
4. Taxpayers must stop using the tables if they adjust the basis of the property for any reason other than:
    a. Depreciation allowed or allowable, or
    b. An addition or improvement to that property that is depreciated as a separate item of property.

Basis adjustments other than those made for the reasons listed in **4** include an increase in basis for the recapture of a clean-fuel deduction[22] or credit and a reduction in basis for a casualty loss.

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21. Rev. Proc. 2008-52, 2008-36 IRB 587.

22. Treas. Reg. §1.179A-1.

Example 9. On March 10, 2009, Martin, a calendar-year taxpayer, bought and placed in service a state-of-the art computer and some peripheral equipment, which he uses in his printing supply business. The equipment is 5-year property and cost $15,000. This constitutes all of Martin's purchases for the year.

Martin figured his MACRS depreciation deduction using the percentage tables. He uses the half-year convention because neither the mid-month nor mid-quarter conventions apply. For 2009, he uses the following table to calculate his MACRS depreciation deduction of $3,000 ($15,000 × 20%).

Table A-1[23] shows the percentages for use with 3-, 5-, 7-, 10-, 15-, and 20-year property using the half-year convention and 200% MACRS depreciation.

Table A-1. **3-, 5-, 7-, 10-, 15-, and 20-Year Property Half-Year Convention**

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

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

Basis Adjustment Due to Casualty Loss

The basis of property must be reduced because of a casualty, and continued use of the percentage tables is not allowed. For the year of the adjustment and the remaining recovery period, taxpayers must figure the depreciation using the property's adjusted basis at the end of the year.

Example 10. Use the same facts as in **Example 9,** except Martin bought the computer and peripheral equipment on October 26, 2009.

Martin figures his MACRS depreciation deduction using the percentage tables. Because this is all of his purchases for the year, Martin must use the mid-quarter convention. For 2009, he uses the following table to calculate his MACRS depreciation deduction of $750 ($15,000 × 5%).

The $2,250 difference between the depreciation deduction in **Examples 9 and 10** ($3,000 – $750) is because of the timing of the purchases.

Table A-5. **3-, 5-, 7-, 10-, 15-, and 20-Year Property Mid-Quarter Convention Placed in Service in Fourth Quarter**

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	8.33%	5.00%	3.57%	2.50%	1.25%	0.938%
2	61.11	38.00	27.55	19.50	9.88	7.430
3	20.37	22.80	19.68	15.60	8.89	6.872
4	10.19	13.68	14.06	12.48	8.00	6.357
5		10.94	10.04	9.98	7.20	5.880
6		9.58	8.73	7.99	6.48	5.439
7			8.73	6.55	5.90	5.031
8			7.64	6.55	5.90	4.654
9				6.56	5.90	4.458
10				6.55	5.91	4.458
11				5.74	5.90	4.458
12					5.91	4.458
13					5.90	4.458
14					5.91	4.458
15					5.90	4.458
16					5.17	4.458
17						4.458
18						4.459
19						4.458
20						4.459
21						3.901

In July 2010, the property was vandalized and Martin had a deductible casualty loss of $3,000. He must adjust the property's basis for the casualty loss, so he can no longer use the percentage tables. His adjusted basis at the end of 2010, before figuring his 2010 depreciation, is $11,250, as shown here. Martin must now figure his depreciation for 2010 without using the percentage tables (this procedure is described later in this chapter).

Equipment cost	$15,000
Less: 2009 depreciation	(750)
Less: 2010 casualty loss	(3,000)
2010 adjusted basis before depreciation	$11,250

DISPOSITION BEFORE END OF RECOVERY PERIOD

If property is sold or otherwise disposed of before the end of its recovery period, the depreciation deduction for the year of the disposition is only part of the depreciation amount for the full year. Property is considered disposed of if it is permanently withdrawn from use in the business or income-producing activity because of its sale, exchange, retirement, abandonment, involuntary conversion, or destruction. After computing the full-year depreciation amount, compute the deductible part using the convention that applies to the property.

Half-Year Convention Used. If the half-year convention was used for the property, the depreciation deduction for the year of the disposition is half the depreciation calculated for the full year.

Mid-Quarter Convention Used. If the mid-quarter convention was used, the depreciation deduction for the year of the disposition is computed by multiplying a full year of depreciation by the percentage[24] listed below for the quarter in which the disposition occurs.

Quarter	Percentage
First	12.5%
Second	37.5
Third	62.5
Fourth	87.5

Example 11. On December 2, 2008, Carly placed in service a copier costing $10,000. Her unadjusted basis for the copier was $10,000. Carly used the mid-quarter convention because this was the only item of business property she placed in service in 2008 and it was placed in service during the last three months of her tax year. Her property is in the 5-year property class, so she used Table A-5 to calculate her depreciation deduction.

Her deductions for 2008, 2009, and 2010 were:

2008	$ 500	(5% of $10,000)
2009	3,800	(38% of $10,000)
2010	2,280	(22.8% of $10,000)

Carly disposed of the property on April 6, 2011. To determine her depreciation deduction for 2011, she first calculates the deduction for the full year. Then this total is multiplied by the second quarter percentage, because the month of April falls within the second quarter.

2011 (full year)	$1,368	(13.68% of $10,000)
Mid-quarter convention rate for second quarter	× 37.5%	
Carly's 2011 deduction	$ 513	

Mid-Month Convention Used. If residential rental or nonresidential real property is disposed of, the depreciation deduction for the year of the disposition is calculated by multiplying a full year of depreciation by a fraction. The numerator of the fraction is the number of months (including partial months) in the year that the property is considered in service. The denominator is 12.

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

Example 12. On July 2, 2008, Zoe purchased and placed in service residential rental property. The property cost $100,000, not including the cost of land. She used Table A-6 from IRS Pub. 946 (Residential Rental Property, Mid-Month Convention, Straight Line — 27.5 Years), to figure her MACRS depreciation for this property. She sold the property on March 2, 2010. She files her tax return based on the calendar year.

Depreciation for 2010 for a full year is $3,636 ($100,000 × .03636). The percentage is found in Table A-6 for the seventh month of the third recovery year. She then applies the mid-month convention for the 2½ months of use in 2010.

Full-year depreciation	$3,636
Fraction representing portion of year property used	× (2.5 ÷ 12)
2010 depreciation deduction	$ 758

Table A-6. **Residential Rental Property**
Mid-Month Convention
Straight Line—27.5 Years

Year	Month property placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2–9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
12	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
13	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
14	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
15	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
16	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
17	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
18	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
19	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
20	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
21	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
22	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
23	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
24	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
25	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
26	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
27	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
28	1.97	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29							0.152	0.455	0.758	1.061	1.364	1.667

CALCULATING THE DEDUCTION WITHOUT USING THE TABLES

Instead of using the rates in the percentage tables to calculate the depreciation deduction, depreciation can be computed manually. Before making the computation each year, the adjusted basis in the property must be reduced by the depreciation claimed the previous year. Consequently, this method is referred to as the declining balance method.

> **Note.** Calculating the MACRS deduction without using the tables generally results in a slightly different amount than using the tables.

Declining Balance Method

When using a declining balance method, the same depreciation rate is applied each year to the adjusted basis of the property. The applicable convention for the first tax year must be used and the method must be switched to the straight line method beginning in the first year for which it will give an equal or greater deduction. The straight line method is explained later.

Depreciation for the year the property is placed in service is computed as follows.

1. Multiply the adjusted basis in the property by the declining balance rate.
2. Apply the applicable convention.

The depreciation for all other years (before the year the method is switched to the straight line method) is calculated as follows.

1. Reduce the adjusted basis in the property by the depreciation allowed or allowable in earlier years.
2. Multiply this new adjusted basis by the same declining balance rate used in earlier years.

If the property is disposed of before the end of its recovery period, the section entitled "Using the Applicable Convention" found later in this chapter includes information on how to calculate depreciation for the year of disposition.

Declining Balance Rate. The declining balance rate is computed by dividing the specified declining balance percentage (150% or 200% changed to a decimal) by the number of years in the property's recovery period. For example, for 3-year property depreciated using the 200% declining balance method, divide 2.00 (200%) by 3 to arrive at 0.6667, or a 66.67% declining balance rate. For 15-year property depreciated using the 150% declining balance method, divide 1.50 (150%) by 15 to arrive at 0.10, or a 10% declining balance rate.

The table[25] shown here lists the declining balance rate for each property class and the first year for which the straight line method gives an equal or greater deduction.

Property Class	Method	Declining Balance Rate	Year
3-year	200% DB	66.667%	3rd
5-year	200% DB	40.0	4th
7-year	200% DB	28.571	5th
10-year	200% DB	20.0	7th
15-year	150% DB	10.0	7th
20-year	150% DB	7.5	9th

Straight Line Method

When using the straight line method, a different depreciation rate is applied each year to the adjusted basis of the property. The applicable convention is used in the year the property was placed in service and the year of disposal.

The depreciation for the year the property is placed in service is computed as follows.

1. Multiply the adjusted basis in the property by the straight line rate.
2. Apply the applicable convention.

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

Depreciation is calculated for all other years (including the year the asset is switched from the declining balance method to the straight line method) as follows.

1. Reduce the adjusted basis in the property by the depreciation allowed or allowable in earlier years (under any method).
2. Determine the depreciation rate for the year.
3. Multiply the adjusted basis computed in **1** by the depreciation rate computed in **2**.

If the property is disposed of before the end of its recovery period, the section entitled "Using the Applicable Convention" found later in this chapter includes information on how to calculate depreciation for the year of disposition.

Straight Line Rate. The straight line depreciation rate for any tax year is determined by dividing the number 1 by the years remaining in the recovery period at the beginning of that year. When computing the number of years remaining, the convention used in the year the property was placed in service must be taken into account. If the number of years remaining is less than 1, the depreciation rate for that tax year is 1.0 (100%).

Example 13. In January, Rodney buys and places in service a building for $100,000 that is nonresidential real property with a recovery period of 39 years. The adjusted basis of the building is its cost of $100,000. Rodney uses GDS, the straight line (SL) method, and the mid-month convention to figure his depreciation.

First Year. Using the mid-month convention, Rodney treats the property as placed in service in the middle of January. Rodney's first-year depreciation for the building is $2,456, calculated as follows:

	Calculation	Result
SL depreciation rate	1 ÷ 39 years	.02564
Full-year depreciation	$100,000 × .02564	$2,564
Mid-month depreciation rate	11½ months ÷ 12 months	.958
First-year depreciation	$2,564 × .958	$2,456

Second Year. Rodney's depreciation for the building for the second year is $2,564, calculated as follows:

	Calculation	Result
SL depreciation rate	1 ÷ 38.042 remaining years (39 years − .958 year (11.5 months))	.02629
Adjusted basis of property	$100,000 − $2,456 first-year depreciation	$97,544
Second-year depreciation	$97,544 × .02629	$2,564

Third Year. Rodney's depreciation for the third year is $2,564, calculated as follows:

	Calculation	Result
SL depreciation rate	1 ÷ 37.042 remaining years	.027
Adjusted basis of property	$100,000 − $2,456 first-year depreciation − $2,564 second-year depreciation	$94,980
Third-year depreciation	$94,980 × .027	$2,564

Using the Applicable Convention

The applicable convention (discussed earlier under "Convention") affects how the depreciation deduction is calculated for the year the property is placed in service and for the year of disposition. It determines how much of the recovery period remains at the beginning of each year, so it also affects the depreciation rate for property depreciated under the straight line method (see "Straight Line Rate" section). Use of the applicable convention is explained in the following discussions.

Half-Year Convention. If this convention applies, a half-year of depreciation is deducted for the first year and the last year the property is depreciated. A full year of depreciation is deducted for any other year during the recovery period.

Compute the depreciation deduction for the year the property is placed in service by dividing the depreciation for a full year by two. If the property is disposed of before the end of the recovery period, the depreciation deduction for the year of the disposition is calculated the same way. If the property is held for the entire recovery period, the depreciation deduction for the year that includes the final six months of the recovery period is the amount of the unrecovered basis in the property.

Mid-Quarter Convention. If this convention applies, the depreciation deduction for the first year the property is depreciated depends on the quarter in which the property is placed in service.

A quarter of a full 12-month tax year is a period of three months. The first quarter in a year begins on the first day of the tax year. The second quarter begins on the first day of the fourth month of the tax year. The third quarter begins on the first day of the seventh month of the tax year. The fourth quarter begins on the first day of the tenth month of the tax year.

Calculate the depreciation deduction for the year the property is placed in service by multiplying the depreciation for a full year by the percentage listed here[26] for the quarter the property is placed in service.

Quarter	Percentage
First	87.5%
Second	62.5
Third	37.5
Fourth	12.5

If the property is disposed of before the end of the recovery period, the depreciation deduction is computed for the year of the disposition by multiplying a full year of depreciation by the percentage listed here[27] for the quarter in which the property is disposed.

Quarter	Percentage
First	12.5%
Second	37.5
Third	62.5
Fourth	87.5

If the property is held for the entire recovery period, the depreciation deduction for the year that includes the final quarter of the recovery period is the amount of the unrecovered basis in the property.

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

27. Ibid.

Mid-Month Convention. If this convention applies, the depreciation deduction for the first year that the property is depreciated depends on the month in which the property is placed in service. The depreciation deduction for the year the property is placed in service is computed by multiplying the depreciation for a full year by a fraction. The numerator of the fraction is the number of full months in the year that the property is in service plus $^1/_2$ (or 0.5). The denominator is 12.

If the property is disposed of before the end of the recovery period, the depreciation deduction for the year of the disposition is computed the same way. If the property is held for the entire recovery period, the depreciation deduction for the year that includes the final month of the recovery period is the amount of the unrecovered basis in the property.

> **Example 14.** Ainsley is a calendar-year taxpayer and she placed nonresidential real property in service in August. The property is in service four full months (September, October, November, and December). She uses a numerator of 4.5 (4 full months plus 0.5). She multiplies the depreciation for a full year by 0.375 (4.5 ÷ 12).

RECAPTURE

Upon the disposition of property using MACRS, any gain on the disposition generally is recaptured (included in income) as ordinary income up to the amount of the depreciation previously allowed or allowable for the property. For this purpose, **depreciation** includes the following.

- Any **special depreciation allowance** (bonus depreciation) previously allowed or allowable for the property (unless the taxpayer elected not to claim it)
- Any §179 deduction claimed on the property
- Any deduction under IRC §179B for capital costs to comply with Environmental Protection Agency sulfur regulations
- Any deduction under IRC §179C for certain qualified refinery property placed in service after August 8, 2005
- Any deduction under IRC §179D for certain energy efficient commercial building property placed in service after December 31, 2005
- Any deduction under IRC §179E for qualified advanced mine safety equipment property placed in service after December 20, 2006
- Any deduction under IRC §190 for removal of barriers to the disabled and the elderly
- Any deduction under IRC §193 for tertiary injectants

There is no recapture for residential rental and nonresidential real property unless that property is qualified property for which a special depreciation allowance was claimed.

IRC §179 DEDUCTION

Taxpayers can elect to recover all or part of the cost of certain qualifying property, within limits, by deducting it in the year they place the property in service. This is the IRC §179 deduction. Taxpayers can elect the §179 deduction instead of recovering the cost over time by taking depreciation deductions.

> **Note.** Estates and trusts cannot elect the §179 deduction.

Property qualifying for the §179 deduction must satisfy all the following requirements.

1. Be eligible property
2. Be acquired for business use
3. Be acquired by purchase

The property may be new or used.

ELIGIBLE PROPERTY

To qualify for the §179 deduction, the property must be one of the following types of depreciable property.

1. Tangible personal property
2. Other tangible property (except buildings and their structural components) used in one of the following ways.
   a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services
   b. A research facility used in connection with any of the activities in item a
   c. A facility used in connection with any activities in item a for the bulk storage of fungible commodities
3. Single-purpose agricultural (livestock) or horticultural structures
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum
5. Off-the-shelf computer software (through December 31, 2012 only)
6. The following types of real property (for taxable years beginning in 2010 and 2011 only)
   a. Qualified leasehold improvement property (as defined in IRC §168(e)(6))
   b. Qualified restaurant property (as defined in IRC §168(e)(7))
   c. Qualified retail improvement property (as defined in IRC §168(e)(8))

Tangible Personal Property

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

- Machinery and equipment
- Property contained in or attached to a building (other than structural components), such as refrigerators, grocery store counters, office equipment, printing presses, testing equipment, and signs
- Gasoline storage tanks and pumps at retail service stations
- Livestock used for breeding, including horses, cattle, hogs, sheep, goats, and mink and other furbearing animals

The treatment of property as tangible personal property for the §179 deduction is not controlled by its treatment under local law. For example, property may not be tangible personal property for the deduction even if treated as such under local law, and some property (such as fixtures) may be tangible personal property for the deduction even if treated as real property under local law.

Off-the-Shelf Computer Software

Off-the-shelf computer software placed in service during the tax year is qualifying property for purposes of the §179 deduction through December 31, 2012. This is computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. It includes any program designed to cause a computer to perform a desired function. However, a database or similar item is not considered computer software unless it is in the public domain and is incidental to the operation of otherwise qualifying software.

> **Note.** Some computer software qualifies to be currently expensed without making a §179 election (e.g., tax software which has a useful life of less than one year).

PROPERTY ACQUIRED FOR BUSINESS USE

To qualify for the §179 deduction, the property must have been acquired for use in a trade or business. Property acquired only for the production of income, such as investment property, rental property (if renting property is not a trade or business), and property that produces royalties does not qualify.

Partial Business Use

When property is used for both business and nonbusiness purposes, a taxpayer can elect the §179 deduction only if they use the property more than 50% for business in the year they place it in service. If the taxpayer uses the property more than 50% for business, the cost of the property is multiplied by the percentage of business use. The resulting business cost is used to compute the §179 deduction.

Example 15. Attorney Sosume bought and placed in service an item of §179 property costing $11,000. She used the property 80% for her business and 20% for personal purposes. The business part of the cost of the property is $8,800 (80% × $11,000).

PROPERTY ACQUIRED BY PURCHASE

To qualify for the §179 deduction, property must have been acquired by purchase. Consequently, property acquired by gift or inheritance does not qualify.

Property is not considered to be acquired by purchase in the following situations.

1. It is acquired by one member of a controlled group from another member of the same group.
2. Its basis is determined either:
   a. In whole or in part by its adjusted basis in the hands of the person from whom it was acquired, or
   b. Under the stepped-up basis rules for property acquired from a decedent.
3. It is acquired from a related person.

Related Persons

For purposes of the §179 deduction, the following are related persons.[28]

1. An individual and a member of their family, defined as only a spouse, ancestors, and lineal descendants

> **Note.** Brothers, sisters, half brothers, and half sisters are not included in this definition.

2. A corporation and an individual who directly or indirectly owns more than 50% of the value of the outstanding stock of that corporation
3. Two corporations that are members of the same controlled group
4. A trust fiduciary and a corporation if more than 50% of the value of the outstanding stock is directly or indirectly owned by or for the trust or grantor of the trust
5. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust
6. The fiduciaries of two different trusts, and the fiduciaries and beneficiaries of two different trusts, if the same person is the grantor of both trusts
7. A tax-exempt educational or charitable organization and any person (or, if that person is an individual, a member of that person's family) who directly or indirectly controls the organization
8. Two S corporations, and an S corporation and a regular corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation
9. A corporation and a partnership if the same persons own both of the following.
   - a. More than 50% of the value of the outstanding stock of the corporation
   - b. More than 50% of the capital or profits interest in the partnership
10. The executor and beneficiary of any estate
11. A partnership and a person who directly or indirectly owns more than 50% of the capital or profits interest in the partnership
12. Two partnerships, if the same persons directly or indirectly own more than 50% of the capital or profits interest in each
13. The related person and a person who is engaged in trades or businesses under common control (See IRC §§52(a) and 52(b).)

Example 16. Sue Urr is a tailor. She bought two industrial sewing machines from her father. She placed both machines in service in the same year she bought them. They do not qualify as §179 property because Sue and her father are related persons. She cannot claim a §179 deduction for the cost of these machines.

When to Determine Relationship. The related party relationship is determined at the time the property is acquired.

A partnership acquiring property from a terminating partnership must determine whether it is related to the terminating partnership immediately before the event causing the termination. For this rule, a terminating partnership is one that sells or exchanges 50% or more of its total interest in partnership capital or profits within 12 months.

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28. IRC §267.

NONQUALIFYING PROPERTY[29]

Certain property, including the following, does not qualify for the §179 deduction.

Land and Improvements

Land and land improvements, such as buildings and other permanent structures and their components, are real property, not personal property, and do not qualify as §179 property. Land improvements include swimming pools, paved parking areas, wharves, docks, bridges, and fences.

Excepted Property

Even if the requirements explained previously are met, the following property is not eligible for the §179 deduction.

1. Certain property leased to others by a noncorporate lessor (see below)
2. Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging (see below)
3. Air conditioning or heating units
4. Property used predominantly outside the United States, except property described in IRC §168(g)(4)
5. Property used by certain tax-exempt organizations, except property used in connection with the production of income subject to the tax on unrelated trade or business income
6. Property used by governmental units or foreign persons or entities, except property used under a lease with a term of less than six months

Leased Property. Generally, a §179 deduction cannot be claimed based on the cost of property leased to someone else. This rule does not apply to corporations. However, a §179 deduction can be claimed for the cost of the following property.

1. Property the taxpayer manufactures or produces and leases to others
2. Property the taxpayer purchases and leases to others if both of the following tests are met.
   a. The term of the lease (including options to renew) is less than 50% of the property's class life.
   b. For the first 12 months after the property is transferred to the lessee, the total business deductions allowed on the property (other than rents and reimbursed amounts) are more than 15% of the rental income from the property.

Property Used for Lodging. Generally, a §179 deduction cannot be claimed for property used predominantly to furnish lodging or in connection with the furnishing of lodging. However, this does not apply to the following types of property.

- Nonlodging commercial facilities that are available on the same basis to:
  - Those **not** using the lodging facilities, and
  - Those using the lodging facilities.
- Property used by a hotel or motel in connection with the trade or business of furnishing lodging when the predominant portion of the accommodations is used by transients
- Any certified historic structure to the extent its basis is due to qualified rehabilitation expenditures
- Any energy property

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

AMOUNT OF DEDUCTION

Dollar Limit

The total amount that a taxpayer can elect to deduct under §179 for most property placed in service in 2010 and 2011 generally cannot be more than $500,000.[30] If the taxpayer acquires and places in service more than one item of qualifying property during the year, they can allocate the §179 deduction among the items in any way, as long as the total deduction is not more than $500,000.[31] The taxpayer does not have to claim the full $500,000.

As mentioned earlier, the §179 deduction is available for certain types of real property for taxable years beginning in 2010 and 2011 only. The maximum amount of **real property** that may be expensed for purposes of §179 is $250,000.[32]

> **Note.** The amount a taxpayer can elect to deduct is not affected if they place qualifying property in service in a short tax year or if they place qualifying property in service for only a part of a 12-month tax year.

Example 17. In 2010, Grisly Baer bought and placed in service a $275,000 timber transporter and a $25,000 circular saw for his business. He elected to deduct $275,000 for the transporter and $25,000 for the saw, for a total of $300,000. This is the maximum amount he can deduct because he did not purchase any other assets that qualify for §179. His $300,000 deduction for the transporter and saw completely recovered their cost. His basis for depreciation is zero.

Example 18. Grisly, from **Example 17,** determines he does not want to claim the entire $300,000 deduction; instead, he wishes to preserve $150,000 for future depreciation. He can allocate the deduction between the assets in any manner he chooses. Grisly allocates $25,000 to the saw; therefore, he has no basis for future depreciation. He allocates the remaining $125,000 to the transporter. This results in a $150,000 basis in the transporter for depreciation in current and future years.

Situations Affecting Dollar Limit. Under certain circumstances, the general dollar limits on the §179 deduction may be reduced or increased, or there may be additional dollar limits. The general dollar limit is affected by any of the following situations.

- The cost of the §179 property placed in service exceeds $2 million.
- The business is an enterprise zone business or a renewal community business.
- The taxpayer placed in service a sport utility vehicle or certain other vehicles.
- The taxpayer is married filing a joint or separate return.

Costs Exceeding $2 Million

If the cost of the qualifying §179 property placed in service in 2010 or 2011 is more than $2 million, taxpayers generally must reduce the dollar limit (but not below zero) by the amount of the cost over $2 million.[33] If the cost of the §179 property placed in service during 2010 or 2011 is $2.5 million or more, the taxpayer cannot take a §179 deduction.

Example 19. Assume Grisly in **Example 17** placed in service machinery costing $2.3 million. This cost is $300,000 more than the $2 million limitation, so he must reduce his dollar limit from $500,000 to $200,000.

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30. IRC §179(b)(1)(B).

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

32. IRC §179(f).

33. IRC §179(b)(2)(B).

Taxpayers cannot elect to expense more than $25,000 of the cost of any heavy sport utility vehicle (SUV) and certain other vehicles placed in service during the tax year.[34] This rule applies to any 4-wheeled vehicle primarily designed or used to carry passengers over public streets, roads, or highways that is rated at more than 6,000 pounds gross vehicle weight and not more than 14,000 pounds gross vehicle weight. However, the $25,000 limit does not apply to any vehicle:[35]

- 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.

Married Individuals

How a married taxpayer computes their §179 deduction depends on whether they file jointly or separately. If they file a joint return, the taxpayer and spouse are treated as one taxpayer in determining any reduction to the dollar limit, regardless of which of them purchased the property or placed it in service. If the taxpayer and spouse file separate returns, they are treated as one taxpayer for the dollar limit, including the reduction for costs over $2 million. They must allocate the dollar limit (after any reduction) between them equally, unless they both elect a different allocation. If the percentages elected by each of them do not total 100%, 50% will be allocated to each of them.

Example 20. Jack is married. He and his wife Jane file separate returns. Jack bought and placed in service $2 million of qualified machinery in 2010. Jane has her own business, and she bought and placed in service $10,000 of qualified business equipment. Their combined dollar limit for the §179 deduction is $490,000 ($500,000 − $10,000). This is because they must figure the limit as if they were one taxpayer. They reduce the $500,000 dollar limit by the $10,000 excess of their costs over $2 million.

They elect to allocate the $490,000 dollar limit as follows.

- $480,200 ($490,000 × 98%) to Jack's machinery
- $9,800 ($490,000 × 2%) to Jane's equipment

If they did not make an allocation election using Form 4562, *Depreciation and Amortization,* they would have to allocate $245,000 ($490,000 × 50%) to each of them.

Joint Return after Filing Separate Returns. If the taxpayer and spouse elect to amend their separate returns by filing a joint return after the due date for filing the return, the dollar limit on the joint return is the lesser of the following amounts.

- The dollar limit (after reduction for any cost of §179 property over $2 million)
- The total cost of §179 property the taxpayer and spouse elected to expense on their separate returns

Example 21. Use the same facts as in **Example 20,** except Jack elected to deduct $30,000 of the cost of §179 property on his separate return and Jane elected to deduct $2,000. After the due date of their returns, they file a joint return. Their dollar limit for the §179 deduction is $32,000. This is the lesser of the following amounts.

1. $490,000 (the dollar limit less the cost of §179 property over $2 million)
2. $32,000 (the total they elected to expense on their separate returns)

> **Caution.** After a tentative deduction is determined by applying the dollar limit, a business income limit must be determined to arrive at the allowable §179 deduction.

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34. IRC §179(b)(5).

35. IRC §179(b)(5)(B)(ii).

Taxable Business Income Limit

The amount of the §179 deduction that a taxpayer is allowed in any year is limited by their taxable income from the active conduct of any trade or business during the year.[36] Taxable business income is calculated differently depending on the form of the business.

For 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 all of the following.

- Wages, salaries, tips, or other pay earned as an employee
- §1231 gains or losses[37]
- Interest from working capital of trades/businesses

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

- §179 deductions
- SE tax deduction
- NOL deduction
- Unreimbursed employee business expenses

Two Different Taxable Income Limits. In addition to the business income limit for the §179 deduction, a taxpayer may have a taxable income limit for some other deduction. They may have to calculate the limit for this other deduction taking into account the §179 deduction. If so, the taxpayer should complete the following steps.

Step 1. Compute taxable income without the §179 deduction or the other deduction.

Step 2. Compute a hypothetical §179 deduction using the taxable income figured in Step 1.

Step 3. Subtract the hypothetical §179 deduction figured in Step 2 from the taxable income figured in Step 1.

Step 4. Compute a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.

Step 5. Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.

Step 6. Compute the actual §179 deduction using the taxable income figured in Step 5.

Step 7. Subtract the actual §179 deduction figured in Step 6 from the taxable income figured in Step 1.

Step 8. Compute the actual other deduction using the taxable income figured in Step 7.

The most common deductions that also have taxable income limitations are charitable contributions and the domestic production activities deduction (DPAD).

36. IRC §179(b)(3)(A).

37. IRC §1231 concerns property used in a trade or business and involuntary conversions.

Example 22. On February 1, 2010, the Praline Corporation purchased and placed in service qualifying §179 property that cost $250,000. It elects to expense the entire $250,000 cost under §179. In June, the corporation gave a charitable contribution of $10,000. A corporation's limit on charitable contributions is figured after subtracting any §179 deduction. The business income limit for the §179 deduction is figured after subtracting any allowable charitable contributions. Praline's taxable income is $270,000, which is determined by adding back the §179 deduction and the deduction for charitable contributions. Praline calculates its §179 deduction and its deduction for charitable contributions as follows.

Step 1. Taxable income figured without either deduction is $270,000.

Step 2. Using $270,000 as taxable income, Praline's hypothetical §179 deduction is $250,000.

Step 3. $20,000 ($270,000 − $250,000)

Step 4. Using $20,000 (from Step 3) as taxable income, Praline's hypothetical charitable contribution (limited to 10% of taxable income) is $2,000.

Step 5. $268,000 ($270,000 − $2,000)

Step 6. Using $268,000 (from Step 5) as taxable income, Praline figures the actual §179 deduction. Because the taxable income is at least $250,000, Praline can take a $250,000 §179 deduction.

Step 7. $20,000 ($270,000 − $250,000)

Step 8. Using $20,000 (from Step 7) as taxable income, Praline's actual charitable contribution (limited to 10% of taxable income) is $2,000.

Carryover of Disallowed Deduction. Taxpayers can carry over for an unlimited number of years the cost of any §179 property they elected to expense but were unable to deduct because of the business income limit. This disallowed deduction amount is shown on line 13 of Form 4562, *Depreciation and Amortization*. The taxpayer uses the amount they carry over to determine their §179 deduction in the next year. That amount is entered on line 10 of the Form 4562 for the next year.

If the taxpayer places more than one property in service in a year, they can select the properties for which all or a part of the costs will be carried forward. The selections must be shown in their books and records. For this purpose, §179 costs allocated from a partnership or an S corporation are treated as one item of §179 property. If the taxpayer does not make a selection, the total carryover is allocated equally among the properties they elected to expense for the year.

If costs from more than one year are carried forward to a subsequent year in which only part of the total carryover can be deducted, the taxpayer must deduct the costs being carried forward from the earliest year first.

If there is a sale or other disposition of the property (including a transfer at death) before the taxpayer can use the full amount of any outstanding carryover of the disallowed §179 deduction, neither the taxpayer nor the new owner can deduct any of the unused amount. Instead, the taxpayer must add it back to the property's basis.

PASS-THROUGH §179 DEDUCTIONS

Taxpayers that are partners in a partnership or shareholders in an S corporation receive a Schedule K-1 from the entity. These entities are also entitled to claim a §179 deduction. However, the entity must pass a pro rata amount through to each partner/shareholder. The §179 deduction is limited at both the entity and the partner/shareholder level. Consequently, it is possible that a taxpayer will not be able to claim all of the pass-through §179 deduction.

Note. For more information about Schedule K-1, see Chapter 5 in this book.

Example 23. In 2010, Lemon Partnership placed in service §179 property with a total cost of $2,150,000. The partnership must reduce its dollar limit by $150,000 ($2,150,000 − $2 million limit on total amount of qualifying property).

Therefore, its maximum §179 deduction is $350,000 ($500,000 − $150,000), and it elects to expense $225,000 of that amount. The partnership's taxable income from the active conduct of all its business for the year was $300,000. It allocates $75,000 of its §179 deduction and $100,000 of its taxable income to Wayne, one of its partners.

In addition to being a partner in Lemon Partnership, Wayne is also a partner in the Pinecrest Partnership, which allocated to him a $30,000 §179 deduction and $35,000 of its taxable income from the active conduct of its business.

Wayne also conducts a business as a sole proprietor. In 2010, he placed in service in his sole proprietor business qualifying §179 property costing $55,000. He had a net loss of $50,000 from that business for the year.

Wayne does not have to include §179 partnership costs to figure any reduction in his dollar limit. Therefore, his total §179 costs for the year are not more than $2 million and his dollar limit is not reduced. His maximum §179 deduction is $500,000. He elects to expense all of the $105,000 in §179 deductions allocated from the partnerships ($75,000 from Lemon Partnership plus $30,000 from Pinecrest Partnership), plus $55,000 of his sole proprietorship's §179 costs, and notes that information in his books and records. However, his deduction is limited to his business taxable income of $85,000 ($100,000 from Lemon Partnership, plus $35,000 from Pinecrest Partnership minus $50,000 loss from his sole proprietorship). He carries over $75,000 ($105,000 in §179 deductions from partnerships + $55,000 in §179 deductions from sole proprietorship − $85,000 taxable income limit) of the elected §179 costs to 2011. He allocates the carryover amount to the cost of §179 property placed in service in his sole proprietorship and $20,000 from the Lemon Partnership, and notes that allocation in his books and records.

Wayne's §179 costs for 2010 are summarized in the following table.

	Total §179 Costs	Taxable Income	§179 Costs Elected	§179 Costs After Business Income Limit	§179 Carryover
Lemon Partnership	$ 75,000	$100,000	$ 75,000	$55,000	$20,000
Pinecrest Partnership	30,000	35,000	30,000	30,000	0
Sole proprietorship	55,000	(50,000)	55,000	0	55,000
Total	$160,000	$ 85,000	$160,000	$85,000	$75,000

Adjustment of Partner's Basis in Partnership

A partner must reduce the basis of their partnership interest by the total amount of §179 expenses allocated from the partnership even if the partner cannot currently deduct the total amount. If the partner disposes of their partnership interest, the partner's basis for determining gain or loss is increased by any outstanding carryover of disallowed §179 expenses allocated from the partnership.

Adjustment of Partnership's Basis in §179 Property

The basis of a partnership's §179 property must be reduced by the §179 deduction elected by the partnership. This reduction of basis must be made even if a partner cannot deduct all or part of the §179 deduction allocated to that partner by the partnership because of the limits.

MAKING THE ELECTION

The election to claim the §179 deduction is made by completing Part I of Form 4562, *Depreciation and Amortization.* If the election is for listed property, Part V of Form 4562 must be completed before completing Part I.

For property placed in service in taxable years beginning after 2002 and before 2013,[38] the taxpayer files Form 4562 with either of the following:

- The original tax return, whether or not it was timely filed, or
- An amended return filed within the time prescribed by law, which is generally three years from the due date of the return (including extensions). An election made on an amended return must specify the item of §179 property to which the election applies and the part of the cost of each such item to be taken into account. The amended return must also include any resulting adjustments to taxable income.

For taxable years beginning after December 31, 2007, the amended return must be filed by the due date of the return including extensions. The §179 election can only be made after that date with the consent of the IRS Commissioner.[39]

Caution. Taxpayers must keep records that show the specific identification for each piece of qualifying §179 property. These records must show how the taxpayer acquired the property, the person it was acquired from, and when it was placed in service.

Mid-Quarter Convention

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.[40] 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.[41]

Example 24. Sango's Demon Slayers is a calendar-year taxpayer. In 2010, she purchased and placed in service the following 5-year property:

		Cost	Percent	Depreciation
Filtration mask	January 22	$ 5,500	55%	$1,925
Hiraikotsu boomerang	October 31	4,500	45%	225
Total 2010 purchases		$10,000	100%	$2,150

If Sango does not elect to deduct 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 Sango elects the §179 deduction for the entire cost of the **boomerang** only, the mask will be depreciated using the half-year convention.

38. IRC §179(c)(2).

39. Treas. Reg. §1.179-5(a).

40. Ltr. Rul. 9126014 (Jan. 1, 1991).

41. IRC §168(d)(3)(A).

Sango 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 deduct $900 of the cost, the mid-quarter convention is not required.

		Cost	§179	Net	Round %	Depreciation
Filtration mask	Quarter 1	$ 5,500	$ 0	$5,500	60%	$1,100
Hiraikotsu boomerang	Quarter 4	4,500	900	3,600	40%	720
Total 2010 purchases		$10,000	$900	$9,100	100%	$1,820

Sango's total deductions under this method are $2,720 ($900 §179 deduction + $1,820 depreciation). This is $570 more ($2,720 – $2,150) than the deduction using the mid-quarter convention previously shown in this example.

REVOKING AN ELECTION

An election (or any specification made in the election) to claim a §179 deduction made between taxable years beginning in 2002 and before 2013 can be revoked without IRS approval by filing an amended return.[42] The amended return must be filed within the time prescribed by law, which is generally three years from the due date of the return (including extension). The amended return must also include any resulting adjustments to taxable income. Once made, the revocation cannot be changed.

Example 25. Meowever Yours, Inc., operates a feline accessory store. In 2010, it purchased a new cash register for $4,000. On its 2010 return, it elected to deduct the entire cost of the cash register.

After the return was filed, its new accountant realized that future income will likely 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 26. BowWow Me, LLC, operates a canine toy store. In 2009, it purchased a $60,000 scent-dispensing apparatus to lure pups into the store. On its 2009 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 likely 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 2009 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 2009 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.[43]

Example 27. Shippo, Ltd., operates a self-defense school. In 2009, it purchased a high-tech grappling dummy for $60,000. On its 2009 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 needs to revoke the election in the future, the entire $40,000 is eligible for revocation.

42. IRC §179(c)(2).

43. Treas. Reg. §1.179-5(c)(4), Ex. 2.

§179 RECAPTURE

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.[44] **These rules do not apply if the property is sold, exchanged, or otherwise disposed of.** Separate rules apply to listed property.

The first step in calculating the recapture amount is to calculate the depreciation that would have been allowable if the §179 deduction had not been claimed. The second step involves subtracting the allowable depreciation from the §179 deduction claimed. The result is the amount to be recaptured.

Example 28. Miroku Blessings is a sole proprietorship providing monk-certified blessings and protective sutras printed on rice paper. In 2009, the owner purchased a new printing press for $5,000, which he elected to write off using §179. In 2011, 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 2009		$5,000
Allowable depreciation (MACRS 7-year property) instead of §179 deduction (percentages from Table A-1, shown earlier):		
2009 depreciation ($5,000 × 14.29%)	$ 715	
2010 depreciation ($5,000 × 24.49%)	1,225	
2011 depreciation ($5,000 × 17.49% × 40% business use)	350	
Total allowable depreciation	$2,290	(2,290)
Recapture amount		$2,710

The **recapture amount** is calculated on his 2011 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.** Miroku reports $2,710 on his 2011 Schedule C. The recaptured amount is also added back into the basis of the printing press.

IRC §179 Recapture by a Pass-Through Entity

When a §179 expense deduction was previously claimed and passed through to partners or shareholders, special rules apply. These rules apply to a partnership or S corporation that sells, exchanges, or disposes of the §179 property. The partners or shareholders must report their share of the transaction on Form 4797, *Sales of Business Property;* Form 4684, *Casualties and Thefts;* Form 6252, *Installment Sale Income;* or Form 8824, *Like-Kind Exchanges*. This is the case regardless of whether they are a partner or shareholder at the time the §179 deduction was claimed. It is possible the partner or shareholder was unable to claim the §179 deduction on their tax return. Consequently, reporting the transaction on the proper form allows the partner or shareholder to reduce any carryover deduction before it is taxed on the §179 recapture.

44. Treas. Reg. §1.179-1(e).

The Form 4797 instructions include a worksheet used to calculate any reduction in the carryforward of an unused §179 expense deduction. The partnership or S corporation must provide the following information on the partner's or shareholder's Schedule K-1 for the transaction.[45]

- Description of the property
- Date the property was acquired and placed in service
- Date of the sale or other disposition of the property
- The partner's or shareholder's share of the gross sales price or amount realized
- The partner's or shareholder's share of the cost or other basis plus the expense of sale
- The partner's or shareholder's share of the depreciation allowed or allowable, excluding the §179 expense deduction
- The partner's or shareholder's share of the §179 expense deduction passed through from the property and the partnership's or S corporation's tax year(s) in which the amount was passed through (This must be reported even though the taxpayer was not a partner or shareholder for the tax year in which it was passed through, or if the taxpayer did not deduct all or part of the §179 expense because of the dollar or taxable income limitations. The tax year(s) in which it was passed through are provided to allow the taxpayer to determine the amount of the property's unused carryover §179 expense, if any, to report.)
- If the disposition is due to a casualty or theft, a statement indicating so, along with any additional information needed by the partner or shareholder to complete Form 4684
- For installment sale dispositions made during the partnership's or S corporation's tax year, any information needed by the partner or shareholder to complete Form 6252 (The partnership or S corporation must also separately report the partner's or shareholder's share of all payments received for the property in subsequent tax years.)
- Any information needed by the partner or shareholder to complete Form 8824 if the disposition involved a like-kind exchange made during the partnership's or S corporation's tax year

Note. If a taxpayer has a carryforward of an unused §179 expense deduction that includes a §179 expense deduction previously passed through for the disposed asset, the taxpayer must reduce the carryforward by their share of the §179 expense deduction shown on Schedule K-1 (or the amount attributable to that property included in the carryforward amount).

45. Instructions for Form 4797.

Example 29. Louis is a partner in XYZ Partnership. He was unable to use all the §179 expense deductions passed through to him and has a carryover of $700 at the beginning of the year. His 2011 Schedule K-1 from XYZ reports as supplemental information his share of an asset sale on which a §179 expense deduction was claimed. The K-1 reports his share of the sale of equipment acquired on June 19, 2003, and sold on February 5, 2011 His share of the sale components is the following.

Sales price	$ 900
Cost	1,000
Expense deduction	900
Depreciation	100

Louis completes the following worksheet[46] and Form 4797.

Worksheet for Partners and S Corporation Shareholders to Figure Gain or Loss on Dispositions of Property for Which a Section 179 Deduction Was Claimed

Keep for Your Records

Caution: See the *worksheet instructions* below before starting.

1. Gross sales price			1. **900**
2. Cost or other basis		2. **1,000**	
3. a Depreciation (excluding section 179 expense deduction)	3a. **100**		
b Section 179 expense deduction	3b. **900**		
c Unused carryover of section 179 expense deduction	3c. **700**		
d Subtract line 3c from line 3b	3d. **200**		
e Add lines 3a and 3d		3e. **300**	
4. **Adjusted basis.** Subtract line 3e from line 2			4. **700**
5. **Gain or loss.** Subtract line 4 from line 1 (see *Where To Report Amounts From Worksheet,* below)			5. **200**

Worksheet Instructions

Caution: *For a disposition due to casualty or theft, skip lines 1 and 5 and enter the amount from line 4 on Form 4684, line 24, and complete the rest of Form 4684.*

Lines 1, 2, 3a, and 3b. Enter these amounts from Schedule K-1 (Form 1065 or 1120S).

Line 3c. If you were unable to claim all of the section 179 expense deduction previously passed through to you for the property (if any), enter the smaller of line 3b or the portion of your unused carryover of section 179 expense deduction attributable to the property. Make sure you reduce your carryover of disallowed section 179 expense deduction shown on Form 4562 by the amount on line 3c.

Where To Report Amounts From Worksheet

Generally, the information from the above worksheet is reported on the lines specified below for Form 4797, Part III. However, for a disposition under the installment method, complete the lines shown below for Form 6252. For dispositions of property given up in an exchange involving like-kind property, complete the lines shown below for Form 8824.

▶ If line 5 is a gain and the property was held more than 1 year, report the disposition as follows.
- Complete Form 4797, line 19, columns (a), (b), and (c); Form 6252, lines 1 through 4; or Form 8824, Parts I and II.
- Report the amount from line 1 above on Form 4797, line 20; Form 6252, line 5; or Form 8824, line 12 or 16.
- Report the amount from line 2 above on Form 4797, line 21; or Form 6252, line 8.
- Report the amount from line 3e above on Form 4797, line 22; or Form 6252, line 9.
- Report the amount from line 4 above on Form 4797, line 23; Form 6252, line 10; or Form 8824, line 13 or 18.
- Complete the rest of the applicable form.

▶ If line 5 is zero or a loss and the property was held more than 1 year, report the disposition as follows. Do not report a loss on Form 6252; instead, report the disposition on the lines shown for Form 4797.
- Complete Form 4797, line 2, columns (a), (b), and (c); or Form 8824, Parts I and II.
- Report the amount from line 1 above on Form 4797, line 2, column (d); or Form 8824, line 12 or 16.
- Report the amount from line 2 above on Form 4797, line 2, column (f).
- Report the amount from line 3e above on Form 4797, line 2, column (e).
- Report the amount from line 4 above on Form 8824, line 13 or 18.
- Complete the rest of the applicable form.

▶ If the property was held one year or less, report the gain or loss on the disposition as shown below. Do not report a loss on Form 6252; instead, report the disposition on the lines shown for Form 4797.
- Complete Form 4797, line 10, columns (a), (b), and (c); Form 6252, lines 1 through 4; or Form 8824, Parts I and II.
- Report the amount from line 1 above on Form 4797, line 10, column (d); Form 6252, line 5; or Form 8824, line 12 or 16.
- Report the amount from line 2 above on Form 4797, line 10, column (f); or Form 6252, line 8.
- Report the amount from line 3e above on Form 4797, line 10, column (e); or Form 6252, line 9.
- Report the amount from line 4 above on Form 6252, line 10; or Form 8824, line 13 or 18.
- Complete the rest of the applicable form.

46. Ibid.

For Example 29

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Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Equipment	06/19/2003	02/05/2011
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	900			
21 Cost or other basis plus expense of sale	21	1,000			
22 Depreciation (or depletion) allowed or allowable	22	300			
23 Adjusted basis. Subtract line 22 from line 21	23	700			
24 Total gain. Subtract line 23 from line 20	24	200			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	300			
b Enter the **smaller** of line 24 or 25a	25b	200			

After completing the worksheet, Louis finds he will only be taxed on $200 of the possible $900 gain. However, his carryover §179 expense deduction is eliminated.

BONUS DEPRECIATION

First-year bonus depreciation is allowed for qualified property placed in service during 2008–2012. The applicable percentages for bonus depreciation are as follows.[47]

Placed in Service Date	Applicable Percentage
After December 31, 2007, and before September 9, 2010	50%
After September 8, 2010, and before January 1, 2012	100%
2012	50%

Qualifying property for purposes of first-year bonus depreciation must meet all of the following requirements.[48]

1. The property must be:
   a. MACRS property with an applicable recovery period of 20 years or less,
   b. Water utility property (as defined in IRC §168(e)(5)),
   c. Computer software (other than software covered by IRC §197), or
   d. Qualified leasehold improvement property (as defined in §168(k)(3)).

47. IRC §§168(k)(1)(A) and (k)(5).

48. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate (JCX-55-10), Dec. 10, 2010.

2. The original use of the property must commence with the taxpayer.

3. The taxpayer must purchase the property within the applicable time period.

4. The property must be placed in service after December 31, 2007, and before January 1, 2013. (An extension of one year is provided for certain property with a recovery period of 10 years or longer and certain transportation property.)

A taxpayer may elect out of bonus depreciation for one or more classes of property for any taxable year. Upon disposition, the bonus depreciation is recaptured the same as any other depreciation deduction. Bonus depreciation may reduce business income below zero.

LISTED PROPERTY RULES

There are special depreciation rules for listed property. Listed property is any of the following.[49]

- Passenger automobiles weighing 6,000 pounds or less
- Any other property used for transportation, unless it is an excepted vehicle
- Property generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video-recording equipment)
- Computers and related peripheral equipment, unless used only at a regular business establishment and owned or leased by the person operating the establishment (A regular business establishment includes a portion of a dwelling unit that is used both regularly and exclusively for business as discussed in IRS Pub. 587.)

> **Note.** Cell phones used to be considered listed property, but they were removed from the definition with the Small Business Jobs Act of 2010, enacted on September 27, 2010.

IMPROVEMENTS TO LISTED PROPERTY

A capital improvement made to listed property is treated as a new item of depreciable property. The recovery period and depreciation method that apply to the listed property as a whole also apply to the improvement. For example, if original property was depreciated using the straight line method, the improvement must also be depreciated using the straight line method.

PASSENGER AUTOMOBILES

A passenger automobile is any 4-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (6,000 pounds or less of gross vehicle weight for trucks and vans). The property includes any part, component, or other item physically attached to the automobile at the time of purchase or usually included in the purchase price of an automobile.

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 pay or hire
- A truck or van that is a qualified nonpersonal use vehicle

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49. IRC §280F(d)(4)(A).

Qualified Nonpersonal-Use Vehicles

Qualified nonpersonal-use vehicles are those that by their nature are unlikely to be used more than a minimal amount for personal purposes. They include the trucks and vans listed as excepted vehicles under the next section entitled "Other Property Used for Transportation." They also include trucks and vans that have been specially modified so that they are unlikely to be used more than a minimal amount for personal purposes, such as by installation of permanent shelving and painting the vehicle to display advertising or the company's name.

OTHER PROPERTY USED FOR TRANSPORTATION

Caution. Although vehicles used to transport persons or property for pay or hire and vehicles rated at more than the 6,000-pound threshold are not passenger automobiles, they are still "other property used for transportation" and are subject to the special rules for listed property.

Other property used for transportation includes trucks, buses, boats, airplanes, motorcycles, and any other vehicles used to transport persons or goods.

Excepted Vehicles

The following qualified nonpersonal-use vehicles are not included in "other property used for transportation."[50]

- Clearly marked police and fire vehicles
- Unmarked vehicles used by law enforcement officers if the use is officially authorized
- Ambulances used as such and hearses used as such
- Any vehicle with a loaded gross vehicle weight of over 14,000 pounds that is designed to carry cargo
- Bucket trucks (cherry pickers), cement mixers, dump trucks (including garbage trucks), flatbed trucks, and refrigerated trucks
- Combines, cranes and 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 employees of schools
- Other buses with a capacity of at least 20 passengers that are used as passenger buses
- Tractors and other special purpose farm vehicles

COMPUTERS AND RELATED PERIPHERAL EQUIPMENT

Related peripheral equipment refers to any auxiliary machine that is designed to be controlled by the central processing unit of a computer.

The following are neither computers nor related peripheral equipment.

- Any equipment that is an integral part of other property that is not a computer
- Typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment
- Equipment of a kind used primarily for the user's amusement or entertainment, such as video games

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

CAN EMPLOYEES CLAIM A DEDUCTION?

An employee can claim a depreciation deduction for the use of their listed property (whether owned or rented) in performing services as an employee only if the use is a business use. The use of the property in performing services as an employee is a business use only if both the following requirements are met.

- The property is used for the employer's convenience.
- Use of the property is required as a condition of their employment.

If these requirements are not met, the employee cannot deduct depreciation (including the §179 deduction) or rent expenses for the use of the property as an employee.

Employer's Convenience

Whether the use of listed property is for the employer's convenience must be determined from all the facts. The use is for the employer's convenience if it is for a substantial business reason of the employer. The use of listed property during regular working hours to carry on the employer's business generally is for the employer's convenience.

Condition of Employment

Whether the use of listed property is a condition of employment depends on all the facts and circumstances. The use of property must be required for an employee to perform their duties properly. The employer does not have to require explicitly that the employee use the property. However, a mere statement by the employer that the use of the property is a condition of employment is not sufficient.

Example 30. Benson is employed as a courier with We Deliver, which provides local courier services. He owns and uses a motorcycle to deliver packages to downtown offices. We Deliver explicitly requires all delivery persons to own a car or motorcycle for use in their employment. Benson's use of the motorcycle is for the convenience of We Deliver and is required as a condition of employment. He can deduct the business portion of his expenses associated with his motorcycle, including depreciation on the motorcycle, on Form 1040, Schedule A, as a miscellaneous itemized deduction, subject to the 2% of AGI threshold.

Example 31. Liza is an inspector for Uplift, a construction company with many sites in the local area. She must travel to these sites on a regular basis. Uplift does not furnish an automobile or explicitly require her to use her own automobile. However, it pays her for any costs she incurs in traveling to the various sites. The use of her own car or a rental car is for the convenience of Uplift and is required as a condition of employment. Consequently, Liza can deduct depreciation on the car and other expenses less reimbursements on Form 1040, Schedule A, subject to the 2% of AGI threshold.

Example 32. Use the same facts as **Example 31,** except Uplift furnishes a car to Liza. Liza chooses to use her own car and she receives payment for using it. The use of her own car is neither for the convenience of Uplift nor required. No depreciation deduction is allowed.

Example 33. Ace Skywalker is a pilot for Obijuan Company, a small charter airline. Obijuan requires pilots to obtain 80 hours of flight time annually in addition to flight time spent with the airline. Pilots usually can obtain these hours by flying with the Air Force Reserve or by flying part-time with another airline. Ace owns her own airplane. The use of her airplane to obtain the required flight hours is neither for the convenience of the employer nor required as a condition of employment. No depreciation deduction is allowed.

Example 34. David Slyderool is employed as an engineer with Zip, an engineering contracting firm. He occasionally takes work home at night rather than work late in the office. He owns and uses a home computer which is virtually identical to the office model. His use of the computer is neither for the convenience of his employer nor required as a condition of employment. No depreciation deduction is allowed.

BUSINESS-USE REQUIREMENT

Taxpayers can claim the §179 deduction and a special depreciation allowance for listed property and depreciate listed property using GDS and a declining balance method if the property meets the business-use requirement. To meet this requirement, listed property must be used predominantly (more than 50% of its total use) for qualified business use. If this requirement is not met, the following rules apply.

- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for the §179 deduction.
- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for a special depreciation allowance.
- Any depreciation deduction under MACRS for property not used predominantly for qualified business use during any year must be figured using the straight line method over the ADS recovery period. This rule applies each year of the recovery period.
- Excess depreciation on property previously used predominantly for qualified business use must be recaptured (included in income) in the first year in which it is no longer used predominantly for qualified business use.
- A lessee must add an inclusion amount to income in the first year in which the leased property is not used predominantly for qualified business use. See IRS Pub. 463 and IRS Pub. 946 for calculating the inclusion amount.

> **Note.** Being required to use the straight line method for an item of listed property not used predominantly for qualified business use is not the same as electing the straight line method. The taxpayer does not have to use the straight line method for other property in the same class as the item of listed property.

Exception for Leased Property

The business-use requirement generally does not apply to any listed property leased or held for leasing by anyone regularly engaged in the business of leasing listed property.

Taxpayers are considered regularly engaged in the business of leasing listed property only if they enter into contracts for the leasing of listed property with some frequency over a continuous period of time. This determination is based on the facts and circumstances in each case and takes into account the nature of the business in its entirety. Occasional or incidental leasing activity is insufficient. For example, if the taxpayer leases only one passenger automobile during a tax year, they are not regularly engaged in the business of leasing automobiles. An employer who allows an employee to use the employer's property for personal purposes and charges the employee for the use is not regularly engaged in the business of leasing the property.

How to Allocate Use

To determine whether the business-use requirement is met, the taxpayer must allocate the use of any item of listed property used for more than one purpose during the year among its various uses.

For passenger automobiles and other means of transportation, the property's use must be allocated on the basis of mileage. The percentage of qualified business use is determined by dividing the number of miles the taxpayer drove the vehicle for business purposes during the year by the total number of miles they drove the vehicle for all purposes (including business miles) during the year.

For other listed property, the property's use must be allocated on the basis of the most appropriate unit of time the property is actually used (rather than merely being available for use). For example, the taxpayer can determine the percentage of business use of a computer by dividing the number of hours they used the computer for business purposes during the year by the total number of hours they used the computer for all purposes (including business use) during the year.

Entertainment Use. Taxpayers can treat the use of listed property for entertainment, recreation, or amusement purposes as a business use only to the extent they can deduct expenses (other than interest and property tax expenses) for its use as an ordinary and necessary business expense.

Commuting Use. The use of an automobile for commuting is not business use, regardless of whether work is performed during the trip. For example, a business telephone call made on a car telephone while commuting to work does not change the character of the trip from commuting to business. This is also true for a business meeting held in a car while commuting to work. Similarly, a business call made on an otherwise personal trip does not change the character of a trip from personal to business. The fact that an automobile is used to display material that advertises the owner's or user's trade or business does not convert an otherwise personal use into business use.

Use of the Automobile by Another Person. If someone else uses the automobile, the owner cannot treat that use as business use unless **one** of the following conditions applies.

1. The automobile's use is directly connected with the owner's business.
2. The owner properly reports the value of the use as income to the other person and withholds tax on the income when required.
3. The owner is paid a fair market rent.

Any payment for the use of the automobile is treated as a rent payment for purposes of **item 3**.

Employee Deductions. As stated previously, if the taxpayer is an employee, their use of listed property is not treated as business use unless it is for the employer's convenience and is required as a condition of employment.

QUALIFIED BUSINESS USE

Qualified business use of listed property is any use of the property in the taxpayer's trade or business. However, it **does not** include the following uses.[51]

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

> **Note.** Property does not stop being used predominantly for qualified business use because of a transfer at death.

Exception for Leasing or Compensatory Use of Aircraft

Taxpayers may treat the leasing or compensatory use of any aircraft by a 5% owner or related person as a qualified business use if at least 25% of the total use of the aircraft during the year is for a qualified business use.

5% Owner

For a business entity that is not a corporation, a 5% owner is any person who owns more than 5% of the capital or profits interest in the business.

For a corporation, a 5% owner is any person who owns, or is considered to own, either of the following.

- More than 5% of the outstanding stock of the corporation
- Stock possessing more than 5% of the total combined voting power of all stock in the corporation

[51] IRC §280F(d)(6)(C).

Related Persons

For the purpose of determining qualified business use, the following are considered related persons.

1. An individual and a family member, defined as only a spouse, child, parent, brother, sister, half brother, half sister, ancestor, and lineal descendant
2. A corporation and an individual who directly or indirectly owns more than 50% of the value of the outstanding stock of that corporation
3. Two corporations that are members of the same controlled group
4. A trust fiduciary and a corporation if more than 50% of the value of the outstanding stock is directly or indirectly owned by or for the trust or grantor of the trust
5. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust
6. The fiduciaries of two different trusts, and the fiduciaries and beneficiaries of two different trusts, if the same person is the grantor of both trusts
7. A tax-exempt educational or charitable organization and any person (or, if that person is an individual, a member of that person's family) who directly or indirectly controls the organization
8. Two S corporations, and an S corporation and a regular corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation
9. A corporation and a partnership if the same persons own both of the following:
   a. More than 50% of the value of the outstanding stock of the corporation, and
   b. More than 50% of the capital or profits interest in the partnership.
10. The executor and beneficiary of any estate

The following examples illustrate whether the use of business property is qualified business use.

Example 35. Jason Greenthum is the sole proprietor of a landscaping business. Jason employs his brother, Mason, in the business. As part of Mason's pay, he is allowed to use one of the company automobiles for personal use. The company includes the value of the personal use of the automobile in Mason's gross income and properly withholds tax on it. The use of the automobile is pay for the performance of services by a related person, so it is **not** a qualified business use. Therefore, the rules listed previously under "Business-Use Requirement" apply.

Example 36. Jason, in **Example 35,** allows unrelated employees to use company automobiles for personal purposes. He does not include the value of the personal use of the company automobiles as part of their compensation and he does not withhold tax on the value of the use of the automobiles. This use of company automobiles by employees is **not** a qualified business use. Therefore, the rules listed under "Business-Use Requirement" apply.

Example 37. James Company, Inc., owns several automobiles that its employees use for business purposes. The employees also are allowed to take the automobiles home at night. The FMV of each employee's use of an automobile for any personal purpose, such as commuting to and from work, is reported as income to the employee and James Company withholds tax on it. This use of company automobiles by employees, even for personal purposes, is a qualified business use for the company. Therefore, the rules listed under "Business-Use Requirement" **do not** apply.

The use of property to produce income in a nonbusiness activity (investment use) is not a qualified business use. However, a taxpayer can treat the investment use as business use to calculate the property's depreciation deduction.[52]

> **Example 38.** Sarah uses a home computer 50% of the time to manage her investments. She also uses the computer 40% of the time in her part-time consumer research business. Sarah's home computer is listed property because it is not used at a regular business establishment. She does not use the computer predominantly for qualified business use. Therefore, she cannot elect a §179 deduction or claim a special depreciation allowance for the computer. She must depreciate it using the straight line method over the ADS recovery period. Her combined business/investment use for determining her depreciation deduction is 90%.

> **Example 39.** If Sarah uses her computer 30% of the time to manage her investments and 60% of the time in her consumer research business, it is **used predominantly** for qualified business use. She can elect a §179 deduction and, if she does not deduct all the computer's cost, she can claim a special depreciation allowance and depreciate the computer using the 200% declining balance method over the GDS recovery period. Her combined business/investment use for determining her depreciation deduction is 90%.

PASSENGER AUTOMOBILE MAXIMUM DEPRECIATION DEDUCTION

The depreciation deduction, including the §179 deduction, that a taxpayer can claim for a passenger automobile each year is limited. Rev. Proc. 2011-26 (issued March 29, 2011) provides further guidance for claiming bonus depreciation on vehicles.

Exception for Leased Cars

The passenger automobile limits generally do not apply to passenger automobiles leased or held for leasing by anyone regularly engaged in the business of leasing passenger automobiles.

Maximum Depreciation Deduction

The maximum deduction amounts for most passenger automobiles are shown in the following table.[53]

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

53. Ibid. See also Rev. Proc. 2011-21, 2011-12 IRB 560.

Date Placed in Service	1st Year	2nd Year	3rd Year	4th and Later Years
2011	$11,060 [a]	$4,900	$2,950	$1,775
2010	11,060 [a]	4,900	2,950	1,775
2009	10,960 [b]	4,800	2,850	1,775
2008	10,960 [b]	4,800	2,850	1,775
2007	3,060	4,900	2,850	1,775
2006	2,960	4,800	2,850	1,775
2005	2,960	4,700	2,850	1,675
2004	10,610 [c]	4,800	2,850	1,675
May 6, 2003–Dec. 31, 2003	10,710 [d]	4,900	2,950	1,775
Jan. 1, 2003–May 5, 2003	7,660 [e]	4,900	2,950	1,775
2002	7,660 [e]	4,900	2,950	1,775
2001	7,660 [f]	4,900	2,950	1,775
2000	3,060	4,900	2,950	1,775

[a] If the taxpayer elects not to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is $3,060.

[b] If the taxpayer elects not to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is $2,960.

[c] If the taxpayer elects not to claim any special depreciation allowance for the vehicle, the vehicle is not qualified property, or the vehicle is qualified Liberty Zone property, the maximum deduction is $2,960.

[d] If the taxpayer acquired the vehicle before May 6, 2003, the maximum deduction is $7,660. If they elected not to claim any special depreciation allowance for the vehicle, the vehicle is not qualified property, or the vehicle is qualified Liberty Zone property, the maximum deduction is $3,060.

[e] If the taxpayer elects not to claim any special depreciation allowance for the vehicle, the vehicle is not qualified property, or the vehicle is qualified Liberty Zone property, the maximum deduction is $3,060.

[f] If the taxpayer acquired the vehicle before Sep. 11, 2001, and either elected not to claim any special depreciation allowance for the vehicle, the vehicle is not qualified property, or the vehicle is qualified Liberty Zone property, the maximum deduction is $3,060.

Note. Passenger trucks and light vans are subject to different maximum depreciation limitations. See IRS Pub. 946, *How to Depreciate Property,* for the associated chart.